

Sixth Sir John Crawford Lecture — Synopsis

Re-thinking Financial Regulation in Light of the Global Financial Crisis: Getting the Balance Right

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1. The Global Financial Crisis: where did it come from?

Something old and something new

At one level the Global Financial Crisis (GFC) is just the latest in a series of bubble events scattered through the history of financial markets. We have witnessed the rapid deflation of an asset-price bubble that took a decade and a half to inflate. As asset prices collapsed in the face of widespread de-leveraging, credit markets seized and banks stopped lending. This merely transmitted the contagion to the real economy where businesses struggled to raise working capital and suffered sharply declining sales volumes as households rushed to cut their consumption, increase saving and repay debt. One feature which distinguishes this crisis from previous similar episodes is the swift and vigorous deployment of macroeconomic stabilisation policy by governments around the world.

High savings and low yields spur leverage

Leading up to the events of September 2008, when the ‘credit crunch’ suddenly transformed into the ‘global financial crisis’, a global savings glut had emerged, largely reflecting savings behaviour in East Asia but in recent times also supported by oil surpluses in the Middle East. Global rates of inflation were low and falling, and government macroeconomic policy in many developed economies lowered official interest rates. This, in turn, reduced relative returns to saving. Excess savings and low returns from traditional savings instruments fostered a willingness in the private sector to enhance returns by assuming higher levels of risk. The financial sector responded by creating a vast array of innovative financial products, slicing, packaging and repackaging risk to be sold on capital markets to yield-hungry investors.

This resulted in a financial system characterised by:

- strong interconnections and linkages globally—credit risk was spread widely through securitisation and there was a growing inability to ascertain the size and location of underlying exposures;
- opaque investment instruments, including asset-backed securities, paired with market hubris which led to widespread underpricing of risk; and
- highly leveraged balance sheets which rendered investors and financial entities vulnerable to sudden movements in interest rates.

The sudden switch from greed to fear

During the initial credit crisis, direct losses to the banking system from sub-prime mortgages in the USA were not large compared with financial sector assets. But the contagion of fear to other securitised products and derivatives weakened financial institutions' balance sheets (as asset prices fell), irreparably in some cases, destroying trust in counterparties. The crisis of credit soon became a crisis of liquidity as counterparties in capital markets no longer trusted one another and financial institutions hoarded liquid assets. The swap/LIBOR spread (an indicator of risk premiums in interbank markets) rose dramatically following Lehman Brothers' collapse, rising to more than 100 basis points in Australia's case and more than 125 basis points in the USA.

The convulsion in global financial markets soon transmitted to the real economy. While the financial crisis has affected all major economies, those that experienced a housing price bubble beforehand have been hit hardest. This includes the USA, the UK, a handful of Western European countries (e.g., Spain and Ireland) and much of Eastern Europe. Aspects of the economic fallout have included restricted credit supply in wholesale and retail markets, large losses of income and jobs, and massive corporate failures.

2. What have we learned about financial markets and their regulation?

The need to balance stability and efficiency

Financial institutions and markets are regulated precisely to avoid costly episodes of instability like the GFC. Designing optimal financial regulation is the search for balance between the wealth-enhancing properties of competitive markets and the wealth-destroying propensities of market instability. Too much regulation comes at the expense of efficiency whereas too little comes at the expense of stability. The GFC calls into question whether the current balance between efficiency and stability is correctly struck. Recent innovation, especially in financial markets, has improved efficiency but arguably at the expense of systemic stability.

Faith in the stability of financial markets has been shaken by the GFC. There has been a rapid retreat to traditional balance-sheet intermediaries (banks and insurance companies) and a serious loss of confidence in financial markets. New financial institutions and products touted as transparent turn out to be nothing of the sort. Reports of the death of 'information asymmetry' – the conceptual foundation of financial intermediation – appear to have been exaggerated.

A 'bank run' can happen in financial markets

The chief lesson of the GFC is that financial markets can suffer the equivalent of a run on the banking system. The notion that markets are swept by waves of sentiment from time to time is not new; nor is the observation that asset prices overshoot their fundamental values as asset-price bubbles inflate and subsequently burst. The truly startling dimension of the GFC is not that asset prices deflated suddenly as borrowers sought to de-leverage their positions but that markets for certain assets, including Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDS), simply ceased to operate.

Efficient Markets Theory contemplates asset prices moving to whatever level is needed to clear the market in the face of changing expectations of future cash flows. In theory, there will

always be a market price, even if it gyrates wildly from day to day or minute to minute. But the complete disappearance of markets is an entirely different matter. When markets closed, the very basis of assessing the solvency of entire institutions evaporated. In addition, assumptions about the liquidity of portfolios filled with (allegedly) tradeable securities were proven utterly unfounded. The GFC exposed market prices as far less reliable for the range of purposes to which they had been addressed than was hitherto understood.

Information asymmetry more pervasive than first thought

The GFC demonstrates that financial markets can portray merely the illusion of information symmetry and that, once confidence has been shattered, tradeable securities can be no more liquid than claims on a failed bank. Securitisation itself has been discredited as potential investors reject asset-backed securities, including RMBS, on the grounds that they cannot be certain that such parcels do not include ‘toxic’ assets.

A key lesson from the GFC is that information asymmetry is more pervasive than first thought and many of the SIVs held out to capital market investors as transparent are just as opaque as bank balance sheets. That they have not been regulated like bank balance sheets explains why the GFC is a repeat of history. Systemic instability induced by crises of confidence in markets appears no less lethal to economic activity than bank runs.

Time to re-strike the balance between stability and efficiency

If capital markets behave more like financial intermediaries than first thought, especially during a crisis, the case for treating them differently for regulatory purposes must be re-considered. So must be allocation of responsibilities among various financial regulators. The grounds on which different parts of the financial system are regulated differently, and by different regulators, have been fundamentally challenged by the GFC. The balance between efficiency and stability in financial systems needs to be re-calibrated.

3. Why was Australia’s experience of the GFC comparatively benign?

No single factor explains Australia’s relatively benign experience of the GFC. Various aspects of Australia’s financial and economic circumstances going into the crisis insulated us from the worst aspects of overseas experience. These include the following:

Strong financial institutions

The Australian banking system was well capitalised and profitable going into the crisis. Indeed, Australia’s banks have maintained their AA rating and profitability throughout the GFC. Their high credit ratings reflect a combination of prudent regulation, less aggressive lending and securitisation practices, and having learned lessons from the heavy loan losses incurred in the recession of the early 1990s. It could even be argued that Australia’s ‘four pillars’ policy (which prohibits mergers among Australia’s four largest banks) shielded the major banks from competition that might otherwise have induced them to adopt more aggressive (i.e., riskier) lending practices.

Australia's underlying economic strength

The Australian economy was in good shape going into the GFC, enabling it to weather the storm better than other advanced economies. Strong demand for raw materials produced a sustained rise in global commodity prices. This produced a once-in-a-generation upswing in Australia's terms of trade and helped unemployment fall to a low of 3.9% in early 2008.

Monetary policy was tight as the RBA battled rising inflation, leaving plenty of scope to cut interest rates when the GFC broke. The Australian Government's fiscal position was strong, allowing ample scope for a large fiscal stimulus to support growth. Importantly, unlike most other OECD economies, Australian house prices did not collapse during the GFC. While house prices in Australia have risen appreciably, they were supported by strong demand for housing and there were no significant pockets of excess supply. Australia was spared this compounding influence on the virulence of the GFC.

Sound financial regulation

Relatively recent experience of the potential for leverage to end in financial disaster forearmed Australia's banks and regulatory authorities against the GFC. Further lessons were learned when HIH, Australia's largest insurance company, failed in 1998 soon after the new stand-alone prudential regulatory agency, APRA, came into existence. A collapse of this magnitude, together with scrutiny at the hands of the Royal Commission which followed, seared the event into APRA's corporate memory and has coloured the regulator's approach to its responsibilities ever since.

The strongest indication that Australia's financial regulators made a positive, albeit not exclusive, contribution to our benign experience of the GFC is the recommendations for improvements to financial regulations that are emerging from post-GFC investigations overseas. Most of the recommendations for strengthening global financial regulations already apply in Australia, or are in the process of being applied, by our regulatory authorities.

4. What regulatory changes might be considered going forward?

Pressure to co-ordinate and harmonise

Pressure to coordinate or harmonise financial regulation across national borders has intensified in the aftermath of the GFC. The ease of contagion from one national financial system to another has been a key lesson of the GFC, as has the scope of the challenge facing national regulators operating in a globalised financial environment.

The G20 review of financial regulation focuses on a number of strategies:

- developing a system-wide approach to financial regulation;
- widening the scope of regulation to all 'systematically important financial institutions, markets and products';
- ensuring that there are mechanisms for continual updating of regulatory frameworks;
- oversight of credit rating agencies;
- measures to dampen 'pro-cyclicality', including mandatory accumulation of excess capital and liquidity buffers in good times and revision of fair value accounting methods;

- building more homogenous and transparent OTC markets and infrastructure;
- reforming executive compensation schemes and internal risk management;
- effective enforcement of standards by regulators; and
- IMF publication of regular Financial Sector Assessment Programs to promote the transparent assessment of regulatory regimes.

Implications for Australia's financial regulatory regime

Generally speaking, Australia already operates a system with the desirable characteristics identified by the G20 or is on the way to doing so. Where this is not yet the case, the proposals are consistent with the underlying logic and practice of financial regulation in Australia. Most fundamentally, Australia already employs a system-wide and integrated approach to financial regulation and has done so since the Wallis Inquiry of 1996-97. Accordingly, our system stands in stark contrast to, for example, the US system of separate federal and state-based regulators and non-integrated supervision of banking and insurance. The adoption of a more systemic approach to regulation in other countries should improve co-ordination, information gathering and risk assessment, reducing external threats to Australia's financial system.

While the changes proposed by the G20 are not inconsistent with the logic of Australia's existing prudential framework or with reforms already under way in Australia, the question remains how free Australia's regulators will be to calibrate prudential standards to local conditions and, in any case, how independently in practice Australian authorities can act of decisions taken offshore. Given that Australian prudential regulation is already in advance of practice in many countries affected by the GFC and that the logic of proposed reforms is not inconsistent with the approach taken in Australia, there should be scope for Australian regulators to act independently of international norms. Credibility of Australia's regulators is essential to effective recognition of their actions by international agencies and foreign regulators.

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