Stephen S Poloz: Speculating on the future of finance

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Economic Club of New York, New York City, 11 December 2014.

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Introduction

Thank you for the invitation to speak here today. It is always a pleasure to be in New York, and it is a special treat for me to address this distinguished audience.

I'd like to talk with you about the future of finance. Now, I know I don't have to convince anyone in this room of the importance of financial intermediation. Just as you can't have lights without power lines, you can't have economic growth without financial intermediation.

But as you also know well, our financial regulators have spent the last five years putting financial reforms in place in the wake of the 2008 financial crisis. There is absolutely no doubt that these reforms will affect the future of finance, but none of us really knows how.

Financial intermediation is already evolving in response to the reforms, and I think it is worth speculating on how these trends might develop in the future. The only assumption I make is this one: no amount of regulation can snuff out the forces of competition – competition is a force of nature, and it is going to manifest itself in some way, for there is a lot of money at stake.

Regulatory response to the crisis: too much or too little?

At the G-20 Summit in Brisbane, leaders acknowledged that we have delivered on the core commitments made in response to the financial crisis.

Yes, there are still some important issues to address, particularly with respect to consistent implementation of these reforms. But for the most part the core of the world's financial system is far safer today.

Depending on your perspective, these reforms are either overly harsh, or too lax. A systemically important bank sees the steep cost of reform, while the unemployed worker still feels the steep cost of the crisis.

My perspective as a central banker is a macro one, and I can tell you that by the end of last year, the cumulative loss to global output owing to the crisis was roughly US$10 trillion, which is close to 15 per cent of global GDP. Over 60 million jobs were destroyed.

We have rightly made a strong commitment to address the most serious fault lines exposed by the crisis, to reduce significantly the probability and severity of future ones. In short, we would like to ensure that this never happens again. No doubt, the sweeping scope and complexity of these reforms has some thinking that the new regulatory architecture is excessively tight, at least at first glance.

Of course, optimizing the scope and intensity of regulation was never going to be easy. The new regulatory architecture is the outcome of a political process with many trade-offs and significant differences across financial systems. Accordingly, the principles behind the reforms matter more than the rules themselves – principles, complemented by a high level of supervisory vigilance.

Fact is, the financial world is a dynamic place, where competition is inherent to it, regardless of market structure. Principles-based financial regulation sets a high bar under which competitive forces can still foster financial innovation, innovation that is more likely to be socially improving than simply evasive.

In Canada, active and vigilant supervision goes hand in hand with this principles-based approach to regulation. To help monitor potential emerging risks, we have a comprehensive radar system that includes surveillance, guidance and enforcement. Canadians have found that this complementary approach to regulation and supervision is conducive to responsible financial innovation.

An important objective of these G-20 financial reforms is consistent implementation across jurisdictions, but in a manner that avoids unduly impeding financial innovation.

I see such innovation in financial intermediation as essential to fostering regulatory balance between maintaining financial stability on the one hand and facilitating competitive market forces on the other hand. As people in the financial industry create new ways to do business – some call this regulatory arbitrage, which of course sounds like a bad thing – their innovations help re-set this balance, prompting regulation to adapt to positive progress in financial intermediation.

There is a natural incentive behind financial innovation, since there is a lot of money at stake for those who innovate successfully. There is a lot at stake for the macroeconomy, too, because a return to sustainable economic growth around the world will require continued financial innovation. Regulation must allow these natural forces to manifest themselves, albeit in a safe way.

Where the creative forces might take us

Given this context, let’s speculate about the future of financial intermediation: How will the forces of competition manifest themselves in the years ahead?

Let’s start with banks. Some may choose to shed business lines that have relatively low risk-adjusted returns. In particular, capital market activities could shrink as the risk weights associated with them increase. This has already started: since 2007 global banks have already sold off more than US$700 billion in assets and operations, of which foreign operations account for almost half.

Furthermore, in response to the new resolution requirements, some large banks may simplify their organizational structures.

I’m not suggesting that large universal banks will disappear. They will likely persist, at least because of the significant economies of scale associated with payments and foreign exchange. Large banks will also remain because there will be an ongoing need to serve global clients.

For their part, smaller and less-complex banks will probably increase their focus on traditional banking.

We can’t be definitive about these predictions, for we simply do not know how competitive forces will operate in this new environment. But it would be surprising if the net effect were not to reduce the availability of credit. If financial markets had imperfections before, some of those imperfections are likely to be even more evident under the new regulatory environment. This is straight out of your first economics textbook.

It goes without saying that reduced availability of credit would be a headwind to economic growth. And, if there are funding gaps in our system at the best of times, and they turn out to be a little bigger under our new regulatory umbrella, those funding gaps will probably be found in all the usual places: lending for young businesses, small- and medium-sized companies, trade finance and infrastructure, to name a few.

These areas of retreat by banks could look like good opportunities for other financial intermediaries. We can imagine several different channels where the forces of competition might emerge, all of which could occur simultaneously.

First, there is market-based finance. As banks rein in their risk-taking, we can expect that market-based finance will play a larger role than it currently does. We can see this happening already.

For starters, in some markets companies increasingly fund themselves by issuing bonds on the market. In the U.S., while bank dealers have significantly reduced their inventories of corporate bonds, non-bank lenders have increased their holdings of corporate bonds. Whether they are structured as asset managers, insurers, non-bank financial firms or retail investors, these groups are opportunistically filling the void that traditional bankers have created.

Securitization is another market-based channel that could really expand in this new world. Although the very word securitization has been tainted by the crisis, I can imagine that a new class of high-quality, low-risk securitization products could differentiate itself from the mistakes of the past.

Such innovations are to be welcomed, provided that they are created in a manner that does not pose new or growing risks to the financial system, such as liquidity shortfalls in times of stress. Importantly, market-based finance can even be a source of economic stability, if such intermediaries react differently to market turbulence than banks. In effect, countries with diversified financing sources may be better placed to weather shocks to the economy.

However, market-based finance is unlikely to erase all of the imperfections in our future financial system. In particular, market-based finance is not very effective in reducing information asymmetries, so it probably will not fill the funding gap for young, small- or medium-sized businesses.

No doubt, Mother Nature has a plan to fill those gaps in time, and one probable source is private lending and equity, a second channel where competitive forces are likely to emerge.

There have been significant advances in technology that are sure to influence the future provisioning of private capital. One notable example is peer-to-peer (P2P) finance, which directly connects private lenders with borrowers via the Internet. An important element of this model is that there is no middleman, nor is there any liquidity or maturity transformation as in traditional banking or market-based finance.

While P2P finance is still in its infancy, it is already transforming private capital provision and growing fast in pockets in the U.K., the U.S. and China. Although it originally focused on pooled funds from smaller investors, P2P finance is increasingly being dominated by big institutions and hedge funds with about two-thirds of the funds loaned coming from institutional investors. This is already changing the face of P2P finance in very important ways.

P2P finance has an impressive cost advantage over traditional banking and since there is a lot of money at stake, as usual, competitive forces are certain to manifest themselves. With automated credit checks and "no skin in the game," the operating expenses in P2P lending, for example, run about one-third that of traditional banks.

With that advantage, P2P lending provides the opportunity for both savers and borrowers to get a "better" deal. However, there is no such thing as a free lunch. The cost of that better deal is the significant risk that the participants take on.

Despite the risks, we can easily imagine a world in which P2P finance thrives. It has already begun to spread to a wide variety of new sectors, such as student loans, real estate, hedging, auto loans, equipment finance, medical loans, business-to-business lending, and so on. Over time, we could see P2P finance become more global, and could also see the development of a deep secondary market in securitized P2P loans.

If I am right that there will be less credit available from traditional banks, it's not a stretch to think that the young, the small and the medium, and the risky companies, will begin to tap into this P2P finance channel to meet their credit needs.

This evolution could be key to an eventual return to sustainable economic growth, as I am convinced that a return to natural growth – as opposed to policy-induced growth – will require a resumption of new firm creation, sustained by innovative financial intermediation.

Will a surge in P2P finance mean new risks to the financial system? Perhaps. Will those risks be systemic in nature? We don't have a clear answer yet, but with the increasing participation of institutional investors in this space and increasing market shares of P2P finance, there could be financial stability implications.

And what if Mother Nature does not fix all the imperfections in our financial system through market-based or private finance? The third channel that we might expect to play an enhanced role in a credit-constrained world is public finance.

Public financial intermediaries are active in such areas as lending to small and medium-sized enterprises and trade finance, and these demands could rise in the years ahead. But the bigger need for a public sector solution is more likely to be in the area of infrastructure investment. So-called "green infrastructure" is particularly susceptible to market failure, as it suffers from both the basic free-rider problem and societal mispricing – a double market failure, if you will.

Public-private partnerships (or P3s) have proven to be an increasingly effective tool for funding these investments, but they have not been a panacea. The P3 space is not exempt from our call for more financial innovation.

Innovative ways of risk-sharing in investment projects – for example, governments offering innovative guarantee structures where they take on a contingent fiscal risk as opposed to laying out large expenditures up front – are clearly worth experimenting with. Private sector intermediaries, pension funds, and sovereign wealth funds should be actively encouraged to develop and propose such innovations. Once again, there is a lot of money at stake.

It should be clear by now that I am a big fan of market forces. The returns from successful financial innovation in market-based finance and P2P finance are likely to be very large, from the perspectives of both the innovator and the macroeconomist. Allowing those competitive forces to flourish, within principles-based regulation aimed at protecting the financial system, is essential for future economic growth. Tweaking public financial intermediation should take care of the rest of our market imperfections.

But all of these market structures exist already, so speculating on their future is not that much of a stretch. That makes me wonder if we are missing something big. How blue-sky do we want to get? Does anybody besides me wonder what the banking system looks like in the background of Star Trek?

Or, what about the corporatist model of finance, which lies in the background of Margaret Atwood's novel, *The Year of the Flood*? Now that's blue-sky thinking: people work for a massive corporation, live in the corporate compound, go to corporate restaurants and events, and bank with a financial intermediary wholly-owned by their own employer, which in turn invests the funds in growth for the corporation.

I suppose that model is far-fetched, but I present it as an illustration that the sky really is the limit in this space. I have offered you a range of possibilities today, but there are many other possible futures for finance.

Financial stability is a shared responsibility

A bright future is one where the financial system is safe and efficient – and innovative. Financial regulation needs to be designed to allow competitive forces to work, and allow innovation to happen.

I said earlier that it is very difficult to strike the perfect balance between regulation and innovation. Indeed, public authorities can't strike a perfect balance alone. That balance is the product of regulation and the underlying forces of competition I have talked about.

The simple fact is that financial intermediation is, for the most part, a scale business. Operating at scale creates the risk of market failure, or market imperfections, as we well know. Accordingly, operating at scale demands that the financial intermediary do so under a social license which, of course, goes hand in hand with regulation.

In short, this is a contract. All contracts function best when the two parties live not just by the letter, but by the spirit underlying the agreement. I've asked you to imagine some possible financial futures; now, can you imagine one where regulated financial players uphold not just the letter, but the spirit of the new global regulatory framework?

What I am suggesting is that the industry be at the vanguard of positive change, and voluntarily embrace the spirit of financial regulation. Use this positive response as a brand to rebuild trust in the street, especially Main Street. And, in the process, demonstrate the effectiveness of principles-based financial regulation that allows competition and innovation to facilitate economic growth.

Conclusion

Let me wrap up.

Financial regulation is costly, but that cost pales compared with the fallout from the financial crisis. We are still paying for that. Global regulatory reform was absolutely essential. So let's work together to make it better. Thankfully, the balance between regulation and innovation is dynamic, not static – competitive forces ensure this.

We are at a critical juncture for the global economy. We have been through a destructive business cycle, and policies will need to remain stimulative until the legacy headwinds subside and the rebuilding phase truly gets underway. That rebuilding phase will require a substantial pickup in new firm creation and young firm survival, in particular, which will foster new job creation. Creative financial intermediation is a necessary ingredient for this rebuilding process.

In Canada, we had a less difficult cycle than most other countries, in part because of the resilience of our financial system. Even so, we saw significant destruction in our export sector, the backbone of our economy. We have been waiting for a resumption of export growth, to be followed by a rekindling of animal spirits, investment in new capacity and new firm and new job creation, and it looks like that natural sequence may have finally begun. We have plenty of room to grow, however, so it will take another couple of years before our economy can enjoy steady, natural growth with inflation sustainably on target.

It is this return to natural growth that we all want to see. But it simply will not happen without vigorous and innovative financial intermediation. We need to embrace our new regulatory architecture and get on with the job.