Guy Debelle: Credo et fido – credit and trust

Text of the 2012 Richard Searby Oration by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, at Deakin, Melbourne, 25 September 2012.

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It is a pleasure to deliver the Richard Searby Oration here at Deakin University. I feel honoured to follow the esteemed speakers who have preceded me. Dr Searby has had a singularly impressive career throughout which he has made a great contribution to the community of Australia in many different arenas. As I read his record, one area with which he has had little direct involvement has been that of finance, perhaps unfortunately, as it could well have benefitted from his guidance. It is the current state of the financial sector that I will talk about today.

As you are all aware, the global financial system has been in a state of turmoil for more than five years now. The repercussions of this have been widespread, although thankfully Australia has been spared the worst of the impact. In other parts of the world, most obviously Europe, the United States and the United Kingdom, the fall-out from the financial crisis has seen millions lose their jobs, many for a number of years. This is most stark in Greece and Spain where around one quarter of the workforce is unemployed. Young people entering the workforce in those two countries have little prospect of finding meaningful employment any time soon; an experience that can scar their income prospects over their whole working lives and runs the risk of leading to a dangerous breakdown in social cohesion.

The crisis has been very much financial in its genesis but with losses that have extended to all parts of the global economy. Unlike some recent downturns, the recovery in a number of countries has been particularly protracted this time around. In a number of countries, even some five years on, the level of output in 2007 has still not yet been reattained. This represents a sizeable loss of income and wealth.

Tonight, I am going to talk about one of the elements that has contributed to this financial crisis being so long-lasting, and which might mean that there is still some way yet for it to run. The issue I want to focus on is the importance of trust in banking, and finance more generally. Hence the title of my talk today. *Credo* is the Latin for "I believe", from which we get the word credit, while *fido* is the Latin for "I trust", from which we get fiduciary and fidelity.[1] So credit is fundamentally an issue of trust. Without trust, we don't have credit. That lack of credit is a phenomenon which is playing out in a number of countries around the world at the moment, again, thankfully, not here in Australia.

The lack of trust is contributing to the unwillingness of financial institutions to extend credit and the difficulty some governments are having in obtaining funding. In turn, the lack of credit growth is exerting a major restraint on the economic recoveries in a number of countries around the world. In the post-war period, easier monetary policy has invariably helped foster a rebound in economic growth following a recession. An important transmission channel for monetary policy to take effect has almost always been a pick-up in lending to businesses and households. That is clearly not happening in many countries at the moment. Central banks in those countries are reaching deep into their toolkits to revive lending and foster economic recovery. But the lack of trust is significantly curtailing the ability of the normal implementation of macropolicy tools, both monetary and fiscal, to engender a sustainable economic recovery.

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[1] My high school Latin teachers will be pleased to see some return, if a few decades after the fact, from their efforts.

The outline of my talk is to firstly discuss the role that the financial sector plays in the economy. Then I will examine the crucial role that trust plays in financial intermediation and in ensuring the financial system runs smoothly. Following that, I will document the breakdown of trust that has occurred over the past five years. To finish on a more positive note, I will outline some of the avenues that might be taken to restore trust in the financial system.

Some of these themes were addressed in a speech entitled “Credit is Trust” delivered by my colleague at the Bank of England, Andy Haldane, in September 2009.[2] Andy highlighted the reduction in trust that had taken place in the previous two years – what was then the first two years of the financial crisis. But three years on from 2009, the situation is even worse. The lack of trust in the financial system has intensified. Distrust has spread beyond the finance system to other institutions. This is particularly evident in Europe, where there is a lack of trust in some quarters in the longevity of the euro, and a lack of trust by bondholders of some European governments that they will be repaid in full. In the case of Greece, this lack of trust proved to be well-founded. This diminished trust in political and economic institutions is a particularly worrying development.

I fear that the path back will be a long one. In all walks of life, including finance, trust takes a long time to build, but can be quickly and easily shattered.

The financial sector and the economy

To set the scene, I will start with a brief description of what the financial sector does. I hope I can avoid being too jargonistic, but please forgive me if I lapse into economists’ speak every once in a while.

The financial sector plays an important role in the functioning of the economy, primarily through intermediation. Simply put, the financial sector sits between savers and borrowers. It takes the funds it raises from the savers through, for example, deposits, and then lends it to those who wish to borrow, be they businesses, governments, or households. If the system is working well, it allocates the funds to their most productive use. This benefits the savers whose money is being invested profitably, and the economy and society at large.

It is important to note that the financial sector is an intermediate sector. It is not at the end of a production chain producing something which directly generates utility for society. It is a critical link along the way, the oil that keeps the economy ticking over. When the oil dries up, the economic engine starts to malfunction and can ultimately grind to a halt.

In that regard the financial sector is different from other parts of the economy. It is one of the reasons it is subject to considerably more regulation and oversight, although clearly the experience of the past few years indicates that in many parts of the world the oversight and regulation were deficient. When the finance sector stops functioning properly it has knock on effects to all parts of the economy in a way that other sectors generally don’t. The experience at the end of 2008 following the collapse of Lehman Brothers demonstrated this point starkly. The contraction in the global economy was breathtaking in its rapidity, but also in its simultaneity, in a way that hadn’t been seen before.

I will now step a bit deeper into the process of financial intermediation to provide a better sense of where trust comes into the process. Again, apologies if this gets a bit too arcane, but hopefully you can bear with me.

Why do financial intermediaries exist? Why don’t I as a saver lend directly to you the company?

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[2] Haldane A (2009), “Credit is Trust”, Speech given at the Association of Corporate Treasurers, Leeds, 14 September.

One of the main reasons is because of the presence of what economists refer to as asymmetric information. Asymmetric information arises when I know more about my own situation than you do. It would be difficult for individual savers to know whether they were lending to a business that was going to put the funds borrowed to a productive purpose and be in a position to repay the loan when it became due.

A financial institution such as a bank that is practised in credit assessment can reduce these information asymmetries. When a bank makes a loan, it does the due diligence on the lender and assesses the capacity of the lender to repay. While the due diligence cannot completely eliminate the information asymmetry, it can allow the bank to make a reasonable assessment of the risk incurred in making the loan. On the basis of that risk assessment, the lender charges the borrower an interest rate to compensate for the risk incurred. With an appropriately diversified portfolio of loans then, the bank should not be overly exposed to any particular development. The risk is mutualised. If there is a problem with one loan, the lender should be earning sufficient interest on the rest of its loan portfolio to cover the loss.

The lender, and thereby the savers who provide the funds to the lender, are compensated for the risk incurred. Relative to lending their own funds directly, the savers are benefiting both from the (hopefully) professional risk assessment that reduces the information asymmetry and the risk mutualisation.

One difficulty in this process that is apparent from what I have just said is the possibility that the risks in a portfolio of loans are correlated. In plain English, when one loan goes bad, how likely is it that other loans will go bad at the same time? For example, in an economic downturn where there is a rise in unemployment, a lender might find that more loans are becoming problematic than expected, because they are all being affected by the realisation of the same risk. The interest rate charged may have been sufficient to compensate the lender for one realisation of the risk but may not have been adequate for a large number of simultaneous realisations of risk.

In addition to intermediating funds, one can also think of the financial sector intermediating risk. As I've just said, a financial institution has a wide range of loans on its books. By holding a diverse portfolio of risk, the institution is, in theory, less vulnerable to the realisation of any of those risks.

But a financial institution doesn't always hold all the risks on its own books. Through channels such as securitisation, a financial institution can also distribute the risk around the financial system to other institutions that are, again at least in theory, better placed to hold that risk. Who might be better placed to take on these risks? Some possible candidates are pension or superannuation funds and insurance companies that should have long horizons and a diversified portfolio of assets.

It is an interesting question as to whether it is better for a bank to pool the risks on its own books or whether it is better for the risk to be off the books of the banks and instead be distributed round the system. If the risks are distributed around the system, the bank making the loan may be less inclined to do the appropriate amount of due diligence, as they are no longer so directly exposed to the consequences. In principle, the entity which buys the risk from the bank should also do an appropriate amount of due diligence. But the experience of the past few years shows that the more chains there are in this process, the more removed the end-holder of the risk is from the originator of the risk and the worse the process of due diligence becomes.

On the other hand, if the bank holds too much risk on its balance sheet, and if too many of those risks crystallise, the bank is likely to find that its ability to continue to intermediate funds is severely curtailed. It will cut back on its lending – what's commonly referred to as a credit crunch – worsening the economic environment. There are plenty of examples of this through history, including in the current crisis. So conceivably, risk should be intermediated as much as funds.

These considerations are currently at play in the debate over the Volcker rule in the United States and the “ring-fencing” proposed in the Vickers report on the UK banking system. The conclusion reached in both those cases is that it is better to separate the investment banking (or risk generation) arm of financial institutions from the commercial banking or regular lending arm of the institution. Then, if some risk blows up in the investment arm, there is not a detrimental spillover to the commercial bank that crimps its ability to continue lending, thereby limiting the impact on the economy.

Alternatively, one can consider a world of fractional risk banking, analogous to fractional reserve banking. With fractional reserve banking, I refrain from lending some portion of the funds you, and others, deposit with me so that I can repay you, should you decide to withdraw the funds at short notice. As long as all the depositors don’t want their funds back at the same time, that is, as long as there isn’t a bank run, then I am fine. In the case of fractional risk, I would retain some part of the exposure on my own balance sheet rather than pass it all on to you, to give me some incentive to monitor the risk and continue to do due diligence. This is often described as “skin in the game”.

Trust and finance

Having spent a bit of time setting the scene by describing how the process of financial intermediation works, I will now focus on the main argument: the role that trust plays in finance.

Trust is pervasive at many levels of the financial system, in large part because of asymmetric information. There is the trust between the depositor and the bank. The depositor is trusting that her funds are safe with the bank. This is embodied in Frank Capra’s famous movie, *It’s a Wonderful Life*, where Jimmy Stewart saves the day with a paean to trust, to stop the run on the bank.

Trust of this sort is particularly important because banks undertake maturity transformation, that is, borrow short and lend long. For example, banks are willing to let you deposit your money “at call”, but lend the money for periods considerably longer than that. If depositors all lost trust in a bank at the same time, as in a bank run, the bank would be unlikely to be able to repay the funds immediately. It could not call in all its loans. It would be forced to engage in a fire sale of its assets, which are mostly illiquid loans. To prevent this situation occurring, central banks provide a liquidity backstop, where they stand ready to lend money to banks if needed, against the bank’s assets (collateral). The trust in these arrangements is almost always enough for them not to be needed.

There is trust between the borrower and the bank. The bank is trusting that the borrower will repay the loan. The bank can do a lot of due diligence on the borrower to be reasonably confident that the lender will repay. But ultimately there will be some trust involved. The bank needs to trust that the borrower has provided accurate information and will act in good faith. There will, however, always be a gap between what the bank can learn through its due diligence and what it needs to be completely confident the loan will be repaid in full.

Because the process of financial intermediation often has a number of links in the chain, there also needs to be trust between financial institutions. Many financial transactions don’t just involve one bank lending out its deposits to the end-borrower. Often the funds are on-lent to one financial institution after another, before ultimately finding its way to the end-borrower. So trust needs to be present at every stage in the chain. One breakdown in this chain of trust between counterparties can throw a spanner in the works of the whole process.

Ultimately there is only so much due diligence that can be done. Risk is always present in the financial system. Information asymmetries will always be present between the two parties in a financial transaction. Transparency can reduce but not eliminate the risk from these asymmetries.

Finally, there has historically been trust between regulators and financial institutions. (I am not sure there is all that much of this trust at the moment, as I will discuss later.) “Trust me, I know what I’m doing”, was the banker’s exhortation for the light touch approach to regulation that was pervasive prior to the crisis in many countries, most obviously the UK. The argument was that banks should be broadly left to their own devices, with the discipline provided by the market deemed sufficient to keep them on track.

The breakdown of trust

Having described the critical role that trust plays in the process of financial intermediation, I will now describe how trust has broken down over the course of the financial crisis.

The period leading up to the financial crisis saw what might be labelled, in the context of my talk today, the development of lazy trust. Things were generally going along fine, so my due diligence was that I will take you, the lender, at your word. I won’t really bother to verify that what you are telling me is true. I won’t bother to consider the possible circumstances that might hinder your ability to repay me.

Moreover, with long chains of intermediation involved, there was often too much distance between the ultimate holder of the risk and the source of the risk. Too many links means that details get lost or misheard. If the due diligence is necessarily incomplete by the very nature of financial transactions, then that incompleteness is likely to get magnified, the more chains there are in the transaction. The due diligence gets dissipated along the chain. There is a presumption that someone further up the chain did the due diligence. And when times were good, no-one thought to challenge that presumption.

So complacency set in, encouraged by the seemingly benign growth in the world economy. That benign environment led to an incorrect pricing of risk. Now this need not be the case, but it does seem to be a trait of human behaviour that has been evidenced many times in financial history. Good times begets complacency.

Let me take a quick detour here. Taken to the extreme, this line of argument leads to a view of the world most famously associated with some Austrian economists. Good times are always setting us up for the next disaster. It is not clear to me what the appropriate policy response should be to this. Certainly one should always remain alert to the possible dangers. And certainly it may be difficult to take away the punchbowl when the party is in full swing. (Maybe that is why central bankers are never invited to good parties…) But surely it doesn’t mean we should never have good times, and instead endure a constantly mediocre performance so that no-one ever gets carried away.

Obviously there needs to be a balance. To some extent, one can do the calculus. The large costs of the current financial crisis does make one think hard whether one should have let the previous boom persist for so long, as great as the benefits of it were while they lasted. But another aspect of human nature is the belief that one can avoid the mistakes of the past by learning from them. Inevitably therefore, there is the ubiquitous assertion that this time it is different. And in many aspects, each time it *is* different. It is easier to assess the differences than the similarities in real time. The similarities only generally become apparent after the fact.

Thus, as mentioned earlier, we actually do need some level of distrust, at least initially, for the financial system to function effectively. I shouldn’t take you completely at your word. I should do some background checking to make sure that what you are telling me is true. I should check whether your circumstances have changed so I can be confident that you will still be able to repay me.

So back to the breakdown of trust. Some time around 2007, it became clear to many in financial markets that there had been a major mis-assessment of risk in many parts of the financial system. While some had been warning about this mis-assessment of risk prior to this, and some had even positioned themselves to benefit from this mis-assessment, as

Michael Lewis described in the *Big Short*, it wasn't until the middle of 2007 that this became a more widely held opinion. Interestingly, through the second half of 2007, there was a marked disconnect between equity markets and credit markets. Credit markets came to the realisation significantly earlier that something was going badly wrong in the financial markets, but for quite a considerable period of time, equity markets assumed nothing worse than a garden variety economic slowdown was in prospect.

Lazy trust evaporated. The financial system switched rapidly from complacency to deep mistrust in a short period of time. In particular, trust broke down between financial institutions, best illustrated by the final days of Bear Stearns in March 2008, and then Lehman Brothers in September of that year (see *House of Cards* by William Cohan and *Too Big to Fail* by Andrew Ross Sorkin, that are amongst the many books written about those two events). Both institutions experienced a run on them by their financial counterparties, who were unwilling to roll over their funding because of the concerns that the poor quality of the assets on their balance sheets might render the two institutions insolvent.

The crucial distinction between uncertainty and risk came to the fore. I can assess the *riskiness* of an asset or an institution by assigning a probability to its likely value. I can then manage that risk appropriately. But if I am *uncertain* and unable to make a firm assessment about the value, the situation is a lot worse. I am likely to pull back and be unwilling to provide any finance to you, except on steep terms and probably only for a short term. Uncertainty is much more pernicious than risk. As I have spoken about earlier,[3] the famous Rumsfeld quote very much applies to the financial crisis. Risk is very much about the "known unknowns" but uncertainty is about the "unknown unknowns". But maybe Mark Twain puts it a lot better: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Financial institutions and investors knew that many assets in the financial system were badly mispriced. In the case of some financial institutions, they knew about the mispricing on their own books and rightly assumed that the same was probably going on with their competitors. But they didn't know how much.

They did not know what exposure various financial institutions had to these mispriced assets. So what is termed "counterparty risk aversion" became all pervasive. The lack of trust meant that financial institutions were only willing to lend to one another for increasingly shorter periods, ultimately only overnight. A financial markets version of the bank run portrayed in *It's a Wonderful Life* took place. In the UK, in the case of Northern Rock, a traditional bank run occurred as depositors became concerned about the safety of their savings. They no longer trusted the institution because they were uncertain about its ability to fund itself, given its reliance on mortgage-backed securities for funding – a market that was no longer functioning at all because of a lack of trust in the value of these securities.

This breakdown in trust led to a breakdown in intermediation. Central banks stepped into this hole to play their historical role of intermediary of last resort. Central banks can replace, to a reasonable extent, the decline in the intermediation of funds by the banking sector. But it is considerably more difficult for central banks to replace the lost trust.

The extent to which central banks have needed to be intermediary of last resort is evident in the vast size of central bank balance sheets in major advanced economies: the euro area, the United States, Japan and also the UK. The central banks are standing between financial institutions that are unwilling to lend directly to each other.

The euro area provides a particularly clear example of this. In the second half of 2011, banks in the euro area became increasingly unwilling to lend to each other. First of all, banks would only lend against collateral (secured lending) rather than lending directly to another bank

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[3] Debelle G (2010), "On Risk and Uncertainty", Address to Risk Australia Conference, Sydney, 31 August.

without any security (unsecured lending). In plain English, this means that banks would only lend to another bank if the borrowing bank would provide something like a government security or a portfolio of mortgages as collateral to the loan. Then even if collateral was provided, the length of time they were willing to provide the loan for shortened, because of a concern that the borrower would not survive long enough to repay.

This placed some financial institutions in significant financial difficulty. Concerns mounted as to whether some institutions would be able to fund themselves at all. As a result of this, the European Central Bank (ECB) announced that it would provide as much funds as banks in Europe required through three year loans. So the European central bank has become the intermediary of last resort for the European banking system because the banks do not trust each other.

More recently, as the lack of trust of some of the governments of Europe has intensified, the ECB has had, in effect, indicated its willingness to act as intermediary of last resort to these governments too. One of the main reasons the ECB has decided to do this is because of the lack of trust in the longevity of the euro. Investors are concerned about the possibility of redenomination risk: the possibility they are left holding an asset whose value is markedly decreased, when a country leaves the euro area and re-introduces its own currency.

As a result of this mistrust, we are witnessing a balkanisation of the financial system in Europe. Investors in one European country don't trust banks or governments in other countries. They pull back from financing across borders, preferring instead to invest their money close to home. This almost certainly is not an optimal allocation of funds to their most productive use.

On top of this dangerous state of affairs in Europe, and amplifying the diminution of trust in the financial sector, recent controversies in the banking sector have hardly provided any justification for the public regaining trust in the banking system.

To the extent that trust was slowly being restored in some parts of the banking system over the past few years, it was shattered by the recent revelations surrounding the LIBOR scandal, allegations of money laundering and the like.

The restoration of trust

So all in all, the state of the financial system in many parts of the world is not in good shape. So what is to be done about it? As in the old Irish saying, the first response is to say I wouldn't start from here. But unfortunately, here is where we are.

Using the recent experience in Europe as an example, we can consider a number of possible avenues as to what might be needed to rebuild trust.

When it comes to the distrust of the state of banks' balance sheets, transparency about the true nature of the assets on the balance sheet will clearly help. But the transparency and the disclosures clearly need to be credible to reduce the information asymmetries. Stress testing of the balance sheet by a credible independent party such as the prudential regulator (APRA in the case of Australia) can give depositors, and other investors, confidence that their money will be safe. These sorts of actions work to take the solvency risk off the table. For depositors, this is reinforced by the presence of deposit guarantees. But often it is the sovereign who is providing the deposit insurance. So if there is a lack of trust in the solvency of sovereign, this interlinkage between the financial sector and the government can amplify the problem, as has been evident in the case of Ireland and Spain, for example.

The willingness of the central bank to provide a liquidity backstop, very evident in Europe at the moment, reduces liquidity risk concerns. Investors are not so concerned that they will be the ones left in the burning building when everyone else has already run to the exit.

The *quid pro quo* for this support is that banks will be subject to more comprehensive regulation and, at least as important, more intensive supervision and scrutiny by their prudential supervisors than was the case before the crisis. The light touch is no longer acceptable. One can make a reasonable case that in Australia's case, this doesn't require much change. APRA has long exercised intensive scrutiny over the banks it supervises. But even here in Australia, there are a number of lessons learned through the crisis that are in the process of being applied.

The regulatory regime for financial institutions has tightened considerably. While this might impose some costs on the financial sector and increase the cost of financial intermediation, the benefits are sure to outweigh those costs. This is particularly the case when we see the terrible costs of the high unemployment being experienced in a number of countries around the world at the moment in the aftermath of their financial crises.

A change in management practice at financial institutions is surely also necessary in a number of cases, and this must start at the top. The culture around risk management and risk tolerance clearly is an important element of this. The practices that became pervasive throughout the first part of this century that contributed to the excesses need to change. What was considered an acceptable way of doing business will no longer suffice.

Given the role that the financial sector plays in the economy, there is a form of social contract between it and the general public. As I have mentioned earlier, the financial sector enjoys a level of support that is not present for other sectors of the economy, because of the crucial role it plays.

But leverage implies financial institutions are more vulnerable. We need to consider what the safe degree of leverage is. That is a debate that is being had currently. The rate of profitability in the financial sector is also a debate society needs to be having. If financial institutions are perceived to be earning too high a rate of profitability, particularly if the institution is enjoying a degree of support from the public sector, that too will impede the restoration of trust.

It will be a long road back to restore trust. Without trust, the process of intermediation and credit provision will be greatly curtailed. In turn, this will impede the path to global economic recovery with costs to all.

We have to lay out the road ahead, put down the road rules in the form of regulations and other curbs on the financial sector. But then the journey still needs to be taken. There are no short cuts.