Discussion

1. Thomas M Hoenig

Introduction

It is a pleasure to be here today and I would like to thank the Reserve Bank for the kind invitation to participate in this conference. The paper in this session is a descriptive account of the evolution of the Australian financial system over the past decade. I enjoyed reading the paper and congratulate Marianne and Philip for preparing an extremely informative account of these important developments. As an outsider, there is obviously little that I can add to the institutional discussion of Australian financial markets. I was struck, however, by the parallels between developments in Australia and the United States. Thus, I would like to provide a US perspective on these trends and highlight some of the important similarities and differences in the US and Australian experiences. In addition, I would like to offer some thoughts on the important policy issues raised in the paper and some of the key questions that are likely to influence policy discussions over the next decade. Let me begin with a comparison of financial developments in Australia and the United States over the 1990s.

A comparison of the US and Australian experiences

A common thread throughout many countries over the last few decades is a rapidly evolving financial system, driven by technological changes, global competition, and financial innovation. Underpinning this system is a supervisory framework that has struggled to provide the flexibility to accommodate such changes while maintaining appropriate levels of discipline and financial stability. The most poignant reminder of this struggle is the increased incidence of financial crises in many countries. These crises have often followed similar patterns: a rapid expansion in credit availability following efforts to liberalise the financial system, subsequent increases in debt levels, emergence of speculative attitudes and asset bubbles, and the presence of inadequate or misdirected supervision.

Several aspects of this pattern appear to characterise the Australian financial problems of the early 1990s, which included several financial institution failures, the worst losses in bank income in almost a century, and a rapid rise and collapse in commercial property values. According to the authors, factors such as deregulation in the mid 1980s, a desire by banks to expand their balance sheets, and weak bank credit assessment procedures all played a role in these banking problems.

In the United States, over 1 500 banks failed during the 1980s and early 1990s, which was more than 10 per cent of all banks. Also, a significant portion of the thrift industry became insolvent and had to be resolved at a taxpayer cost of US$125 billion. With some striking similarities to your experience in Australia, the US problems can be attributed to financial deregulation, a combination of expanded powers and weak supervision for thrift institutions, and boom-bust cycles in real estate, energy, agriculture, and commercial and LDC lending.

I would also note that much of this pattern fits the real estate and banking crises in Japan and Scandinavian countries and the banking and currency crises in South-East Asia and Central and Latin America.

Fortunately, the recoveries in both Australia and the United States have been strong and long-lasting, with dramatic improvements in bank profitability. In fact, US banking profits have been at or near record levels for the last few years and bank capital is now at its highest level since 1941. This improved performance can be attributed to many of the same factors mentioned in this paper for the Australian turnaround: greatly improved bank asset quality, better control of expenses, increases in non-interest income, and – the dream and goal of central bankers – greater economic and monetary stability.

Other recent changes in Australia have also mirrored those in the United States. Several Federal Reserve studies have found nearly identical trends in rising consumer debt levels, a shift in household balance sheets toward stocks and other market instruments, a retreat from the corporate borrowing excesses of the 1980s, and a continued shift toward securitisation, direct financial intermediation through markets, and the use of derivatives to parcel out and manage financial risk. Thus, access to credit by different groups has continued to increase in both countries, while capital markets and market discipline play ever larger roles in allocating credit and capital and influencing risk-taking.

One other common trend in Australia and the United States is consolidation and convergence across different types of financial institutions. This has been an ongoing trend in the United States for several decades. It began with a breakdown in the barriers between various types of depository institutions and then spread into greater competition among banks, securities firms, and insurance companies. The most recent step in this direction is our *Gramm-Leach-Bliley Act of 1999* (GLB), which allows banking organisations to merge with other types of financial institutions under a financial holding company structure.

I should also mention that the US banking industry itself has undergone considerable consolidation as a result of industry competitive pressures and the removal of various legal barriers which had previously limited bank branching, bank holding company expansion, and interstate banking. While we still have nearly 8 500 banks – which is much different than here in Australia – we have had a significant consolidation among larger banking organisations and the number of banks has declined by more than 6 000 since the early 1980s.

A final point of comparison between Australia and the United States is that both countries have made extensive changes in their supervisory systems in response to banking problems and the evolutionary changes that I just summarised. Although the approaches our countries have taken differ somewhat, the basic themes are much the same: risk-focused supervision and harmonised, functional regulation across different financial institutions.

In the United States, for example, we have focused our examination procedures toward the most significant risk exposures at individual banks and have given increased attention to bank risk-management controls and policies. We also allow well-capitalised and well-managed banks and banking organisations to take on greater activities and operate under fewer restrictions. However, because of the larger number of banks in the United States compared with Australia, much of this framework is implemented through banking laws and regulations rather than individual bank suasion.

In our recent legislation to merge banking, securities, and insurance, we have followed, in part, the Australian pattern of functional regulation with each of these activities to be supervised by separate industry authorities. However, we still maintain an active supervisory role for the Federal Reserve through its oversight of state member banks and as umbrella supervisor for both bank and financial holding companies. We continue to believe this ‘hands-on’ experience provides invaluable insights for our monetary policy, financial stability, and lender of last resort responsibilities, particularly given the diversity and size of the US financial system.

I think these comparisons between our countries help show that financial regulators throughout the world are grappling with many of the same trends and policy concerns. Next, I would like to discuss what I believe are some of the most important supervisory concerns we all face.

Some regulatory challenges

Besides a comprehensive discussion of the evolution of the Australian financial system during the 1990s, the paper by Marianne and Philip highlights a number of important challenges facing policy-makers in adapting to ongoing changes in financial markets. I would like to focus in somewhat more detail on two issues that I believe are critically important in maintaining financial stability in the years ahead. One issue is how to protect the safety net and prevent its extension to a broader class of financial institutions and activities. A second issue is how to strike a better balance between regulation, prudential supervision and market discipline in light of the changing financial landscape.

Protecting the safety net

An important element in maintaining financial stability is the existence of a government safety net: explicit or implicit guarantees that promote systemic stability by protecting depositors and creditors of financial institutions. (Australia does not have a formal deposit insurance system.)

Two developments identified by the authors threaten to extend the safety net beyond its historical scope: consolidation within the banking industry and the breakdown of barriers between banking and other financial services.

The creation of large banking organisations raises the ‘too-big-to-fail’ (TBTF) problem: government reluctance to close large institutions for fear of systemic consequences to deposit-taking, lending, or payments systems. TBTF, whether explicit or implicit, tends to blunt market discipline leading to the distortion of risk/return trade-offs, inefficiencies in resource allocation, increased taxpayer exposure to losses from bank failures, and the creation of competitive inequalities between large and small banking organisations.

The merging of the provision of banking and other financial services also threatens to extend the safety net beyond its original intent, which was to promote financial stability by protecting bank depositors and the banking system.

Unless we can prevent the extension of the safety net by insulating it from risks of new activities, prudential supervision may need to be extended to a larger part of the financial system with attendant costs and potential inefficiency. Moreover, the extension of both the safety net and prudential supervision to a broader range of institutions and activities is likely to introduce new distortions and competitive inequalities between financial service providers. (Under GLB, we attempt to limit the extension of the safety net by limiting activities of banks but allowing parent organisations to participate in other financial activities that are insulated from the subsidiary banks.)

Striking a new balance

A second important challenge is how to modify the regulatory framework in light of the changing structure of financial markets and institutions. As noted by the authors, policy-makers are in the process of rebalancing the regulatory mix by placing less emphasis on tight regulatory restrictions on the permissible scope of bank activities and more emphasis on risk-focused prudential supervision and on market discipline.

However, there is still considerable difference of opinion among policy-makers about the right balance among these three tools. In the United States in particular, there is ongoing debate over the relative importance of prudential supervision and market discipline.

My own view is that while there is certainly greater scope for the use of market discipline in containing risk-taking by financial institutions, there are important practical and conceptual limitations. Some of the practical limitations can be overcome through improved disclosure of risk exposures, risk-management practices, and the financial condition of institutions. However, since the underlying basis of systemic risk is an externality, markets are unlikely to correctly price this risk either with or without a safety net.

Consequently, we are likely to be forced to continue to rely heavily on prudential supervision. Our task is complicated by the continuing need to adapt supervisory practices to changes in financial markets. At the same time, we need to ensure that supervisory practices do not become overly costly or intrusive to financial institutions.

Key questions for the future

In their paper, Marianne and Philip also discuss how the changing financial structure will influence the nature and transmission of financial disturbances. I want to conclude my remarks by highlighting some key questions that may serve as a basis for a more general discussion of their paper.

Marianne and Philip suggest that the financial system of the future is likely to be more stable and to pose less risk to the macroeconomy. In addition, they indicate that future financial disturbances will tend to come from financial markets rather than financial institutions.

While I find these conclusions to be both sensible and appealing, I think they deserve more discussion and so I will recast them as questions deserving of additional study.

First, will banks and other financial institutions be a less important source of financial disturbances in the future? In part, the answer to this question depends on the answer to two other questions. How confident are we that financial institutions can measure and control risk in this new environment? And, have we fixed the moral hazard and incentive problems caused by safety nets that contributed to past financial crises?

Second, will financial markets be a more important source of disturbances in the future? If so, are there policies that can minimise the impact of financial market disturbances and, in particular, what role can the central bank play in maintaining financial stability in this new environment?

Third, will the financial system pose less risk to the macroeconomy in the future? To answer this question, we need to know how robust the financial system is likely to be in a less benign macroeconomic environment. While we have stress-tested individual financial institutions, how will the financial system as a whole respond to a less favourable economic environment?

Finally, let me raise two questions about the relationship of financial market changes to monetary policy. One question concerns the role of asset prices in the formulation of monetary policy. If asset prices become a more important source of financial market disturbances, should asset price developments play a larger role in monetary policy? A second question is how the evolution of financial markets is likely to affect the monetary transmission process. Does monetary policy still work through the same channels when intermediation moves from the banking system to capital markets and are changes necessary in our operating procedures to ensure the effectiveness of monetary policy in this new environment?

2. General Discussion

The discussion of the paper by Gizycki and Lowe covered depositor protection arrangements in Australia, the recent rise in household debt, and the role of asset prices in the formulation of monetary policy.

Observing that Australia and New Zealand are the only OECD countries without a formal deposit insurance system, some suggested that this might be a matter of concern. Under the present system, if a deposit-taking institution were to fail, depositors could incur losses. Some questioned the government's commitment not to bail out depositors in the event of a crisis; they argued that it would be very difficult for a government to resist political pressure to provide financial support for depositors of a failed bank, who would otherwise lose their savings. Given this, it was argued that a system of deposit insurance could help by defining and limiting the government's obligations.

One participant noted that it was not clear why the Wallis Inquiry had rejected the proposal for deposit insurance for Australia, and said that this was especially puzzling given considerable interest within the private sector for deposit insurance. Another wondered whether a privately funded deposit insurance scheme was a plausible alternative for Australia, since such a system had been successful in Germany. Others felt, however, that the Australian financial market was too small for such an arrangement to be viable.

The recent changes in the structure of the household sector's assets and liabilities documented in the paper by Gizycki and Lowe also drew considerable interest. Participants generally agreed with the authors' view that lower interest rates in the 1990s and a proliferation of new lending products had been the primary reasons for the rise in household debt. The implications of rising household debt for the balance sheets of lending institutions and Australia's foreign debt were also discussed. Some were concerned by the fact that a substantial portion of household debt was intermediated by banks, and wondered about banks' ability to manage this risk. A few participants also expressed concern about the foreign-currency denomination of a substantial fraction of Australia's foreign debt. It was pointed out, however, that this should not be a cause for concern since financial institutions use the swap market to hedge this currency exposure.

The role of asset prices in the formulation of monetary policy was also discussed. In particular, the question was posed: should central banks be concerned about asset prices above and beyond their implication for inflation and growth over the forecast horizon of the next couple of years? One participant pointed out that the difficulties associated with identifying asset market bubbles make it extremely unclear how such factors should be incorporated into monetary policy. Others, however, felt that there are some warning signs that fairly reliably signal the presence of an asset-price bubble, and that monetary policy has a role responding to the emergence of such bubbles.