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'Managing Risk in Financial Markets'

Address to Capital Market Dysfunctionality Conference

University of Technology Sydney

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I will give a Government perspective on the topic of managing risk in the financial system. Firstly, I will make some general comments about the nature of risk in financial markets; secondly, the impact of the GFC on financial markets in Australia; and thirdly, the Government's response to systemic market dislocations.

Managing financial market risk goes to the heart of how governments operate. Governments want to be able to oversee a growing economy, they want their citizens' wellbeing to improve over time, and they need to be able to provide appropriate safety nets for the disadvantaged. To be able to do this, governments must have well-functioning financial markets.

And for some time we had that. It seemed that we had thrown off the shackles of the lows of the traditional business cycle and that continued growth could be expected over time.

Risk and uncertainty

In the run up to the Global Financial Crisis, we saw greater development in financial markets which largely brought benefits to the community, but also brought with it significant risks.

We know that as countries develop and become richer, companies and households increasingly acquire financial assets and liabilities; the stock of which rises faster than incomes.

Second, as financial markets become developed, the stock of assets, both financial and physical, is increasingly acquired with debt. The third effect has been the significant amount of financial innovation that has occurred leading into the GFC. This innovation brought with it, in certain instances, greater complexity. This increase in complexity, notably in wholesale financial markets, was one of the contributing factors to the GFC. Whether it is the complexity itself, or the inability of agents to adequately take account of these risks, we end up with the same result — a serious mispricing of financial assets.

At the same time, financial markets bring with them some key challenges.

Financial intermediation is both inherently risky and critical to economic stability. It is because the banking industry contains such risks that it can suffer severe contractions without careful macroeconomic management by Government. And because banking is critical to a modern economy, if it does collapse, it can be disastrous for the rest of the economy.

Aligned to this is the structure of incentives in the financial sector and the relationship between risk and return. The central tenet in modern finance being that investors are naturally risk averse, so in exchange for taking on more risk they demand higher return. Therefore, riskier assets tend to have lower prices and these produce higher expected returns.

Of course, a well-managed financial firm takes calculated and limited risks, risks that will make money for the firm if they pay off, but will not destroy the firm if they do not. But why did major firms — such as AIG and Lehman Brothers — take risks that were critically unbounded, albeit low in probability?

In addition, we just have the uncertainty of financial markets. Investment decisions are often made in a setting of uncertainty because, by the time the investment can yield a return, the conditions determining its profitability may have changed. Some unanticipated changes can be hedged.

But rarely can all unanticipated changes be hedged, especially those that are uncertain to occur because it is difficult or impossible for an insurer — whether an insurance company or an issuer of a credit default swap — to calculate a premium. The low-probability events, which can trigger systemic problems, are very difficult to guard against, especially when such an event is transmitted through a financial system as a result of the interconnectedness of firms.

In light of those risks, where does this place a Government which wishes to act in the best interests of its citizens? How does it reach the balance between stability and competition and innovation while avoiding systemic risks arising domestically or globally?

The effect of the GFC on Australia

Governments have few policy tools to reach this balance. The overarching tools of monetary policy that seek to manage the supply of credit and, in this context, to avoid asset bubbles, has been commented on. The policy tools I wish to talk about are the rules that can be put in place to guide the behaviour of firms — the governance arrangements in firms, and the role of supervision.

In general, governments have sought to devise a range of responses that provide them with some assurance that all measures have been taken that will lessen the chances of a future systemic global shock.

Before discussing the Government's response, I want to make some comments on the impact of the GFC in Australia which we know was much more moderate than in other countries. I do so because this is the underlying rationale for the actions that have been taken by the governments of the G20 nations.

During the GFC, Australia saw how quickly poorly-functioning markets can damage the economy.

Between November 2007 and June 2009, the value of the ASX dropped by about 41 per cent, causing significant losses for investors and the superannuation fund sector.

According to data from the Australian Prudential Regulation Authority, after years of steady growth, the annual rate of return across all types of Australian superannuation funds dropped from 14.5 per cent in June 2007 to minus 8.1 per cent in June 2008, and minus 11.5 per cent in June 2009.

Unemployment increased from 4.1 per cent in February 2008 to 5.8 per cent in August 2009.

While the Australian economy has performed strongly over the past four years, households are still feeling the effects of the GFC today.

SuperRatings, an independent Australian rating company which reports on pension fund investment returns, reported that for the 2011-12 financial year, the median balanced option in Australian superannuation funds was 0.4 per cent.

The median balanced option refers to ‘balanced’ options with exposure to growth-style assets of between 60-76 per cent. Approximately 60-70 per cent of Australians in the major pension funds are invested in their funds’ default investment option, which in most cases, is the balanced investment option.

While the Australian economy grew strongly over the 2011-12 financial year, the combined effects of global economic uncertainty, and the domestic considerations of the ASX have meant that consumer confidence continues to be subdued. This has led to increased consumer caution, as households have been actively shifting their investment portfolios towards more conservative assets such as bank deposits.

In summary, I have mentioned the domestic impacts. I will not dwell on the ongoing international ramifications as we currently see that reported daily.

I will now move on to the Government’s response.

G20 reform agenda

As part of the worldwide response to the GFC, Australia continues to work with other members of the G20 to implement new global standards for financial regulation.

The G20 structural and regulatory reform agenda is designed to enhance medium-term growth prospects and build more resilient financial systems. Each nation is also working to strengthen confidence in its banks.

Basel III

The G20 objectives for financial markets are seen in the new capital and liquidity rules for financial institutions and financial market infrastructures.

Basel III has been developed to apply the lessons learned from the GFC, specifically by increasing the stability and resilience of both domestic and global financial systems by strengthening the regulation, supervision and risk management of the banking sector.

The measures are designed to improve the ability of the banking sector to absorb shocks, improve risk management and governance, and strengthen banks' transparency and disclosure.

Basel III will also promote international consistency in financial sector regulation, by reducing national discretion and ensuring regulators have less capacity to lower standards. The Basel Committee on Banking Supervision considers that there is a collective interest in agreeing to a set of minimum standards to be applied by all its members.

In Australia, Basel III will impose new capital and liquidity requirements on Australia's banking sector and reforms to over-the-counter derivatives markets.

For Australia, it's important that our financial institutions are not only well regulated, but are seen to be well regulated by other economies. As Australia's banking system relies in some respects on foreign funding, we need to ensure that we maintain our international reputation for sound economic management.

The Basel III standards are being implemented with some adjustments to meet Australia's circumstances, as allowed by the Basel Committee.

While the adjustments include an accelerated timetable for adopting the minimal capital requirements, I note that the larger Australian banks already meet the 2013 higher capital requirements, and should be able to meet the 2016 target with a prudent earnings retention strategy.

Effectiveness of Basel III

Basel III sets out a sound and effective way forward for the world's banking systems. Yet it has attracted its share of detractors. Recently, two senior regulators criticised Basel III, calling for it to be reworked in favour of more simple rules.

There are two practical problems with this argument. Firstly, it is simply too late to change course — economies around the world are in the process of implementing the Basel III recommendations. Secondly, opening up Basel III to renegotiation would most likely end in a stalemate.

Basel III has also been criticised for increasing the operating costs of financial institutions. Yet a study by the IMF, *Estimating the Costs of Financial Regulation*,[1] published last month, estimated that average bank lending rates are likely to increase in the long term by relatively small amounts.

The IMF paper put these figures into perspective by pointing out that the smallest increment by which major central banks adjust their short-term policy rates is 25 basis points, and that this tends to have a small effect on economic growth. Of course, adding safety margins to the financial system comes at a price. In effect, governments which adopt the substantially stronger capital and liquidity requirements set out in Basel III are taking out an insurance policy against another economic crisis.

The second tool which Governments have at their disposal is the governance arrangements in place in firms.

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[1] *Estimating the Costs of Financial Regulation*, International Monetary Fund Staff Discussion Notes, 11 September 2012

Governments have acted to seek to reduce the perverse incentives that arise in financial firms, through better remuneration practices and more fulsome disclosure of business activities.

As well, the market itself disciplines the failure of firms and individuals. However, the ramification of that failure for the rest of the community highlights the importance of appropriate standards of behaviour and the need for sensible risk taking in terms of business decisions.

Accountability structures within firms, boards that understand the business of the firms and the potential risks that their business is engaged in, and transparent disclosure practices to the market would all contribute to better governance.

The third tool is effective supervision. We are internationally recognised for the skill and expertise of our financial regulators. The Governments I have worked for have always been supportive of their regulators. This was the case long before the GFC. Effective supervision is essential to mitigate potential financial market risks. That said, there will always be tension between business and regulators in terms of sufficiency of capital, available liquidity and prudent management.

A dialogue between business and the regulators is to be encouraged. This is one way that the risks in the system become more visible and agents can take action to address those risks.

In my view, prescriptive rules are necessary to provide a framework in which institutions can operate. Sound corporate governance principles and a proactive approach to complying with relevant regulation are essential to ensuring that the risks inherent in the financial system are managed effectively.

Each of these tools, rules, governance and supervision is brought to bear by Governments to give them some assurance that markets are acting in the best interests of the community. That is what the community expects of Government. For markets to work individuals have to have confidence in these markets. The Government accepts this responsibility to seek to restore that confidence.