

Re-thinking Financial Regulation: *getting the balance right*

Sir John Crawford Lecture

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What caused the GFC?

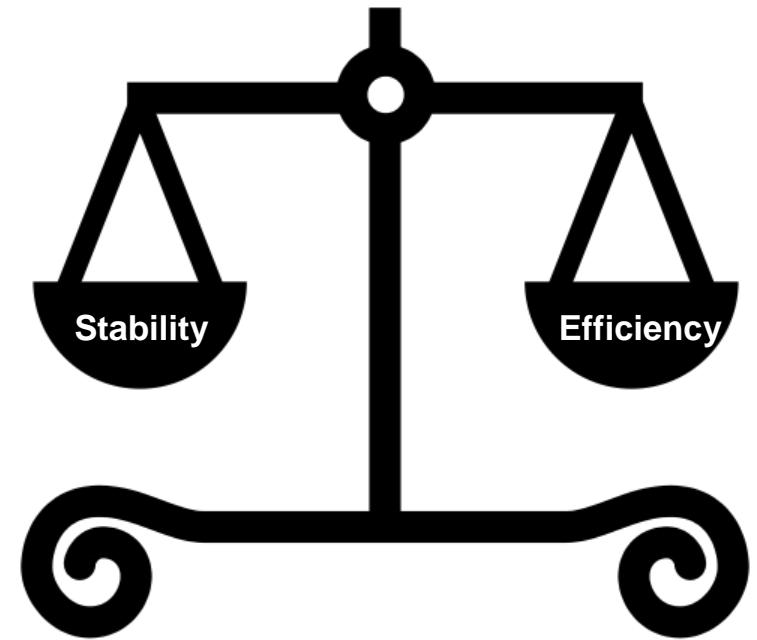
- At one level, the GFC is just another in a long sequence of financial crises over the centuries...
 - Niall Ferguson's *Ascent of Money*
- The savings 'glut' meets financial innovation
 - high savings in East Asia plus Middle East oil surpluses flood global capital markets
 - falling yields and rising asset prices spur leverage through innovative financial instruments
- Greed turned to fear when the US Government allowed Lehman Brothers to collapse

What have we learned?

- Systemic risk is pervasive and lethal, and afflicts financial markets as much as financial intermediaries
 - excessive leverage is still the underlying source of asset price bubbles but the capacity for leverage is greatly expanded in a globalised financial system
- Financial markets can suffer the equivalent of an irrational 'bank run'
- Asymmetric information is more ubiquitous than first thought
 - securitisation also suffers from information asymmetry in spite of the 'transparency' of the instruments and vehicles involved

Balancing stability and efficiency

- Optimal financial regulation has always sought to balance stability against efficiency
- Chief lesson of the GFC is the need to re-strike this balance going forward ...



Why did Australia fare so well?

- Pre-conditions for the GFC were largely absent in Australia
 - our financial institutions were strong
 - good returns available domestically kept our banks away from riskier investments overseas
 - our financial regulations were sound and had been tightened following the 1990s recession and the failure of HIH Insurance
- Underlying strength of the Australian economy
 - facilitated early and significant intervention
 - kept us clear of house price collapses as population growth has been strong

Proposed regulatory changes

What is the G20 proposing?

- a system-wide approach to financial regulation
- widening the scope of regulation to all 'systematically important financial institutions, markets and products'
- measures to dampen 'pro-cyclicality'
- oversight of credit rating agencies
- more transparent OTC markets and infrastructure
- reforming executive compensation schemes and internal risk management
- effective enforcement of standards by regulators
- publication of regular IMF Financial Sector Assessment Programs

Key themes of reform

- Stronger regulation and oversight of systemically important firms
 - tougher prudential requirements to reflect the higher cost of their failure
 - crisis management groups for major cross-border firms to strengthen international cooperation on resolution
- Pressure to coordinate/harmonise financial regulation across national borders (to forestall regulatory arbitrage)
 - e.g., convergence towards global accounting standards for financial instruments, loan-loss provisioning, off-balance sheet exposures and impairment and valuation of financial assets

How should Australia respond?

- Australia's regulatory framework needs review and adjustment but not a major overhaul
 - moves are already afoot to tighten capital and liquidity standards
 - credit rating agencies now require to be licensed
- A key concern for Australia is that regulatory reforms agreed through the G20 are neither appropriate nor necessary for Australian conditions
 - debate is just beginning about how best to facilitate 'mutual recognition' of Australia's response to regulatory reform

Short-term concerns

- Will securitisation recover as a competitive force in the Australian financial system?
 - given potential reforms to disclosure and liquidity requirements, will securitisation regain its popularity as a funding alternative to on-balance-sheet financing?
- How should the Australian government withdraw from its guarantees undergirding bank deposits and offshore borrowing?
- How should regulatory responsibilities be divided among Australia's three financial regulators in a post-GFC world?

Dhanyavaad!

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