Michele Bullock: Has the way we look at financial stability changed since the Global Financial Crisis?

Speech by Ms Michele Bullock, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the Bloomberg Breakfast, Sydney, 14 March 2017.

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Good morning and thank you to Bloomberg for the invitation to speak this morning. This is my first speech as Assistant Governor Financial System. And while I have not been involved in the Bank's Financial Stability area before, I was part of the Financial System Group when it was established in 1998 – sitting in its sister department Payments Policy. So reflecting my own recent journey in getting my head around this area, I thought today I would have a look back at how the Bank's work on financial stability has evolved over the past 20 years and particularly since the financial crisis. I have posed the question 'has the way we look at financial stability changed since the GFC?' I will give you the answer up front. At the big picture level, the way we look at it hasn't changed that much. But we are even more attuned to the tail risks than we were and more attuned to the need to take action if we sense that the risks are building. We are, as are policymakers globally, more sensitive to risk. But first a little history.

Most of you will be familiar with the history of the Reserve Bank of Australia. Briefly, its genesis was in the Commonwealth Bank of Australia, which was established by legislation in 1911. In this early incarnation, the Bank only had the ordinary functions of a commercial and savings bank. But over the succeeding years it gradually took on a number of activities that are typical of central banks. It was given control over note issue in the 1920s and then progressively acquired exchange control powers and controls over the banking system. The Bank's powers in relation to the administration of monetary and banking policy and exchange control were formalised in legislation in 1945. Then in 1959, the Commonwealth Bank was effectively split into two. The original institution became the Reserve Bank of Australia, whose role was to carry out central banking functions, while the commercial and savings bank functions were transferred to a new institution that kept the name Commonwealth Bank of Australia.

Why this brief history lesson? I thought it was worth highlighting up front that the Reserve Bank has always had financial stability as one of its core functions. The focus on the activities of private banks and the ways in which they could be influenced or controlled grew in part out of the experiences of the Depression in the early 1930s and the major banking crisis in Australia in the 1890s.

Since its establishment as a stand-alone central bank, there have been two key changes to the way the Reserve Bank approached its financial stability obligations. The first was in the early 1980s when, following the financial system inquiry undertaken by the Campbell Committee, the Australian financial system was deregulated. Previously banks had been heavily regulated so were limited in their ability to take risks. In the new deregulated environment, the Bank built up a banking supervision framework. Prudential standards were introduced and the focus was on the risk management frameworks of the banks.

The second key change followed another financial system inquiry undertaken by the Wallis Committee. As a result of the inquiry, the banking supervision function was transferred to a new institution – the Australian Prudential Regulation Authority (APRA). The Reserve Bank, however, retained a role focusing on 'overall financial system stability'. How did we interpret this? I think it was set out well in the Bank's 1999 Annual Report, the first year of these new arrangements. The Bank stated that its 'objective is to ensure that financial disturbances in *any* part of the financial system do not ultimately threaten the health of the economy.' It went on to set out the foundations for financial stability: low inflation; a safe and robust payments system; efficient and smoothly functioning financial markets; and a sound framework of prudential supervision.

Since then, we haven't changed the way we interpret our mandate for financial stability. We are somewhat more explicit about recognising the potential human cost of financial instability in terms of financial distress and unemployment and are more attuned to the behavioural risks associated with risk cultures and financial innovations. But we have substantially increased our communication on financial stability issues. For example, in 1999, when we first started reporting formally on financial stability, we published 10 pages in the Annual Report, of which only around half were actually an assessment of financial stability. There were six charts – credit spreads in overseas bond markets, credit to GDP, credit growth, house prices, banks' impaired assets and risk-weighted capital ratios. In March 2004 when we first published the Financial Stability Review, the assessment was around 40 pages, including over 40 charts, and it is now routinely between 50 and 60 pages with upwards of 60 charts. We also give a lot more speeches covering financial stability issues, such as this one. But while we publish much more detailed analysis, the substance of the core issues has not changed substantially. The global financial environment was considered in the 1999 assessment as was credit, household balance sheets, property prices, and the resilience of the banks.

So how, if at all, has the GFC changed the way we look at financial stability? It hasn't fundamentally changed the way think about financial system stability, though we now have a deeper understanding of the nature of the risks and the potential channels of contagion. We have also built significant capacity to better monitor risks both in the banking and non-bank sectors. Overall, I would say that policymakers around the world have become more alert to system-wide risks.

Prior to the GFC, there was a common, but not universal, view that the system was fairly stable. While there were some concerns about growth in credit and asset prices, there were a number of plausible explanations suggesting that the stability of the global financial system would continue. Among these were the long period of global macroeconomic stability and low inflation that was expected to continue and that low yields were a natural consequence of the flow of savings from Asian economies. There were alternative, more pessimistic views centred around the view that investors were seriously underestimating risk and taking on too much leverage. But the more prevalent view seemed to be that the diversification of risk made possible by financial innovation, and the relative strength of capital and liquidity levels, would stand the system in good stead. You could say it had a 'this time is different' flavour.

While recognising these arguments, policymakers in Australia never entirely bought into this. The experience with losses in commercial property in the late 1980s, the collapse of HIH in 2001 and the housing boom in the early 2000s perhaps made Australian regulators a little more circumspect. APRA had therefore maintained a strong supervisory focus on the Australian financial institutions. But we were also fortunate in Australia that the boom in commodity prices and substantial rise in the terms of trade through the 2000s produced a very favourable economic environment at a time when many of the major economies moved into recession. It was probably also fortuitous that there had been a bit of a shake-out in the housing market in Australia in 2004/05 so we were not in a boom phase when the GFC hit. All of these factors resulted in the Australian financial system coming out of the GFC in relatively good shape.

Post-GFC, however, policymakers globally (including Australia) are more exercised about system-wide risk. This has resulted in three changes: more scrutiny of the global financial system, strengthened regulation and a greater willingness to respond when risks appear to be rising.

One concrete outcome of this at the global level was the creation of the Financial Stability Board (FSB) in 2009, successor to the Financial Stability Forum (FSF). The FSF had been set up by the G7 finance ministers and central bank governors in 1999 to enhance international cooperation to promote stability in the international financial system. Australia was a member of the FSF. Following the GFC, the G20 called for the FSF's membership to be broadened and its effectiveness to be strengthened. This resulted in the establishment of the FSB with a broader membership and mandate. Specifically, it was to promote international financial stability by coordinating national financial authorities and international standard-setting bodies as they have worked toward developing strong regulatory, supervisory and other financial sector policies. This involved assessing vulnerabilities affecting the global financial system and proposing actions to address them, promoting implementation of financial sector regulation and policies and monitoring implementation of the agreed reforms. This has taken the FSB into such areas as supervision, resolution regimes, derivatives markets, shadow banking, compensation practices, data and disclosure, and legal and accounting issues. And the FSB is actively looking for the next potential source of systemic risk. At its most recent meeting, for example, it considered issues raised by FinTech, misconduct and climate-related financial exposures.

On the regulatory side, the international standard-setting bodies looked to lessons learnt from the crisis and in some cases revised their standards. The Basel Committee on Banking Supervision introduced a significantly strengthened capital and liquidity framework for banks, with additional requirements for the global systemically important banks, or G-SIBs. Minimum capital levels were increased, capital buffers incorporated, and leverage ratios and liquidity requirements introduced. Disclosure requirements in banking and the financial markets increased. Australia has followed this international move. APRA increased capital requirements, and applied the liquidity coverage ratio (from 2015) and net stable funding ratio (to commence from 2018) to larger and more complex Authorised Deposit-taking Institutions (ADIs). And it is working on implementing the recommendation of yet another financial system inquiry, undertaken by David Murray, that Australian banks' capital ratios should be 'unquestionably strong'.

Standards covering financial market infrastructure were also strengthened and supervisory oversight increased. Central counterparties (CCPs) and securities settlement facilities generally performed well through the GFC. CCPs in particular withstood the default of Lehman Brothers, although the complete resolution was complicated and took some time. This resulted in increasing regulatory pressure for securities and derivatives to be cleared through CCPs, making them even more systemically important. Regulatory oversight increased along with this increase in importance, with attention focused on risk management and loss absorbance capability of CCPs, recovery plans and resolution in the event that the CCP was unable to recover. International work in this area is ongoing, with the FSB releasing a consultation paper on CCP resolution in February. As overseer of the stability of central counterparties in Australia, the Reserve Bank has been applying these new standards to domestically operating CCPs, the most prominent ones being the ASX CCPs for equities and derivatives.

Finally, there seems to be more willingness for regulators and policymakers to take action if they see risks building. Prior to the GFC there was a school of thought that because asset price bubbles could not be detected in advance, it was better to clean up after any bust, rather than lean against the cycle with policy. This was not the only view, however, and some policymakers had argued for a number of years that there were indicators that could be used to detect financial imbalances and that in some circumstances policy settings should take these imbalances into account.[1]

Post-GFC, there has been some swing to this latter view. There is now more acceptance of the need to take action when system-wide risks are rising. This is reflected in the increasing use of what are commonly known as macroprudential policies.

As my colleagues David Orsmond and Fiona Price note in a Bulletin article in December 2016, there is no universally accepted definition of macroprudential policy.[2] They define it as 'the use of prudential actions to contain risks that, if realised, could have widespread implications for the financial system as a whole as well as the real economy.' They also note that the use of such tools has increased in a number of countries post-GFC.

In Australia, we see macroprudential policy as part and parcel of the financial stability framework. As we have set out on other occasions, the essence of macroprudential policy is that prudential supervisors recognise potential system-wide risks in their supervision of individual institutions and react accordingly.[3] APRA can and does take an active supervisory stance, modifying the intensity of its prudential supervision as it sees fit to address institution-specific risks, sectoral risks or overall systemic risk. A recent example might help to illustrate this.

In 2014, the Australian regulators took the view that risks were building in the residential housing market that warranted attention. There was very strong demand for residential housing loans, particularly by investors. Price competition in the mortgage market had intensified and discounts on advertised variable rates were common. There also seemed to be a relaxation in non-price lending terms. The share of new loans that were interest only was drifting up and the growth of lending for investment properties was accelerating. Unsurprisingly in this environment, the growth in housing prices was strong, particularly in Melbourne and Sydney.[4]

The regulators judged that more targeted action was needed to address the risks – to put a bit of sand in the gears. So APRA tightened a number of aspects of its supervision. It indicated that it would be alert to annual growth in a bank's investor housing lending above a benchmark of 10 per cent. It also set some more prescriptive guidelines for serviceability assessments and intensified its scrutiny of lending practices. ASIC also undertook a review of lending with a focus on whether lenders were complying with responsible lending obligations.

There is no doubt that the actions did address some of the risks. Nevertheless, the early experience suggests that, while the resilience of both borrowers and lenders has no doubt improved, the initial effects on credit and some other indicators we use to assess risk may fade over time. We are continuing to monitor their ongoing effects and are prepared to do more if needed.

Where to from here? With the GFC close to 10 years ago now and a substantial amount of regulatory reform having been undertaken, the focus is turning to implementation and taking stock of the effectiveness of the reforms. This is reflected in the FSB's current agenda. But there is also some thinking to be done about how monetary policy considerations should factor in financial stability issues, and the role that macroprudential policies might play in addressing system-wide risks in a low interest rate environment.

In conclusion, I would like to return to the question I posed at the beginning of this talk, and in fact the question I posed myself when I first came into this area a few months ago – has the way we look at financial stability changed since the GFC? While the basic way we look at financial stability has not changed, experience with the GFC reinforced the need to focus on system-wide issues. We need to spend time analysing them and thinking about whether policy responses might be required. We are still learning how best to do this.

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[1] Bloxham, P, C Kent and M Robson (2010), Asset Prices, Credit Growth, Monetary and Other Policies: An Australian Case Study, RBA Research Discussion Paper No 2010–06.

[2] Orsmond, D and F Price (2016), 'Macroprudential Policy Frameworks and Tools', RBA Bulletin, December, pp 75–86.

[3] Ellis L (2012), 'Macroprudential Policy: A Suite of Tools or a State of Mind? ', Speech at Paul Woolley Centre for the Study of Capital Market Dysfunctionality Annual; Conference, Sydney, 11 October.

[4] RBA (Reserve Bank of Australia) (2014), Financial Stability Review, September.