

# Bank Regulation and the Future of Banking

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Thank you for inviting me to be part of this panel on Bank Regulation and the Future of Banking.

As you know, the world of bank regulation has seen a lot of activity in recent years. This activity has coincided with a rethinking of the role of financial institutions in our societies. It has also coincided with market-based pressures to change the way that financial institutions manage their risks.

Many of the regulatory changes are quite complex and my fellow panellists – John Laker and Steven Münchenberg – are better placed than me to discuss the details. Instead, what I would like to do is to talk first about some of the implications of these changes for the financial system, including the consequences of making financial intermediation more expensive. I would then like to highlight a few of the broad regulatory issues that we are likely to confront over the years ahead.

## **The Increased Cost of Financial Intermediation**

First, the higher cost of financial intermediation.

Prior to the financial crisis, credit spreads were low, leverage was easily available, financial institutions had become highly interconnected and large maturity mismatches were common. You might remember, it was the time of the ‘Great Moderation’ – many financial assets were priced for perfection and many financial institutions had based their business models on the assumption that little would go wrong.

For a while, everything looked to be working out quite well; financial institutions were highly profitable and global growth was strong. But in reality, risk was being underpriced and there was too much leverage, and little was done to address the building vulnerabilities.

The result has been that the citizens of many advanced economies have paid a heavy price. There has also been a serious erosion of trust in the financial sector globally, with the banking industry suffering considerable ‘brand damage’. Quite rightly, many people question how global banks, with their sophisticated risk models and their highly paid staff, could have managed risks so poorly. Fortunately, in contrast to these global developments, the Australian banks have fared considerably better. But because finance is a global industry, some of the consequences of the events abroad are being felt here as well.

In the wake of this experience, it is not surprising that regulators and, to some extent the financial institutions themselves, have sought to address the various problems. Capital ratios are being increased, and the quality of capital is being improved. Maturity transformation is being reduced. And banks are holding more liquid assets. These changes are occurring not just because of new regulations, but also because they are being demanded by the marketplace.

Together, these various changes are increasing the cost of financial intermediation conducted across

the balance sheets of banks. In effect, the choice that our societies are making – partly through our regulators – is to pay more for financial intermediation and, perhaps, to have less of it. The benefit that we hope to receive from paying this higher price is a safer and a more stable financial system.

This choice has a number of related implications, and I would like to mention just a couple of these.

The first concerns lending spreads and the return on bank equity.

In particular, loan rates are likely to be higher relative to short-term money market rates than would otherwise have been the case; in effect, some of the incidence of the higher cost of financial intermediation falls on the borrowers. In addition, if banks are safer, then, all else constant, some of the incidence of high cost of financial intermediation should also fall on the owners of bank equity who should be willing to accept lower returns. But, of course, the story does not stop here. Lower returns on equity are likely to increase the incentive for bank management to take on new risks in an attempt to regain earlier rates of return. Lower rates of return may also lead to renewed efforts at cost cutting. This could have some positive effects, but if it were to involve cuts to the risk-management function, cost cutting could create new risks. And finally, to the extent that investors realise that credit and other risks are higher than they had previously thought, they might want more compensation for holding bank equity despite the efforts to make banks safer.

These various effects are quite complicated and they will take time to play out. The one change that we have already seen very clearly is a rise in loan rates relative to the cash rate. For example, during the 10 years prior to 2007, outstanding variable mortgage rates averaged 150 basis points above the cash rate. Today, this difference is around 270 basis points.

This increase is due partly to the global loss of trust in financial institutions, which has led to all banks paying more for funds in capital markets. It

is also due to the strong competition for deposits domestically, with banks prepared to pay large premiums for liabilities that are called ‘deposits’ rather than ‘wholesale funding’. It is worth pointing out that a similar dynamic is also occurring in a number of other countries where there is strong demand for deposits, including the United Kingdom, Sweden and New Zealand. In Australia, while public attention has clearly focused on the widening spread between the mortgage rate and the cash rate, there has been much less attention paid to the fact that reductions in the cash rate have not been passed through fully into deposit rates. Only a few years back, depositors did well to be paid an interest rate close to the cash rate on their at-call deposits, and not long before that they were paid well below the cash rate. In stark contrast, today there are a number of deposit products that pay about 2 percentage points above the cash rate.

In effect, what we are seeing as a result of both market and regulatory developments is an increase in most interest rates in the economy relative to the cash rate. This is something that the Reserve Bank has spoken about at length and it has been an important factor in the setting of monetary policy over recent years. In particular, this increase in interest rates relative to the cash rate has been offset by the Bank setting a lower cash rate than would otherwise have been the case. While it is difficult to be too precise, the cash rate today is in the order of 1½ percentage points lower than it would have been in the absence of these developments.

A second broad implication of the increase in the cost of financial intermediation is that there is likely to be less of it, particularly across the balance sheets of banks. This effect is being compounded by a reduced appetite for debt by the private non-financial sector.

One area where banks are likely to find it more difficult than in the past is in lending to large businesses. Given the current pricing, many large businesses can raise funds more cheaply in capital markets than banks can, even where the credit rating

of the business is lower than the bank. In part, this reflects the brand damage done to banking which is unlikely to be repaired any time soon. With banks paying more for funds, and being subject to a range of regulatory requirements, they are likely to find it hard to intermediate between savers and the large borrowers that can go directly to the savers. This will, no doubt, provide opportunities for some banks as they help businesses connect directly with these savers, but other banks will need to focus even more on lending to households and small and medium businesses. These structural changes will bear close watching over the years ahead.

### Some Regulatory Issues

I would now like to turn to the related topic of the future direction of financial regulation. This is obviously a very broad topic, but there are three issues that I would like to touch on. These are: the importance of system-wide supervision; the regulation of innovation in the financial system; and the interconnections between financial institutions.

First, the importance of supervision.

One of the clearest lessons from financial history is that the financial sector has an uncanny ability of finding ways of connecting savers with borrowers. When obstacles are put in the way, detours are often found. New forms of financing pop up. New institutions develop. New products come into play. We saw numerous examples of this in Australia in earlier decades, and there are many overseas examples as well, some of which are quite recent.

This intrinsic flexibility of finance is one reason why the international regulatory community is spending a lot of time thinking about so-called 'shadow banking'. There is a legitimate concern that current efforts to tighten regulation will push activities off banks' balance sheets, in time creating new risks to the global financial system. While tighter rules were clearly needed in some areas, we need to remain aware of the limitations of rules alone.

Looking back over the global experience of recent years, it seems that in some jurisdictions rules have been viewed as a substitute for supervision. This has been a mistake. The preservation of financial stability cannot be achieved by rules alone. It requires active and competent supervision.

Importantly, a good supervisor needs a whole-of-system focus. The supervisor needs to think about the consequences of institutions following similar strategies. It needs to examine closely the interconnections between financial institutions, including those outside the formally regulated sector. It needs to examine developments in aggregate credit growth, construction activity and asset prices, and how these aggregates are distributed across the country. And it needs an understanding of how the competitive dynamics in the system are changing. And then having thought about these issues, the supervisor must be willing, and able, to act and constrain activities that pose unacceptable risks to the financial system. Judgement, not rules, is the key here.

On this score, Australia has been well served by APRA's approach to supervision, which has had an industry-wide focus. APRA has been supported in doing this by the Reserve Bank and by the Council of Financial Regulators which has regular discussions about system-wide developments. It is important that as the new rules are agreed and implemented, this strong focus on system-wide supervision is retained.

The second issue – and one that has probably not received the attention that it deserves – is how regulation should deal with financial innovation.

Over many decades, our societies have benefited greatly from innovation in the financial system. Financial innovation has delivered lower cost and more flexible loans and better deposit products. It has provided new and more efficient ways of managing risk. And it has helped our economies to grow and our living standards to rise.

But financial innovation can also have a dark side. This is particularly so where it is driven by distorted remuneration structures within financial institutions, or by regulatory, tax or accounting considerations. Problems can also arise where the new products are not well understood by those who develop and sell them, or by those who buy and trade them.

Over recent times, much of the innovation that we have seen has been driven by advances in finance theory and computing power, which have allowed institutions to slice up risk into smaller and smaller pieces and allowed each of those pieces to be separately priced. One supposed benefit of this was that financial products could be engineered to closely match the risk appetite of each investor. But much of the financial engineering was very complicated and its net benefit to society is debateable. Many of the products were not well understood, and many of the underlying assumptions used in pricing turned out to be wrong. Even sophisticated financial institutions with all their resources did not understand the risks at a microeconomic and system-wide level. As a result, they took more risk than they realised and created vulnerabilities for the entire global financial system.

Recently, a number of commentators have turned their attention to how society might improve the risk-return trade-off from financial innovation, in particular the question of how we obtain the benefits that innovation can deliver while reducing the risks. Doing this is not easy, but a common thread to a number of the proposals is for greater public sector oversight of areas where innovation is occurring.

There are considerable challenges here, but it is useful to think about how this might be done in practice. I suspect that the answer is not more rules, for it is difficult to write rules for new products, especially if we do not know what those new products will be, and the rules themselves can breed distortions. But to return to my earlier theme, one concrete approach is for supervisors and central banks to pay very close attention to areas where innovation is

occurring: to make sure that they understand what is going on and to test, and to probe, institutions about their management of risks in new areas and new products. And ultimately supervisors need to be prepared to take action to limit certain types of activities, or to slow their growth, if the risks are not well understood or not well managed.

The third issue is the interconnections between financial institutions.

These institutions, by their very nature, are often highly interconnected: they hold one another's liabilities and they trade with one another extensively in financial markets. These interconnections are an important part of a well-functioning financial system and they have tended to increase over time as finance has become more important to economies and more globalised. However, these interconnections bring risks, and addressing these risks has been an important element of the global regulatory reform work over recent times.

There are a number of dimensions to this work. These include moves requiring foreign banks to set up subsidiaries, rather than branches, and efforts to increase margining in financial markets. But the one dimension that I would like to talk a little about is the greater use of central counterparties. These counterparties replace bilateral connections with connections to a central entity whose job it is to manage risk. By doing so, they hold out the promise of a more stable financial system.

There are, however, some complications, so in pursuing these benefits we need to proceed with care.

While a central counterparty reduces bilateral exposures, it does create a single point of failure – if the central counterparty fails every participant is affected. This means that the risk-management practices of the central counterparty are very important, and designing and implementing the appropriate regulatory arrangements is an ongoing task. So too is understanding the implications of any

increase of demand for collateral assets that might arise due to greater use of central counterparties.

Another complication is that it is typically quite costly for every participant in financial markets to become a member of a central counterparty. This means that some participants need to use the services of another institution that is a member of a central counterparty. If many participants use the same intermediary institution, then an extensive set of new bilateral interconnections will have been created and this introduces new risks that need to be managed. Indeed, since there are economies of scale in the provision of these intermediary services, there is a clear potential for concentration.

A third complication is that there is not a single central counterparty and not all dealings in financial instruments will go through a central counterparty. The issue of how various central counterparties relate to one another, and compete with one another, is important. So too is understanding how the bilateral exposures between institutions change when some types of transactions go through a central counterparty and others do not.

These are difficult issues and it is important to get the details right. I encourage you all to think about them and to remain actively involved in the debates.

## Conclusion

Finally, it is worth repeating that the Australian banks have fared better than many of their international peers over recent years. This is partly because of the strong economic outcomes in Australia as well as APRA's approach to regulation and supervision. But it also reflects the Australian banks' higher lending standards than in some other parts of the world and their relatively limited exposure to innovative, and ultimately quite risky, financial products.

While Australia did not have a financial crisis, the North Atlantic crisis is having a significant impact on our financial system. This is occurring through the tightening of regulation and though developments in the marketplace. Many of these changes are positive and, over time, they should enhance the safety and resilience of our financial system. But as these changes take place, all those interested in finance need to do their best to understand the impact on the cost and availability of finance. And we should not lose sight of the importance of system-wide supervision, including understanding the innovations in both the Australian and the global financial systems.

Thank you. ✎

