

Discussion

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It is a great pleasure to be asked to comment on an excellent overview of the critical issues relevant to financial stability by Claudio Borio. The reason I liked the paper so much is that it drew my attention to what Claudio calls the ‘durable aspects’ of financial instability. For example, when I was vacationing last week, wandering around with the red light on my Blackberry flashing constantly as it kept me updated with news about the turmoil in financial markets, Claudio’s paper forced me to step back from the chaos of the moment and think about the underlying forces that drive such turmoil.

Claudio’s main messages are that many of the market’s current problems were caused by market participants overextending themselves in a favourable economic environment and that the challenge for policy-makers is to do more to prevent financial crises by imposing ‘speed limits’ on the system. This suggestion would take policy-makers into very challenging territory because financial crises are closely related to phenomena such as asymmetric information, positive feedback loops, and limitations of risk perception and incentives that are not easily influenced by policy.

Nevertheless his point is well taken; it is all well and good to have better cars and better roads, but they are of little use if there is an idiot behind the steering wheel. How do you get drivers to slow down and encourage them to take fewer risks? Without pretending to fully understand the events of recent weeks, let me use Claudio’s approach to reflect on some of the possible causes of the sub-prime crisis.

First, it is clear that the enduring features of financial markets described by Claudio have had an important influence on recent events. For example, I agree with Claudio that overextension by households and investors helped to lay the foundations for a crisis. Second, changes in financial markets over the past two decades have amplified the effects of this overextension. For example, financial innovation and globalisation have meant that the crisis has spread more widely and rapidly than it might have in the past.

The question is – how could we have prevented the over-borrowing that took place in the sub-prime mortgage market in the United States, or the underestimation of risk that led to over-investment in some securitised loan products? Let me first look at households. Although Claudio did not dwell long on this issue, I think that we should be concerned about the increasing concentration of risk on household balance sheets. I also think that it would be sensible to impose speed limits in this area. One way of doing this would be to improve financial literacy. For example, the Netherlands Bank recently surveyed Dutch households and found that only around 40 per cent of respondents could answer basic questions about inflation and interest rates. Thus, although improving financial literacy is likely to be an uphill battle, it is definitely worth the effort.

I also think that there is scope to improve consumer protection by improving access to independent advice and ensuring that the vendors of complex loan products are not being paid according to turnover. Looking at my own country, we have

tried to encourage mortgage lenders to enter into a voluntary code of conduct that would require them to consider the risks that borrowers are taking and match loan sizes with households' capacity to pay. Supervisors also have a role here. We have seen several cases in the Netherlands where lenders and financial advisers have sold unsuspecting customers products without notifying them of their true risks. As Claudio mentioned, these factors all work together to create an environment where excessive borrowing takes place and risks to financial institutions also increase.

Turning to the broader issue of risk perceptions and the incentives to manage risk, Claudio was particularly supportive of using built-in stabilisers, such as incorporating estimates of parameters relevant to periods of financial stress into estimates of loss-given default. I agree that this is the best way to go, particularly after the recent turmoil in financial markets. This has implications for the banking book as well as the trading book, where assumptions about liquidity and the price at which contracts can be liquidated need to be scrutinised more carefully.

When it comes to the use of more discretionary prudential measures, as Claudio pointed out, it can be difficult to find the right reference point. For example, it may sound easy to lean against the wind but in practice it is not, especially when policy-makers are imperfectly informed about the mispricing of risk. Here I agree with Claudio that macro stress testing has an important contribution to make, though it too has its challenges. Looking forward I believe that there is much more work that needs to be done before stabilisers can be introduced effectively.

Consistent with the line taken by the Basel Committee, I also think that a longer-term assessment of risk should be further promoted and should be introduced to other regulated sectors such as the insurance industry and pension funds. This is important because these sectors have, in addition to banks, been important players in the market for credit instruments.

But can we rely on prudential stabilisers for currently regulated entities to maintain financial stability? Or should we extend the scope of regulation to other entities such as hedge funds as well? This issue has of course been debated for a long time. Thinking back to the LTCM crisis, the aftermath of that event resulted in the balance of power between banks and hedge funds shifting dramatically toward banks. It also enabled regulators to strengthen counterparty risk management through the Basel Committee, which further strengthened the competitive position of banks. Although hedge funds have reasserted themselves in recent years, I think that the current crisis presents us with another opportunity to incorporate our greater awareness of risk into better regulation.

Let me wind up by emphasising the pivotal roles of central banks and prudential regulators more generally, and the importance of cooperation between them. I have mentioned the possibility of developing prudential stabilisers further, and also broadening the field of regulation. However, such actions would require the agreement of political decision-makers and would benefit from international coordination. In my opinion the International Monetary Fund, given its increased focus on financial sector surveillance, can make a major contribution by placing these longer-term objectives firmly on the agenda in its discussions with national policy-makers. Thank you.