Ravi Menon: A new financial landscape – rebalancing on three fronts

Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Inaugural Sim Kee Boon Institute Annual Conference on Financial Economics, Singapore, 5 May 2011.

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Introduction

Professor De Meyer, distinguished speakers, ladies and gentlemen, good morning.

1. The crisis of 2008–2009 has triggered a fundamental shift in the global financial landscape. A new balance is emerging, as market participants and financial authorities learn the lessons of the crisis and revisit existing paradigms. While the contours of this new landscape are still forming, a significant rebalancing is taking place along three dimensions on the regulatory front:

2. First, there is a redefinition of the respective roles of the market and regulation.

3. Second, there is increasing attention on realigning macroeconomic stability and prudential supervision.

4. Third, as regulatory reform efforts gather pace, there is a growing need to reconcile international standards with domestic discretion.

Redefining the role of markets and regulation

5. Let me begin with the relationship between markets and regulation. Stability is fundamental to a well-functioning financial system. But this stability does not occur naturally. The idea that self-regulation and market discipline are sufficient to ensure stable financial systems has come under heavy fire in the aftermath of the crisis. Financial markets differ from other markets in two important ways.

6. First, financial markets do not always self-correct. In fact, their propensity for leverage makes them prone to volatility and excess. The recent crisis has revealed how the real world deviates significantly from the assumption of perfect markets: information is asymmetrical, risk can be mispriced for sustained periods, and economic decisions are frequently guided by complex behavioural considerations rather than rational calculations.

7. Second, the cost of failure in financial systems is much higher than in other markets. The risk of destructive transmission is far greater with financial networks spanning many segments of the real economy. When companies fail, capital is reallocated to more productive uses in a process of creative destruction. In contrast, when financial institutions fail, capital is destroyed in a process that can feed on itself and lead to systemic instability.

8. Robert Shiller from Yale University, one of the few economists who predicted the crisis, argues that “we have to distance ourselves from the presumption that financial markets always work well and that price changes always reflect genuine information”. It is this misguided belief that prices always reflect fundamentals, that leads to asset bubbles. Government regulation is therefore imperative. Effective regulation and supervision of the financial sector is necessary to promote prudent behaviour and sound risk management and minimise the risk of financial shocks.

9. But we should guard against drawing the wrong lesson from the crisis: it is not about more regulation and less markets. The new financial landscape paradoxically requires both – better regulation but also better functioning markets.

10. Market competition remains the best way to promote innovation and create prosperity. Regulation must not stifle markets but seek to make them work better. In the financial sector, this means a judicious mix of rules and incentives for stronger capitalisation, more effective risk management, better transparency, and sharper market discipline. This has been central to the approach taken by the Monetary Authority of Singapore – never hesitating to impose high standards of prudence and financial discipline but always careful to do so in a manner that does not undermine enterprise and innovation.

11. Financial innovation – especially in derivative products – has been blamed as a cause of the crisis. This is not quite correct. Innovation has been a feature of finance for decades. The crisis was caused fundamentally by failures in macroeconomic policies and financial supervision. Monetary policy was too easy for too long in too many countries. This led to low interest rates and lax lending standards that precipitated unsustainable housing booms, mainly in the United States but also in other countries. Financial supervision failed to detect and correct the build-up of leverage in the system, especially in the shadow banking sector. Complex financial products obscured the risks in sub-prime lending and transmitted these risks across the financial sector. As Edwin Truman from the Petersen Institute puts it, "Financial engineering contributed to the market dynamics once the crisis got underway, but it was not 'the cause' of the crisis."

12. Regulation should therefore not restrict financial innovation but seek to create conditions in the market that promote effective risk management. Regulation and markets need to work hand in hand. Take the example of securitisation, which has been much maligned since the crisis. Let's look at the good, the bad, and the ugly of securitisation. The good is that securitisation is a useful means of mitigating and diversifying credit risk through capital market intermediation. The bad is that securitised products became so complex that the inherent risks were obscured when bad loans were passed on to unknowing investors. And it became ugly when these "toxic assets" blew up in the balance sheets of financial institutions across the spectrum, triggering a crisis of systemic proportions.

13. The solution is not to restrict securitisation. Rather, regulation must seek to help correct the imperfections in the securitisation market. International securities regulators have therefore recommended improvements in disclosure standards to allow investors to understand the risks of these products better. To enhance market discipline, it has also been proposed that originators retain a portion of each issue to keep some "skin in the game", to align their incentives with those of investors. Finally, additional capital may be needed to cover residual risks.

14. The stability of the financial system is not the responsibility of regulators alone. Regulators can provide the traffic lights and signposts on the road to reform, but road safety ultimately depends on the drivers on the road, the industry players. The management of risk must not take a back seat to the drive for increased profits.

Realigning macroeconomic stability and prudential supervision

15. The second realignment that is taking place is based on the post-crisis realisation that financial stability cannot be secured solely through a combination of macroeconomic policies aimed at price stability and microprudential supervision aimed at the safety and soundness of individual financial institutions.

16. Price stability is not sufficient to achieve financial stability. Sharp increases in asset prices, even in a climate of relatively low consumer price inflation, have typically led to credit booms and risky behaviour that eventually undermined financial stability. Likewise, prudential rules to ensure the safety of individual banks have not been sufficient to keep the banking system as a whole safe. Inter-linkages and common exposures across institutions can multiply aggregate risks and destabilise the system.

17. Hence the resurgence of interest in what is called the macroprudential dimension – policies and tools aimed at containing risks in the financial system as a whole. However, macroprudential policies are still at an experimental stage. Different countries have adopted different measures in the name of sustaining systemic stability, ranging from limits on aggregate credit and caps on debt-to-income ratios to taxes on asset market transactions and controls on capital inflows.

18. Singapore has been experimenting, since 1996, with its own toolkit of macroprudential measures to tame excesses in the housing market. While we do not as yet have a completely coherent policy framework, the main outlines of Singapore's approach are becoming clearer. It includes a suite of tools ranging from prudential instruments like loan-to-value ratios and fiscal measures like stamp duties on property transactions, to supply-side and other administrative measures. Singapore does not target asset prices but keeps a close watch on asset price movements, looking for signs of speculative froth, excessive leverage, or concentration risks.

19. Systemic stability is also a shared responsibility. It requires coordinated efforts across different government regulators and agencies. MAS is fortunate in this regard. As an integrated regulator which supervises the banking and insurance industries, as well as the capital markets, MAS is well placed to take a comprehensive view of risks within the financial system as a whole. As a central bank responsible for macroeconomic stability, MAS is also able to monitor and understand the effects of monetary and liquidity conditions on systemic risks. And MAS works closely with other government entities on issues such as system-wide safety nets – such as the deposit guarantees of 2009 and 2010 – taking a comprehensive whole-of-government approach.

Reconciling international standards and domestic discretion

20. The third dimension of rebalancing in regulatory reforms is that between international standards and domestic discretion. We have known for some time that we live in a globalised, interconnected world. But we did not know the extent of our interconnectedness until the crisis hit home. Cross-border bank lending is more than 40 per cent of world GDP. Global finance is really a vast and complex network of connections. Financial shocks are transmitted through this network with speed and virulence. Regulators used to worry about institutions that were "too big to fail"; now, they worry about institutions that are "too connected to fail". Size matters ; but connectivity matters more.

21. This high degree of interdependence means that governments in major economies can no longer act in isolation. Regulatory policies must be globally consistent to minimise the risk of arbitrage. Supervisory actions must be internationally coordinated to maximise their effectiveness.

22. Yet, regulation and supervision is essentially a national prerogative, that must cater to the domestic context and circumstances to be effective. Recognising this tension, international policymakers have focused on reaching consensus on international standards that serve as a minimum benchmark, while allowing countries the freedom to choose appropriate regulatory tools to fit individual circumstances. A uniform, one-size-fits-all international regulatory regime will not work.

23. The most striking application of this principle is in the approach being taken for the regulation of global systemically important financial institutions, or G-SIFIs. These institutions, because of their size, complexity, cross-border nature, and interconnectedness, would cause significant disruption to the global financial system and economic activity, if they failed in a disorderly manner. There is thus a need for global supervisory cooperation, in order to identify the key points of failure within such institutions. The Financial Stability Board, together with other international standard setting bodies, is rethinking its approach towards the monitoring, sharing, and mitigation of systemic risks posed by G-SIFIs.

24. A number of the proposals being considered are international in nature, like those improving supervisory cooperation between regulators, and requiring higher loss absorbency capacity for G-SIFIs. However, primary responsibility for these G-SIFIs lies with national regulators, who must retain discretion over the specific supervisory stance to take with respect to these institutions.

Conclusion

25. Let me conclude. This is a fertile time for the study of finance and risk. The financial landscape is undergoing dramatic change. The three dimensions of rebalancing that I outlined are still being played out, with many unanswered questions. What should be the balance between markets and regulation? What is the optimal level of capital in the banking system? How can we minimise the risk of liquidity shortfalls? Should trading activities be separated from commercial banking? How should incentives be structured to promote sound risk management? Can financial innovation help to reduce financial risks? What do we do with financial institutions that are both too big to fail and too big to save? How should macroprudential policies be designed?

26. The Sim Kee Boon Institute can play a key role in advancing our understanding of these issues and providing thought leadership. The Institute has already published a number of interesting papers on topics ranging from securitisation to the effects of poison pills on corporate governance. I look forward to more insights from the Institute in the years ahead. We can expect nothing less from an Institute named after one of the pioneers of the Singapore Civil Service. Sim Kee Boon helped to chart Singapore's economic development through the turbulent 1970s, when stagflation and oil price shocks shook the world's economies. We are living in even more interesting times today.

27. The Institute has gathered an impressive collection of talent here today. I wish you fruitful discussions.

Thank you.