T T Mboweni: Central banks and financial stability – some lessons for the future

Keynote address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the 48th ACI World Conference, Cape Town, 13 March 2009.

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Introduction

Honoured ACI members, organisers, moderators, guests, ladies and gentlemen.

Thank you for the invitation to speak at this illustrious event. It is indeed a privilege and a rare opportunity to share some ideas about the state of the global financial system with market practitioners from across the world. It is difficult in the current circumstances to give an optimistic address. Nevertheless, I will try to avoid to paint too dismal and depressing a picture and instead will focus on things that we can learn from our recent experiences, to contribute towards a better future.

The mood in the global economy has changed from almost over-exuberance to the depths of a recession in less than two years. We are certainly experiencing unprecedented events and the actions taken to restore stability and trust in the global financial system are surpassing previous ones. Judging from the programme of your conference, we expect that these issues will be discussed in greater detail over the next two days. This presentation will also make, towards the end, some comments about the state of the South African banking sector.

It remains difficult to understand how various role players, including supervisors, central banks, rating agencies, multilateral agencies, governments, risk managers and highly competent private sector participants, failed to fully comprehend these developments that, with hindsight, were bound to bring us at some time to this point.

Yet, the important thing is not to apportion blame, but to try and understand how we can avoid repeating the same mistakes. There are many lessons to be learnt, and we are of the view that these lessons can be valuable not only from the point of view of supervisors and policy makers, but also that of traders, bankers and other financial market participants. Clearly, as the situation is still unfolding, one can at best only talk of "preliminary lessons".

Lesson number 1: The sum of perfectly rational individual decisions doesn't equal a perfectly rational market

With hindsight, it is clear that, although individual institutions hedged, transferred and managed their risk exposures in very sophisticated ways, at a systemic level a point is reached at which it becomes impossible to fully diversify or transfer risk. The global financial system is a finite entity, and although risk can be passed around, it does not disappear. We had probably underestimated the inter-linkages of financial systems across the globe, and the extent to which globalisation had created a complicated network of circuits for the contagion of financial risk.

The lesson to take forward is that we should never lose sight of the systemic implications of individual institutions, transactions and events. Financial stability is a systemic concept, and it will play a much bigger role in future and should be taken much more seriously than was the case during the exuberant years prior to 2008. Issues such as macro-prudential analysis and supervision, crisis preparedness and stress testing of the financial system are likely to feature much more strongly in our collective endeavours for years to come.

Lesson number 2: If something seems too good to last, it probably is

The current crisis resulted from a specific combination of a number of causes. For years, liquidity in global financial markets was mispriced, and therefore generally taken for granted. Interest rates were low, and huge profits were locked in through carry trades where funding could be obtained at a minimal cost in overnight markets, and invested in high-yielding longer-term assets, be it emerging-market financial assets, equities, securitised mortgage loans or asset-backed securities.

South Africa was a beneficiary of this trend: between 2004 and 2007, net inflows recorded in the financial account of the balance of payments totalled R391 billion. If the inflows that are included under "unrecorded transactions" are added, this figure would be well over R500 billion. Compare this to a combined net outflow of around R23 billion over the prior four years. The advantages of these inflows were significant: they allowed the South African Reserve Bank to restore a fragile foreign exchange reserves position to a more healthy one, they helped the country to finance its current account deficit, to build infrastructure, to boost economic growth and to increase employment. Overall, they made the country slightly more resilient against the adverse developments that we are currently experiencing.

However, we have been abruptly reminded that portfolio flows are fickle, and cannot be relied upon as a source of external funding when the tide turns. Even though South Africa still maintained a positive net balance on its financial account for the first three quarters of 2008, there were significant net outflows of portfolio investments as global investors were forced to deleverage. In addition, funding in the international markets has become much more expensive.

We have also been reminded that markets move in cycles, and the fallacy of some people who advocated a "decoupling of emerging markets" or that "the business cycle has been conquered" has been proven to have widely missed the point. What is the lesson to be learnt? The lesson is that prolonged periods of high asset growth that are not fully justified by trends in the real sector are bound to correct. For example, how can house prices continue to grow at double-digit rates if economies grow by two to three per cent per year? How can the balance sheets of banks consistently grow four to five times faster than the underlying economy? How can off-balance sheet activities of banks consistently outpace on-balance-sheet growth without signalling some sort of distortion? How can profit targets and bonuses keep on rising year after year, while the underlying real economy is still very much the same?

It is human nature to be more tolerant of continuous rises in asset prices than of price declines. Perhaps we should be more careful in future: if growth rates and price increases are not justified by developments in the underlying activity in the real economy, asset bubbles develop, and the effects when such bubbles burst can be very serious.

Lesson number 3: The seeds of the next crisis are sown in the solutions for the current one

Without having much choice, central banks and governments in (mainly) the industrialised world have taken unprecedented actions in their attempts to restore confidence in the financial system. These actions included significant liquidity injections, lowering of collateral requirements, asset swaps, longer-maturity refinancing operations, intervention in foreign exchange markets, co-operation among central banks in their market operations, monetary accommodation, quantitative or credit easing, capital injections into banks and other financial institutions, substantial fiscal stimulus packages and, in some cases, nationalisation of banks. Looking at the instruments available to banks and governments, there really are only a few that have not been used in one way or another during this crisis.

Actions being implemented now may be the lifeline for the world financial system, but we are also well aware that they may, inherently, have negative consequences over the long term. The major central banks will have to plan their exit strategies well. Governments will have to

manoeuvre themselves out of their heavy indebtedness, the potential crowding out of the private sector would have to be addressed and some reasonable limits to moral hazard will have to be restored. In a recent speech[1], Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, noted that "the striking feature of central bank lending and other government financial support during the current turmoil is the extent to which it has extended well beyond the boundaries that previously were understood to constrain such lending", and that "the scope of the financial safety net ultimately must be rolled back". Although inflation is currently not an issue that many people are worried about, we all know that the measures currently taken are potentially inflationary, and at some point this will have to be attended to. As one of our colleagues has remarked when "the house is on fire, we need all the fire engines on the scene, the mopping up operations will come later".

Lesson number 4: Every good party needs a strong bouncer

In financial markets, the bouncers are the supervisors. Looking at previous issues of the IMF's Global Financial Stability Report, the BIS Quarterly Reports, and various individual central banks' Financial Stability Reports, it is evident that many of the causes of the financial crisis had been noted, but that they had not been acted upon. As pointed out by our colleague Jean-Claude Trichet[2] in his capacity as chairman of the Global Economy Meetings of central bank governors at the BIS – meetings that we also attend on a regular basis – several policy makers had indicated to market participants that they needed to prepare for a significant correction. With hindsight, there were clear danger signs that supervisors could possibly have countered more decisively. To list but a few of these warnings, excessive leverage through securitisation and re-securitisation, excessive dependence on short-term wholesale funding, a complete under-estimation and under-pricing of risk, in particular liquidity risk, skewed incentive structures, an overreliance on mathematical and statistical risk models without a proper understanding of their assumptions, dynamics and constraints, a blind reliance on credit ratings without properly analysing and understanding their methodologies and caveats, and a proliferation of financial innovation that resulted in complex products that were not well understood by those selling or buying them.

However, supervisors and advocates of financial stability seemed powerless to address these issues while the party was still going on. Only weeks before being nationalised, Northern Rock reported record profits and was hailed for its innovative business model and financial strength, including capital adequacy. It is very difficult for supervisors to spoil the fun while everything is going so well.

Yet, if supervisors and financial stability functions in central banks have to take on the role of bouncers, they have to have muscle! Much attention is currently given in international forums to strengthening supervisory and regulatory frameworks and to giving more legal powers to financial stability practitioners. For example, some of the recommendations that have been made by the Financial Stability Forum are to strengthen the prudential framework for banks, including with regard to capital, liquidity, risk management and market infrastructure, to strengthen the framework for transparency and valuation, changing the role and uses of credit ratings, and enhancing the responsiveness of authorities to risks and cooperation in dealing with weak banks.[3]

Other issues being addressed in various forums are ways in which the pro-cyclicality of financial regulations could be reduced, how areas of regulatory arbitrage could be eliminated,

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1 Lacker, J. Financial Conditions and the Economic Outlook. Remarks made at the South Carolina Business and Industry Political Education Committee, 13 January 2009.

2 Trichet, J-C. Undervalued risk and uncertainty – some thoughts on the market turmoil. Speech at the 5th ECB Central Banking Conference, Frankfurt am Main, 13 November 2008.

3 Draghi, M. How to restore financial stability. Lecture at the 5th Bundesbank Lecture, 16 September 2008.

and how cross-border supervisory and crisis resolution frameworks could be strengthened, for example through supervisory colleges.

Lesson number 5: Common sense should prevail

A comment was recently made that perhaps one good thing about the current crisis is that engineering students will in future actually do what they have been trained for: to be engineers. In the past decade or so, the financial world has been taken over by mathematicians, statisticians, engineers and scientists. These professionals have made breakthroughs in the development of sophisticated risk management and valuation techniques, which contributed vastly to financial innovation and the development of new products. But we have probably over-relied on these models. After all, engineering is a different field from banking, finance and business management, and in many instances a great divide was created between the business acumen of boards of directors of banks, and the models on which the banks' operations were based. While financial and risk modelling should continue to play an important role in future, it should be better balanced by basic business common sense, which should challenge the underlying assumptions of such models and attempt to understand their inherent limitations and constraints.

Some comments on the South African banking system

We would like to conclude this address as promised earlier, by making some comments on the South African banking system, and why it appears to have weathered the storm relatively well up to now. To date, South Africa's banking system has remained largely shielded from the direct effects of the global financial market crisis, although our banks have been somewhat affected by the general re-pricing of risk and increases in funding costs. South African banks have very limited direct exposure to the troubled toxic securitised debt market in the US, partly owing to prudential restrictions on the type of assets and on the extent to which domestic banks are allowed to invest offshore. In addition, securitisation activities of our banks have been moderate and prudent. As a result, the high leveraging observed in some other jurisdictions has not been evident in the South African banking sector and our banks have continued to follow a fairly traditional banking model. Even more significantly, South African banks are predominantly funded by domestic deposits, and not through internationally held structured products. As at the end of December 2008, the total foreign-currency denominated deposits of banks amounted to R78,3 billion, and other foreign-currency denominated funding to R86,7 billion, together comprising 6,7 per cent of banks' combined total funding liabilities of R2,4 trillion. Even of this relatively small amount, only a portion is provided by non-residents.

South African banks are well capitalised, with an overall capital adequacy ratio of 13,0 per cent of risk-weighted assets under the Basel II measurement, as at the end of December 2008, which is 3,5 percentage points above the minimum requirement of 9,5 per cent. Even on the basis of capital to total un-weighted assets, they are not highly leveraged. Also noteworthy is that Tier 1 capital adequacy stood at 10,2 per cent. This high level of capitalisation makes the banking sector more resilient to economic shocks. Although some deterioration in asset quality has been observed over recent months (for example, impaired advances to gross loans and advances increased to 3,8 per cent by December 2008), this was more attributable to the tightening of domestic monetary policy and slowing growth than to the global financial crisis. These trends are not out of line with what would be expected in the current stage of the domestic economic cycle, and impaired loans are adequately provided for. The foreclosure procedures in South Africa are also different from those in the US, for example, allowing banks to recover a greater portion of their non-performing loans.

In this environment, the South African Reserve Bank (SARB) will continue to focus its monetary policy decisions based on the inflation outlook, within the context of its inflation-targeting framework whilst taking full cognisance of the global collective efforts to avoid a

deep recession. An improved inflation outlook, against a backdrop of slowing domestic and global growth, allowed the monetary policy committee of the SARB to reduce the policy rate by 150 basis points since December 2008, to 10,5 per cent.

The SARB continued to drain significant amounts of liquidity on a net basis in order to maintain a shortage in the money market as part of our monetary policy implementation framework. The domestic interbank market continued to operate, with no anomalies observed in either the volumes or rates of interbank funding. In general, financial market stability continues to be observed in South Africa.

Far from being complacent, however, we are monitoring the situation closely. Crisis preparedness is a key consideration for the South African Reserve Bank. In fact, in partnership with the World Bank we are hosting a regional crisis preparedness simulation test for the SADC region next week, to be facilitated by the Toronto Centre. We are also very conscious of the potential impact of the global economic slowdown on our own economy, and are starting to feel the painful effects of this through job losses, rising insolvencies and lower volumes of exports. In this regard, fiscal and monetary policies have to play a much more central role.

Conclusion

There is a G-20 meeting of ministers of finance and central bank governors taking place in the United Kingdom on Saturday, 14 March 2009. Many issues similar to those you might discuss here are also on the G-20 agenda. Hopefully, the G-20 conclusions will assist in taking us forward. Time is of the essence.

I wish you well in your deliberations.

Thank you very much.