EQUILIBRIUM, RISK TAKING AND REGULATION

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Ladies and Gentlemen,

I would like first to thank the BIS for inviting me to join this very timely conference.

I will begin my remarks today with a few general observations on financial crises and then consider whether the current macro-financial environment is now safer, and able to prevent crises from happening in the future.

I will take the perspective of a private sector banker, which has been my profession over the last 4 years, although somebody who has been brought up for many years in a central banking environment never really forgets the public policy perspective. I also do not ignore the fact that being the first speaker this morning, I have the task of spraying some adrenaline in the air.

IS THE FINANCIAL SYSTEM SAFER?

The question most people ask – and would like to have a straight answer - is whether the system is now safer. The answer policy-makers generally give tends to be positive, and reassuring. The argument is generally based on a comparison with the pre-crisis period, based on a whole series of data and statistics – such as bank capital or leverage, and the number of new regulations adopted - showing how much more regulated the system is. For instance, Eurozone banks have raised significant amounts of capital: average common equity tier 1 capital (CET1) increased from 7% in 2007 to 14% at present. Euro area banks' loan-to-deposit ratios have declined from above 140% to close to 110%.

Some even argue that we may have gone too far in over-regulating the financial system, which results in an impaired capacity to finance the economy and is thus responsible for the slow pace of economic growth. Some have come to advocate the reversal of the pendulum, as we can see very clearly on the other side of the Atlantic.

I would like today to put forward the idea that this assessment is partial, to say the least, and possibly misconceived. In reality, there can be no serious assessment of what has been done to repair the situation unless there is an equally serious understanding of what really happened and of what were the real causes of the crisis.

Let me mention a few problems with the prevailing line of thinking.

PRE-CRISIS EQUILIBRIUM

Let me start with the first shortcoming of the analysis, which is the reference point of the comparison, i.e. the pre-crisis period, in particular 2007. This reference is used not only to observe that, indeed, regulation has been toughened, but also to evaluate the riskiness of financial institutions. Summers and Sarin, for instance, compare current market-based risk measures of differents banks with those before the crisis. Looking at the 6 largest US banks, they observe that "measured on a market basis they have less equity relative to assets than they did previously". This lead them to conclude that banks were more fragile in 2016 than in 2007. Aside from the fact that market valuations recovered recently, the authors base their reasoning on the assumption that pre-crises valuations were the "right" ones, i.e. that the markets were pricing risk appropriately at that time.

The reference to the pre-crisis situation is also used to assess the extent to which the economy has recovered since the crisis and the remaining slack. GDP data, for instance show that US GDP recovered its 2007 level at the end of 2010, while the Eurozone only at the end of 2014.

Using the pre-crisis level as a benchmark is not surprising, but it is misleading. Unless we believe that the crisis happened because of a purely exogenous shock – some act of God - rather than the result of endogenous destabilizing forces, we should recognize that these forces were most probably at play in 2007, and in previous years. The whole pre-crisis period was infected by the build-up of imbalances that led to the crisis. The pre-crisis period can thus not be considered as an equilibrium reference point, to make any significant comparison about the appropriateness of the current situation.

To sum up, stating that the situation is much better now than prior to the crisis – in terms of capital, leverage, or economic activity - may be self-congratulatory, but is in fact of very little use. It doesn't really provide an answer on whether we have a more stable financial system.

Let me continue along this line to address the second problem, which refers to the main cause of the crisis. It is generally recognized – especially by policy makers and the public opinion at large – that the main responsibility of the financial crisis lies in the financial system itself, in particular the excessive risk taking by financial institutions, in an insufficiently regulated environment. In extreme synthesis, it's largely the fault of the bankers, who danced as long as the music played, as one of them naively admitted. And some of them got away with it.

This is certainly a nice way to put it. Mervyn King paraphrasing Churchill brilliantly summarised the standard scapegoating by stating that "never so much money was owed by so few to so many".

This is the approach followed by the political authorities and the regulators of the G20 countries after the crisis. It has been the main inspiration for the legislative effort over the last few years, aimed at changing bankers' incentives and toughening regulation.

In what sense this approach is a problem?

Nobody would deny that regulation was insufficient and created wrong incentives for financial institutions. Nobody would deny that financial institutions, in particular banks, took on board too many risks and mispriced them while trying to selling them back in the markets. Nobody would deny that some of those responsible for such behavior got away without paying the price.

The question that is often swept under the carpet is why this happened. Why was regulation weak? Was it only regulation? Was it only the bankers' fault?

Unless we get an answer to these questions - and until we continue to believe that it was all due to weak regulation and bad bankers' behavior - we may get the wrong answer to the question of whether the system is safer today.

As I mentioned, these are fundamental questions, that require a lot of thinking, and I certainly do not have the ambition to answer them today. I would like just to point to a few issues, that I consider important but have not attracted sufficient attention yet.

REGULATION AND SUPERVISION

The first issue is the key complement to regulation, i.e. supervision. How was supervision implemented before the crisis? I understand that this is not an easy issue for the supervisors to address. But in my view, the way in which supervision was implemented prior to the crisis has had an equal, if not even greater responsibility than regulation in producing the destabilizing forces that led to the crisis. To show that supervision is as relevant as regulation, you just need to make a cross-country comparison of the impact of the crisis, in particular within Europe where the overall regulatory framework is quite similar. This comparison shows that rules were interpreted very differently in Europe by the various national supervisors. This allowed financial institutions and bankers to act in very different ways across countries, and this is why the crisis impacted banks very differently. In some countries supervisors clearly did not understand what financial institutions were doing. In others, supervisors were led by financial institutions to think that everything was fine, which was not the case, otherwise they would have stopped the music much earlier.

Let me raise a specific issue in this respect, related to the independence of supervisors. This is one of the "sacred" principles of supervision, recognized and promoted by international supervisory fora. However, this principle has been applied very differently, and probably ignored in several cases. In fact, the crisis shows – in my view – quite clearly that countries where suprevisors enjoyed greater independence experienced lesser problems. Taxpayers contributed less to bank bail-outs than in countries where the supervisors were closely associated to the political authorities, in particular the Finance ministry.

Has this lesson been learned? Initially yes, especially in those countries where the responsibility for banking supervision was moved back to the central bank, which is generally more independent than supervisory authorities. I am nevertheless surprised that three years after the creation of the Single Supervisory Mechanism, within the ECB, there are still some (politicians) who are asking to take such responsibility away from it, allegedly because the ECB is too powerful or too independent.

The same trend is developing in the US, where the competent supervisory authorities are under increasing pressure to relax their practices. This is seen as an easier avenue to pursue than that of changing the overly complex regulatory framework.

There are no doubts that supervision has changed, all over advanced economies, and become much more involved in monitoring banks' behavior. However, the role and scope of supervision has been constrained and made less efficient by a series of factors. The first is the fact that a large part of the financial sector continues to remain unregulated, or little regulated, and nobody asks whether that part of the system is indeed safer. The second is that supervision tends to be constrained by attempts – by the regulators, and the supervisors themselves - to set one-size-fits-all rules for situations that are, and will remain for some time, substantially different. The most obvious case concerns the two sides of the Atlantic. The objective of creating a banking union and a capital market union in Europe is likely to reduce these differences over time. However, differences in banking structures will remain for a long time. The financing of the European economy will continue to rely primarily on banks, and such financing will continue to remain on European banks' balance sheets. Applying rigid and one-size-fits-all regulation across the Atlantic leads to distortions, clearly at the disadvantage of this side. And this is the reason why it is so difficult to reach an agreement on the new accord, in particular after the most recent US Treasury clarification that the new rules will not be fully implemented in the US.

The last issue that I would like to raise is that of simplicity. Regulators seem to be going full circle. After having moved away from the Basel1 system, which allegedly was too simple, and induced excessive risk taking which was difficult to monitor, we seem now to be moving back to it, as risk models are considered too complex for supervisors to assess and monitor. Regulators seem to be inspired by the thought – or the illusion - that by standardizing models, rather than trying to understand and assess them, their life will be easier. However, the idea that simpler rules will make bankers' life easier, and thus the supervisor's life easier, is an illusion. Just as an example, ask yourself why it is so difficult to finance infrastructure with the new regulatory framework.

In the end, the impasse of the Basel process largely derives from the attempt to set one-size-fits-all rules between supervisors who do not seem to have a full trust in each other, in particular on their respective discretionary powers to implement robust supervision. This creats uncertainty for the financial system, and is ultimately a detriment for the world economy.

A BROADER FRAMEWORK

As I mentioned before, we need to have a better understanding of the fundamental causes of the crises to make sure that are indeed moving towards a safer system. Otherwise we run the risk of looking only at one part of the problem, or one part of the solution, say regulation, while others have not been addressed, or have even moved in the opposite direction.

I would like to refer here to Ragu Rajan's contribution, in his book *Fault lines*, which remains in my view one of the most thorough analyses of the key underlying factors that led to the financial turmoil. The added value of Rajan's book is to ask the fundamental question: Why? Why was financial regulation so lax? Why were financial institutions allowed to operate in the way they were? Why was supervision blind to obvious flashing lights?

Unless we provide some answers to these questions, we risk adopting the wrong measures or getting back to the same situation in a few years, as history shows. To take Rajan's perspective, the main causes of the crisis were the policies implemented prior to the crisis itself, which aimed at counteracting the consequences of globalization in advanced economies, in particular with respect to the stagnation of middle class income. Deregulation and light supervision have been a key part of the policy-mix which deliberately encouraged debt creation, for the benefit of households, to support their consumption in a general context of increasing world savings.

To assess whether we live in a safer financial environment, it is not sufficient to look at regulation, but also at the other components of the policy-mix and the more fundamental economic environment, and how this affected the flow of savings and investment.

Let's look at one key indicator, i.e. debt, in particular non-financial institutions' debt. Taking a snapshot of 25 major countries covered by the BIS statistics, we note that Germany in the only one that has seen a decline, albeit a very small one, in non-financial debt measured as a percent of GDP. Most other countries have seen a substantial increase in overall debt; with an average gain of 40% of GDP over the past decade. The bulk of that increase has come from the public sector, but not only.

How much debt is too much debt depends on several factors, including the cost of funding, its reliability and pace of change. Zooming in on Europe, in its macroeconomic imbalance scoreboard the Commission suggests a threshold of 133% of GDP for total private sector debt and 60% for public sector debt; or a total of 193%. Amongst the major euro area economies, only Germany is currently below, at 177% of GDP. The euro area average stands at around 250% as does the US.

Another useful indicator for financial stability is external imbalances. The IMF's latest External Sector Report found that about one-third of global current account imbalances in 2016 were "excessive", but with some rotation towards advanced economies.

Turning to asset prices, they have gone back to the pre-crisis levels, for whatever it means. Several central bankers, including in this house, have recently warned of somewhat stretched valuations, and the potential risk of bubbles.

How can this evidence be reconciled? We have higher debt, wider imbalances and asset prices back at record highs. One should expecte the opposite. Higher debt should be accompanied by higher risk and higher interest rates. Why is this not the case? Why is instead liquidity so abundant, interest rates even lower than prior to the crisis, while debt continues to pile up?

The answer which immediately comes to mind is that monetary policy has been overly accommodative, absorbing risk and thus more than counteracting the impact of higher debt. This is why many observers, including in this house, have been calling for an end to such policies, which are creating distortions in asset prices.

I believe that this view is partial, and maybe even incorrect. The proof is that the Federal Reserve has stopped QE and even raised rates, but long term rates have not gone up. The single most relevant impact on long term US rates over the last few years has been the Trump election, and the impact has faded over time.

As the ECB started talking about tapering, yields initially increased, but then came back to rather low levels.

The jury is still out, but I seriously doubt that a substantially tighter monetary policy over the last few years would have made a big difference for long term rates, in particular in core European countries. It would probably have initially led to higher real rates, slower growth, lower inflation, a more difficult de-leveraging and thus over time…. even lower rates, or defaults.

The fact that inflation and long term rates have remained low after the tapering of monetary accommodation suggests that monetary policy is neither the only, nor the main driver of underlying financial conditions. It is at best accompanying the abundant conditions, and trying to avoid the negative repercussions.

This means that the current financial environment is the result of more fundamental forces, which have been at play at the global level for several years, even before the crisis, resulting in an unprecedented and continuously rising level of global wealth over world income. Since the real rate of interest is inversely related to the ratio of wealth over income, it is not surprising that it has continuously decreased over the last decades, and is likely to continue to fall, unless something exceptional happens – like wars or financial crises – that destroys part of the wealth accumulated and generates a new process of capital accumulation which is naturally accompanied by a higher interest rate.

Following this line of argument, the first question to ask is whether the recent trend is likely to continue, i.e. that the accumulation of wealth resulting from the desire to save at the global level is faster than the pace of world income growth. The second question, if the answer to the first is yes (as I tend to believe), is what are the consequences for financial stability of such a continued development. In other words, what is the impact of a prolonged period of low, and possibly even lower, interest rates on financial stability. The third question, if the answer to the second is (as I tend to believe) that the threats to stability have increased and become more unpredictable than in the past, is whether the reforms implemented over the last few years, in particular with respect to bank regulation and supervision, are adequate and sufficient.

CONCLUDING REMARKS

Having asked so many questions, I have very little time left to try to give some answer. I will leave this task to those who have more time for deep and rigorous thinking. I would just like to conclude with some food for thought related to the questions I have asked.

A first thought is that in order to correct the imbalance between savings and investment, which is fueling the accumulation of wealth, and in turn puts downward pressure on interest rates, much stronger incentives to invest are required. This implies a greater propensity to take risk, and to finance risk. However, post-crisis regulation has gone in the opposite direction, making it more difficult, in particular for banks (but also insurance, investment funds), to finance the production of risky assets, while at the same time incentivizing the demand for safe assets, in an environment where the supply of such safe assets has decreased. No surprise that the equilibrium rate of return has gone into negative territory.

The second thought is that in order to ensure a better flow of funds between areas of the world where there is excess supply of savings towards those where there is excess demand for savings, and to improve the resilience of the financial system, there is a need to improve global market integration. The opposite seems to have happened. Such increased fragmentation is apparent even within an integrated market like the Eurozone. An issue is the extent to which such additional fragmentation is the result of recent regulatory changes.

The third thought, which is only recently starting to be recognized by regulators and supervisors – although maybe not yet by academics – is that a financial system which is not profitable is fragile and potentially a source of instability. Let me add a corollary: an environment in which there is systematic and persistent excess of savings over investment is a threat for the stability of financial institutions. Regulators cannot turn their eyes away from such an issue, just by answering that "banks have to change their business models", simply because their business models are very much dependent on the structure of regulation.

The fourth and final thought – I would like to share you this morning – is that an environment characterized by countinuous higher accumulation of wealth over income (which leads to higher assets to GDP ratios, i.e. higher debt to GDP ratios), and thus lower rates of return on such savings, is inherently unstable. Furthermore, the way in which such instability develops is so peculiar and discontinuous that it is very difficult for the financial system to protect against it. Regulation might have made it even more difficult.

What does this mean? It means that if the financial system is not able to absorb and distribute risk efficiently, because the risks it faces are not easily diversifiable (like hurricanes), the system itself is more vulnerable and prone to global instability. Such instability, when it manifests itself, can be absorbed only through the recourse to very large – potentially infinite - resources, in other words with taxpayers' money, either directly or through central banks' balance sheets.

This is probably the opposite of what was intended at the start of the post-crisis reform effort, i.e. that going forward there should be a lesser use of taxpayers' money to maintain financial stability in the face of global shocks. However, the combination of the reform effort and the continuous (ex ante) excess flow of net savings, may lead to the paradoxical result that, when the next crisis will happen, public funds will have to be used even more than in the past.

This paradox suggests that not enough thinking has been devoted to these issues, in particular to whether the increased regulation is indeed ensuring a safer financial system. I would seriously invite you to fill the gap.

Thank you very much for your attention.