# FINANCING THE FUTURE

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### Introduction

It's a pleasure to be here, and thank you to the organisers for inviting me to talk on the topic of financing the future.

About two weeks ago, I was in Melbourne hosting the G20 Finance Deputies' meeting and participating in the meeting hosted by Australia's G20 'Sherpa', Heather Smith. These were important working meetings to set up for the achievement of a strong outcome for the Brisbane Summit.

The G20 focus on encouraging growth and resilience in the global economy is directly relevant to the themes of this conference and this session.

So I'd like to touch on three things today:

1) Firstly, why G20 efforts to lift growth through strong action on economic reform and infrastructure is of central importance to generating a robust recovery in the global economy;

2) Second, I want to provide an assessment of the G20's progress in building global financial stability;

3) And, finally, I want to outline how these financial stability goals can be consistent with and support growth objectives over time.

**Growth agenda**

Before discussing global financial regulation, I want to start by highlighting the interaction of the G20 growth agenda and financial risk.

At their meeting in February, Ministers and Central Bank Governors committed to work together to 'shift the dial' on growth. Based on analysis from international organisations they committed to undertake ambitious but realistic policy action to achieve more than 2 per cent additional growth over the next five years.

This decision was taken because of a strong consensus that global recovery is still too weak, unemployment is still too high in many countries, and that important fragilities remain that could threaten that recovery. As the Bank of International Settlements put it rather poetically, 'the financial crisis still casts its long shadow on the world economy.'

In recent years, we have seen an extraordinary reliance on monetary policy to support growth.

Many central banks have resorted to unconventional measures to help stimulate demand and risk-taking in the private sector. While this helped to support growth and avoid deflation or even depression, all are alert to the possibility that extended low interest rates can lead to excessive risk taking in financial markets.

Monetary policy can only take us so far with our growth objective. Hence the need for concerted and coordinated implementation of economic and structural reform to stimulate private sector led growth.

A stronger joint commitment to structural reforms, and particularly those that stimulate trade, competition, employment and investment, can create the right environment where monetary policy does not have to do so much of the work. Sound infrastructure investment is key here, as it can add to both supply and demand.

Such a policy package can increase citizen well-being, and also reduce risks in the recovery by paving the way for a more balanced policy mix.

At our recent G20 Officials' meeting we reflected on progress in achieving our growth objective. Whilst they are still draft, the preliminary growth strategies include around 700 measures, 200- 300 are new measures, with many representing a substantive response to reform gaps within member countries.

The estimates suggested we were around half way there. All agreed that we will need to do more to meet the task we have set ourselves.

The next version of the growth strategies will be given additional impetus and informed by the imminent Trade Ministers' meeting and then the Employment Ministers' meeting. Ultimately, come November, we need to provide G20 Leaders with solid growth strategies to lift growth.

Furthermore, there is a view that our work to increase growth is even more critical now than when we set the task. The world outlook has, if anything, become a little less positive. Geopolitical risks have increased. There is evidence of potential mispricing of risk in some financial markets, though this is against the background of much sounder balance sheets in most of the private sector than five years ago.

The sense in recent G20 and other international meetings is that the Australian Presidency's G20 priorities are the right ones for the current circumstances. Evolving economic developments are adding further urgency to the task and this shared sense among G20 members is one of the reasons I have confidence that the G20 can deliver on its commitment.

The Treasurer is aiming to deliver on the 2 per cent Sydney growth ambition at the Finance Ministers and Central Bank Governors meeting in Cairns, to provide a solid platform for Leaders at the November Summit.

**The importance of a sound, resilient and stable financial system to boost growth and jobs**

In addition to this focus on the immediate challenge of recovery, a key task of the G20 this year is to lay the basis for longer term financial stability.

This brings me more directly to the theme of this session, 'financing the future'. This theme raises the issue of how bodies like the G20 can assist in building a financial sector that provides growth and stability, and the right combination of these.

There are two aspects to this.

The first is to build a robust and resilient system – that is, the G20 and national authorities should develop a system of regulation and institutions that provides a solid foundation to underpin activity in the real economy. This includes arrangements that both reduce the risk of damaging shocks emanating from the financial system and minimises the impact of these shocks if, and when, they occur.

The second element is to work across the G20 to ensure the global financial system gives sustained support to real investment and growth – that there is indeed ‘financing for the future’.

The global financial crisis demonstrated the catastrophic impacts financial instability can have on the real economy. We learnt the hard way that we can’t have sustainable growth without simultaneously maintaining financial stability.

The crisis also revealed fundamental deficiencies in regulatory frameworks and architecture in key economies. Banks were under-capitalised, derivatives markets were opaque and risky, and entities outside the ‘traditional’ and regulated banking sector became a major propagator of financial risk and contagion. And when major institutions failed, financial distress rapidly spread throughout the financial system.

When the crisis hit, the North Atlantic economies found many institutions were ‘too big to fail’, requiring large bailouts. This, in turn, placed considerable strain on public finances.

**What Australia wants to achieve by the Brisbane G20 Summit on financial regulation**

Australia has sought to focus the G20 financial regulation agenda on substantially completing reforms that directly address the flaws that were exposed by the crisis.

We are focusing the G20’s efforts this year on finalising key elements of four core reforms – those being:

1) building resilient financial institutions;

2) addressing ‘too big to fail’;

3) making derivatives markets safer; and

4) addressing risks in the shadow banking sector.

This is not an easy task and there is a considerable amount of work to do and much of this work has happened within the Financial Stability Board. But, by focusing the G20’s attention, we hope to complete as much as possible of the policy response to the crisis. This will support financial stability. It will also provide a more certain and stable platform from which market participants can get on with their business.

And by focussing the agenda we hope to reduce the ever present risk of regulatory over-reach. This often stems from the tendency for the regulatory agenda to grow as policy makers try to pin down every risk rather than the most critical ones. This is the point at which stability and growth trade-offs can be harmful, where the cost of regulation can outweigh the benefits secured.

But through our focus this year, I don't think we have reached this point. In my view, the four priority areas outlined above are foundational to sustained growth. They are largely about recognising and better allocating existing costs in the system.

A reasonable question to ask is: 'has the G20 agenda made the financial system safer?'

Given the early stage of reform implementation, perhaps a more sophisticated variant of this is: 'will the financial system be safer once these reforms are completed and in place?'

I think a preliminary answer to both of these questions is yes, but with important qualifiers.

In terms of the first question, I think we can point to some concrete gains that have already reduced the risk of damaging financial crises.

- We already have banks that are better capitalised and stronger liquidity arrangements are in place which makes banks more resilient to potential short-term disruptions.
  - The average Common Equity Tier 1 capital for large, internationally active banks has increased from 5.7% of risk-weighted assets at the end of 2009 to 9.5% in June 2013.[1] Prior to the crisis, the minimum requirement for common equity was 2% of risk-weighted assets, before the application of regulatory adjustments.[2]
  - As at 30 June 2013, 91% of large internationally active banks reported a Liquidity Coverage Ratio at or above the minimum requirement which comes into effect on 1 January 2015.[3]

[1] BCBS (2014), 'Basel III Monitoring Report', March, Available at <http://www.bis.org/publ/bcbs278.pdf>; and BIS (2014), '84th Annual Report 1 April 2013–31 March 2014', June, Available at <http://www.bis.org/publ/arpdf/ar2014e.pdf>

[2] Basel III increased the level and quality of capital banks are required to hold. BCBS (2010), 'The Basel Committee's response to the financial crisis: report to the G20', October, p5. Available at <http://www.bis.org/publ/bcbs179.pdf>

[3] BCBS (2014), 'Basel III Monitoring Report', March, p22. Available at <http://www.bis.org/publ/bcbs278.pdf>

- Risky exposures in the derivatives market are declining as a result of better collateralisation and the use of central counterparties.[4]
- Supervisors are more alert to the risks emanating from so called ‘shadow banks’ - that is institutions undertaking maturity and liquidity transformation outside the formal banking system. In some cases these are already being regulated more closely.
- And countries are cooperating to develop plans and monitor arrangements for ‘resolving’ failed international banks in a more orderly way. These would be tested in crisis situations, but the existence of dialogue and scenario plans means we are in a far better place than we were in 2008.

But the task is clearly not complete and further work is required to underpin the resilience of the international financial system. That is the priority for this year.

- In the area of resilient institutions, capital backstops are being finalised for large international insurers. And approaches are being developed to improve the rigour and consistency of risk weights that are applied to bank balance sheets. This is critical to the robustness of Basel capital ratios.
- In the area of shadow banking we are looking to finalise the policy framework for flexible but targeted regulation of shadow banking activity. This will address concerns that risk will just migrate from the more intensively regulated banking sector.
- In the area of derivative markets, remaining reforms will further increase transparency and reduce risk. And further work will be done to ensure consistent cross border implementation of the reforms.
- The largest challenge is dealing with institutions that are ‘too big to fail’. Here proposals are being developed for the Brisbane Summit to provide more confidence that large international banks have enough loss absorbing capacity to maintain critical functions in the event of failure. There is also work to guard against the ‘rush for the exits’ if a large international institution fails, increasing the chances of orderly cross border resolution.

[4] BIS (2014) ‘Statistical release OTC derivatives statistics at end-December 2013 Monetary and Economic Department’, May, p2. Available at <http://www.bis.org/publ/otc_hy1405.pdf>

So, if the G20 is successful, citizens can have more faith in the stability of financial institutions due to better capital and liquidity buffers. If there is a failure, more tools will be available to reduce the impact of contagion and the likelihood of resorting to taxpayer bailouts.

We will have more transparent markets, with greater visibility of the build-up of risky positions and more market discipline.

We will also have a principles-based framework in place to regulate shadow banking activity where this has systemic significance.

But of course, no one is kidding themselves that this policy agenda in itself will eliminate the risk of damaging financial disruption. For one, the reforms are only as good as the quality of supervision. This was a key lesson from Australia's and Canada's experience on the one hand, and the experience in the US and some European economies on the other.

Then there will be a necessarily long period as these reforms are fully implemented. And of course, new risks will emerge as markets react to developments and the regulation itself.

This suggests the need for constant monitoring of the build-up in financial risks, and potential interactions with the real economy.

Indeed my final reason for having some confidence that the G20 agenda is resulting in a safer financial system relates to stronger arrangements for international cooperation and dialogue, which complement the formal standards and policies being developed.

The new institutional architecture, put in place since the crisis, makes a critical contribution to a safer international financial system and economy. The strengthening of the FSB and better international surveillance by the IMF provide constant expert monitoring of financial risks.

And the existence of the G20 itself is critical. It has the right membership, covering the largest emerging and advanced economies. It ensures that the 50 top international economic policy makers – Treasurers and equivalent, Central Bank Governors and key international organisation heads – meet four times per year, and G20 leaders meet at least once per year. The G20 can monitor risk build up in 'real time' and marshal appropriate responses.

This ‘steering committee’ function is critical, which is one reason Australia is putting so much effort into reforming the format to ensure that engagement between Ministers, Central Bank Governors, and Leaders is effective. The strong agreement on the need for ambitious growth strategies in the context of identified financial risks, that I started this talk with, is but one example of this in action.

**Financing investment**

Let me make a few brief comments on the G20’s work to ensure adequate financing for investment.

This is a broad agenda which covers improving the environment for quality infrastructure investment and investment by SMEs. But there is also work underway within the G20 to enhance the range of financing options.

This is particularly important given both cyclical factors still affecting bank finance (particularly in Europe), and the *intended* impact of financial stability reform which is to place ‘safety limits’ around bank balance sheets regarding maturity and leverage.

Therefore, work in this area is aimed at ensuring the widest range of institutional and capital market financing is available. This is not only pro-growth, but can also result in a safer allocation of risks within capital markets.

**Domestic implications**

I have maintained my focus on international policy, but will make a few high level remarks on domestic implications, recognising the Financial Systems Inquiry is underway, including with a mandate to assess the effectiveness of financial regulation.

Australia’s interests in the success of the G20 financial stability agenda should be clear.

For one, we, like others have learned things about the operation of the financial system from observing events internationally. We have an interest in incorporating relevant additional safeguards, suggested by this experience, into our financial system.

Additionally, with our financial markets heavily integrated with those internationally, we have a strong interest in participating in the development and implementation of carefully calibrated standards that work for Australia’s specific circumstances.

Finally, Australia should promote a robust international system that mitigates unpredictable shocks to our economy.

And, like other countries, we have an interest in hastening the development of the widest range of financing channels to support productive investment.

**Conclusion**

In conclusion, the G20 under Australia's presidency is rightly focused on getting the global economy back on track. This matters for living standards across the G20 and also can result in a stronger and better balanced recovery with less financial risk.

In the area of financial regulation reform we are trying as much as possible to complete the response to the crisis, and move into a more business as usual 'post crisis' phase.

Of course, if the G20 and FSB are successful in achieving this year's agenda this does *not* mean the task of financial regulation and monitoring is completed. Rather, there will be a continued focus on implementation of agreed standards, and post-implementation monitoring of reforms to ensure they are delivering on policy objectives.

And we will want ongoing political focus on the need for sound financial regulatory standards, to guard against the tendency for excessive risk taking, both by markets and governments, as the memory of the crisis fades.

But progress on our financial regulation agenda will be an important step towards making the global financial system robust and resilient — perhaps the most important contribution the G20 can make to 'financing the future'.

Thank you.