SPEECHES

# Responding to the global financial crisis - What's on the reform agenda?

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Thank you for the opportunity to speak with you today about how APRA sees the policy reform agenda in the aftermath of the global financial crisis.

I thought I'd start with an economics lesson. The first words that my high school economics teacher, Mr Hoffman, wrote on the blackboard in my first economics class more than 35 years ago were:

> "*Post hoc, ergo propter hoc.*"

Those of you with a classical education may recognise this Latin phrase. It means: "After this, therefore because of this". And it is a well-known fallacy of logic: just because one event follows another does not mean that the first event caused the second event.

Mr Hoffman's message was simple: to understand economics, always analyse cause and effect; don't assume causality from circumstance. He stressed to us that, if we learnt nothing else from being in his class, we should remember this.

Understandably, when there has been a breakdown in financial markets of the magnitude of the one we are currently dealing with, there will be calls for more financial sector regulation. But, as

we think about the causes of the global financial crisis and what policy responses are needed to address those causes, we would do well to remember Mr Hoffman's advice. We should make sure

that the changes we make are well thought through and not based purely on circumstantial evidence.

The global financial crisis does not mean that a policy 'U-turn' is required and APRA does not have a long policy reform agenda to deal with the crisis.

Why not?

Firstly, it is difficult to disentangle the underlying causes of the crisis: to what extent was it a market failure; a failure of macroeconomic policy; a failure of risk management; or a failure of regulation? Clearly, each was a factor.

Secondly, even though the impact of the current crisis has been felt globally, it is apparent that some countries (notably Australia and Canada) have withstood its effects much better than others. This, notwithstanding decades of convergence of international prudential standards under the auspices of the Basel Committee on Banking Supervision. This suggests that something more than just adding another chapter to the rulebook is needed.

## Good Luck or Good Management?

It is worth taking a moment to look at why Australia has been able to cope with the global financial crisis better than most other developed countries?

In some quarters, APRA gets the credit for this; others attribute it to the 'four pillars' policy; some say Australia was just lucky.

In my view, there is no single factor underpinning Australia's relative success. Rather, I'd put it down to a combination of reasons:

1. maintenance of sound fiscal and monetary policy settings by successive Governments and the Reserve Bank (admittedly, with some assistance from a ten year commodities boom);
2. a financial market that is dominated by large and, generally, soundly-run financial institutions not prone to excessive risk-taking; and
3. active and conservative prudential supervision.

To me, each of these factors played a part; without any one of them, Australia's position might have been much worse. (Where we were lucky was getting all three right at the same time!)

## What needs to be done?

Nevertheless, Australia's experience has not been the norm. Already there have been a number of inquiries by international regulatory bodies into the causes of the global financial crisis and a number of reports have been produced advocating policy reform.

These are some of the main reports that are driving the regulatory reform agenda:

- the Financial Stability Forum Report on Enhancing Market and Institutional Resilience;
- the Turner Review – A Regulatory Response to the Global Banking Crisis;
- the G20 Report on Immediate Actions of the Washington Action Plan; and
- the Basel Committee Initiatives in Response to the Financial Crisis.

I don't propose to debate the underlying causes of the global financial crisis today. Suffice to say that there was too much leverage in the global financial system and the quality of that leverage was poor.

Clearly, some reform is warranted if we are to prevent a recurrence of this: in some countries, substantial reform is needed. APRA is looking closely at what is being proposed overseas to assess what – if any – policy changes might be needed in Australia.

But adjustment to the policy framework is only part of the solution. The rigour with which prudential policies are implemented often counts for just as much – if not more – than the make-up of the policies themselves.

And, in this context, it is worth remembering that the onus for effective implementation of prudential policies does not rest solely with the regulator. Effective 'take-up' of prudential regulation has two dimensions:

- the adoption of sound risk management practices and good corporate governance within financial institutions; and
- active supervision by prudential regulators to promote and enforce prudential standards.

Each is equally important.

Unfortunately, the quality of the implementation of prudential policies is often overlooked (or simply taken for granted) when comparing different regulatory regimes. Yet, in practice, time and time again, this proves to be the critical differentiating factor between them.

### Dr Jordan's Remedy

As if to illustrate this, I recently heard a talk by retired Cleveland Federal Reserve Chairman, Dr Jerry Jordan. Dr Jordan visited Australia earlier this year to give a series of lectures on the global financial crisis. While he was not speaking in any official capacity, it was nevertheless interesting to hear his insights on regulatory reform.

Here's a shopping list of the changes Jordan is looking for:

- broker origination to be tied to bank lending standards (preferably with trailing commissions);
- restrictions on 'no-deposit' lending;
- interest rate rises to be factored into serviceability tests;
- sub-prime/ low doc loans to meet minimum credit criteria; and
- board chairman and audit committee chairman to be independent.

All sensible risk management initiatives. But what strikes you about this list of reforms is:

1. There are no grand policy re-thinks here. These are all practical, 'nuts-and-bolts' risk management measures: sound underwriting principles and good corporate governance.
2. These are also things that are already in place in Australia and form part of APRA's supervisory framework.

To me, these examples reinforce the merits of a pragmatic approach: one based on sound risk management principles where there is an active dialogue between regulated institutions and the regulator. This sort of approach yields better results than reliance on rules alone.

## So where to from here?

Having said all that, Australia will be introducing some incremental policy changes. The first of these I'm sure you would have read about.

### i. Executive Remuneration

Clearly, dysfunctional incentive structures – structures which favoured short term asset growth over long term risk management - have been a factor in the collapse of a number of overseas financial institutions. To address this risk, APRA currently has out for comment some draft prudential standards on executive remuneration.

The new draft requirements are not aimed at reining in executive pay packets. Rather, they seek to ensure that remuneration practices adopted by regulated financial institutions align with the risk profile of the business being written and do not act to incentivise unsound, 'risk-seeking' behaviour.

It will be up to firms to come up with their own ways of satisfying these principles. But, typically, we would expect it to lead to more compensation in the form of deferred payments or equity, and a capacity for 'claw-back' of compensation in line with performance over the longer term.

The changes will take the form of extensions to APRA's prudential standards on Governance and will require boards of regulated financial institutions to:

- have in place a remuneration policy which aligns incentive pay to risks in the business; and
- establish a Board Remuneration Committee made up of independent directors to oversee the implementation of this policy.

## ii. Liquidity

The supervision of banks' liquidity has been notoriously difficult for prudential regulators – especially those, like APRA, that seek to move beyond simple liquid asset ratios. There are two challenges:

- how to get timely information – especially when maintaining adequate liquidity is a day-to-day proposition; and
- liquidity management needs can vary significantly from institution to institution – making it difficult to set universal requirements.

For these reasons, APRA has long preferred a scenario-based approach – one which measures a bank's liquidity needs against a range of different stress scenarios.

We will shortly be releasing a policy discussion paper which will propose changes to existing scenario parameters – particularly those dealing with a 'name crisis' and a 'market disruption' – which take on board lessons learnt from the global financial crisis. If accepted, these changes will take effect from 1 January next year.

## iii. Capital Adequacy

A consistent theme through all of the international reviews into the global financial crisis is a need to bolster capital requirements for financial institutions: both in terms of quantity and quality. In particular, there is a strong push to address procyclical elements in the system.

Procyclicality is being considered at both a macroprudential level (ie restraining asset price bubbles in the financial system) and a microprudential level (ie dealing with excessive credit growth on the balance sheets of financial institutions).

At the macroprudential level, there has been a debate of late about whether or not monetary authorities should 'stand against the wind' in an attempt to deflate asset price bubbles. But monetary policy can, at times, be a very blunt instrument.

On the other hand, at the microprudential level, a more forward-looking approach to reserving offers considerably more hope of better positioning bank balance sheets to cope with inevitable expansions and contractions in economic activity. Such an approach could also take into account macroprudential indicators in much the same way as a resilience reserve operates in life insurance.

Of course, I appreciate that what I am suggesting runs counter to the changes introduced in 2005 with the adoption of IFRS. These changes – which moved provisioning to an incurred loss basis and valued assets at current market values – had the effect of substantially depleting bank provisioning levels at close to the top of the cycle.

While it would be convenient if accounting rules on provisioning could fall into line with APRA's prudential objectives, it is not fatal if this cannot be achieved. Accounting rules serve a different constituency. From a prudential standpoint, banks need to reserve for estimated credit losses over the full life of the product, not just on an incurred loss basis. APRA will be looking to see that this occurs.

I expect that we will hear a lot more on this issue as international regulatory bodies advance their work on addressing procyclicality in the financial system.

### iv. Failure Resolution

APRA is also bringing forward a range of measures to deal with troubled financial institutions. This includes the establishment of a Financial Claims Scheme (FCS).

You should note that the FCS is not a compensation scheme. Rather, it offers advance payment on amounts due to depositors under the depositor preference provisions of the Banking Act. You should also note that this is just one of a range of failure resolution measures available to APRA and, given APRA's focus on prevention, one that we hope never to use.

## Conclusion

In conclusion, let me reiterate that APRA will be watching what comes out of the international policy reform process closely. And we will take on board iterative changes to improve our policy framework. But, that is not where we see the main game. Our focus will remain on active and conservative supervision of regulated financial institutions.

We realise that APRA's conservatism can – at times – be an irritant to business aspirations. And that some of the decisions we take can be 'line-ball'. But, ultimately, erring on the side of caution

serves not only to protect beneficiaries, but also to provide an important source of confidence in our financial institutions.

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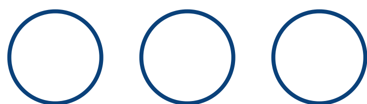

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