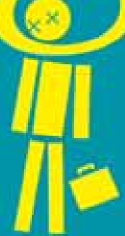
CIS POLICY FORUM 23

Regulation or Strangulation?

Banking After the Global Financial Crisis



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THE CENTRE FOR INDEPENDENT STUDIES

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Introduction

In March 2012, The Centre for Independent Studies hosted a roundtable discussion of the worldwide drive to tighten regulation of banking and finance in the wake of the global financial crisis. Participants included finance industry practitioners, academics and economics journalists. This volume documents the two papers presented to the roundtable as a basis for discussion—one by Robert Carling surveying the issues, and the other by Professor Ian Harper commenting on some of the key issues.

A Survey of the Issues

Robert Carling

Finance as an industry may be shrinking, but the regulation of it is a booming industry.

Rightly or wrongly, inadequate regulation and supervision of banking (and finance more broadly) have received much of the blame for the global financial crisis. The argument is that deregulation in the 1980s and 1990s led banks and other financial institutions to take excessive risks and grow so large, complex and interconnected that they became a source of serious economic instability.

The contribution of these developments to the global crisis relative to other factors is debatable, but the notion that inadequate regulation of finance was at the core of the crisis has held sway with policymakers and regulators. The last three years have seen feverish activity by international organisations, national governments, and regulatory agencies in many countries, sometimes acting in coordination and sometimes unilaterally, to reshape the regulatory framework and extend its scope. If all that is planned comes to fruition, the overall effect will be a quantum leap in regulation.

Australia will adopt the tighter regulations developed and agreed internationally as Basel III. Some countries are going much further than the Basel III prescription.

The regulatory response to the global financial crisis raises many questions and issues. I don't pretend to have all the answers, but I will try to set the scene, clarify the issues, and express some opinions. For each topic, I will identify what I consider to be the key issues for discussion.

Policy responses to the global financial crisis

A good place to start is to see how more financial regulation fits into the overall schema of policy responses to the global financial crisis. First, we had the emergency bank bail-outs and rescues in September-October 2008; then the fiscal stimulus, which has given way in some countries to fiscal consolidation; at the same time monetary policy came to the rescue in orthodox and heterodox (quantitative easing) forms; and since 2009—as I have described it—a boom in financial regulation.

While most of these policy responses are temporary or transitional—one certainly hopes they are—the re-regulation of finance is a permanent structural change in response to what policymakers in the major industrial countries see as a fundamental failure of finance that revealed itself in the global financial crisis. Increased regulation of finance will stay with us long after the other policy responses have gone, standing as one of the enduring legacies of the global financial crisis. The benefits and costs will be with us for a long time.

Historical context

Historically, there is a pendulum in financial regulation, and it is instructive to put the latest swing of the pendulum into a long-term historical context. The overall set of policy responses to the global financial crisis as described above takes us back to the 1930s in the search for anything comparable, at least in peace time. That was the last time the world saw a tightening of financial regulation on anything like the scale we are seeing now, as post-Depression concerns about financial stability trumped efficiency considerations. Finance remained relatively repressed for many years after the 1930s, and only began to be liberalised in the 1980s and 1990s.

Now the pendulum has swung again, with the global financial crisis and the ensuing Great Recession raising concerns about financial stability. Those concerns are understandable, but they are not a reason for disregarding the immense benefits of an economically efficient financial system. We have to keep the crisis in perspective and get the balance between stability and efficiency right. It will be a long time before the pendulum swings back to less regulation, but I expect it will eventually do so.

International regulatory activity

So what is being done at the international level to change financial regulation? The regulatory response to the global financial crisis was a large exercise in international cooperation and coordination, involving G20 leaders and finance ministers and down. This approach reflected the cross-border dimensions of the crisis and the view that a high degree of consistency was needed to counter regulatory arbitrage and the future emergence of new centres of regulatory weakness in the global financial system. The G20 set the broad principles and directions. In 2009, the Financial Stability Board (FSB) was created to coordinate international standard setters and national authorities, monitor country compliance, and assess and respond to developments in financial stability as deemed necessary.

The best-known among the international standard setters being coordinated by the FSB is the Basel committee on banking regulation, which long ago promulgated the standards known as Basel I and II, and in response to the global financial crisis, has developed Basel III, the full details of which have not yet been worked out.

Sitting below the international standard setters such as the Basel committee are the national authorities—governments, central banks, and regulators such as the Australian Prudential Regulation Authority (APRA)—which promulgate international standards within their own jurisdictions. National authorities do not, however, always follow the international script. When the global financial crisis burst in 2008, for example, even Basel II had not been implemented in the United States. And since the crisis, some countries have gone their own ways, adhering in part to international agreements but going beyond them in some respects or in different directions in others.

The key features of Basel III are:

- Improvements in the risk coverage of the capital framework—already implemented as Basel II.5.
- Unchanged minimum capital requirement of 8% of risk weighted assets, but within that, an increase in the common equity tier 1 requirement from 2.5% to 4.5%.
- On top of the minimum, a capital conservation buffer of another 2.5%, bringing the total capital requirement to 10.5% and common equity to 7%.
- Surcharges for systemically important financial institutions (SIFIs) of 1–6% (for global SIFIs) and a yet to be decided amount for domestic SIFIs.
- Potentially counter-cyclical surcharges of up to 2.5% under the banner of 'macro-prudential regulation.'
- The above to be fully implemented not later than 2018.
- A 'back-stop' maximum leverage ratio of 3% of non-risk-weighted assets.
- A liquidity-coverage ratio to ensure banks have sufficient liquid funding to survive one month of stressed funding conditions.
- A longer term net stable funding ratio that will require banks to have some minimum proportion of long-term stable funding over a one-year period.

The increases in minimum capital adequacy requirements are significant, and Basel III introduces a capital conservation buffer, a counter-cyclical buffer, and a surcharge for SIFIs. It also introduces the concept of 'living wills' for financial institutions to spell out in advance how they would attempt to cope with a life-threatening experience (recovery plans) and how they would be disposed of if they failed to cope (resolution plans).

But Basel III is not the sum total of the international regulatory response. The FSB has other topics on its lengthy work program. Some countries have already said they will go above the Basel III capital adequacy standards. The United States has its Dodd-Frank legislation, which among many other things, introduces a version of the so-called Volcker rule restricting commercial banks' proprietary trading activities. The United Kingdom is going to ring-fence retail banking. And the European Union is developing a vast network of new regulation, as well as leaning towards new taxes on banks and financial transactions.

What caused the global financial crisis?

Before looking at the issues raised by this regulatory onslaught, let's consider the diagnosis of the global financial crisis on which it is based. The most popular narrative identifies banks, especially big banks in the United States and Europe, as the prime culprits. Officialdom has adopted this narrative, and even promoted it—hence, the regulatory onslaught to reduce the risk of future financial crises and reduce their magnitude and consequences when they do occur.

We should not forget the other factors that caused the crisis: loose monetary policy, lax supervision of financial institutions under previous regulatory regimes, global economic imbalances, and policies in the United States that went too far in encouraging home purchases. These factors set the scene for the crisis, but the behaviour of financial institutions made the crisis much worse than it would otherwise have been. There is a case for regulatory reform, but what is happening now is misdirected and even excessive.

ISSUES FOR DISCUSSION

A. What was the relative importance of the regulatory framework and other factors in causing the financial crisis? Even if non-regulatory factors were the most important, did the crisis still expose a need for regulatory reform?

B. If the crisis was mainly attributable to the inadequacy of regulation, was the main problem with the rules themselves or the way they were applied (or not applied)?

C. What does the crisis tell us about the kind of regulatory reform that is needed?

Assessing international responses

Looking at the international responses, it is difficult to argue with higher capital adequacy standards and increased liquidity requirements in general. The capital conservation buffer seems conceptually sound, but the wisdom of macro-prudential regulation (counter-cyclical capital surcharges) and capital surcharges for SIFIs is debatable. The buffer and surcharges could cumulate to very high capital requirements (as high as 20%), and one can't help wondering whether there is an element of overkill. The development of resolution plans as part of living wills is at an early stage, and the efficacy of this concept remains to be seen.

Beyond Basel III, the US Dodd-Frank legislation is a hydra-headed monster of 848 pages that will give birth to some 400 rules and regulations. The *Economist* recently published an excellent critique of Dodd-Frank.[1] It is difficult to see what else bank levies and financial transactions taxes will achieve other than generate some more revenue for European governments, which are always hungry for revenue and ready to tax anything that moves. So far the idea has not caught on outside Europe.

ISSUES FOR DISCUSSION

A. How important is the international harmonisation of regulation?

B. Are the Basel III prescriptions broadly appropriate? If not, where are they excessive or where are they inadequate?

C. Are the capital conservation buffer, macro-prudential regulation, and the capital surcharge for SIFIs conceptually sound and practically workable?

D. Is a Volcker rule such as that embodied in the US Dodd-Frank legislation appropriate?

E. Is 'ring-fencing' of retail banking, or other forms of structural separation, desirable?

F. Would new taxes, such as one on selected bank liabilities or transactions, be beneficial?

Australia's approach to tighter regulation

Australia is bracketed with a few other advanced countries, such as Canada, for its superior regulatory and supervisory policies and practices, which are credited with at least helping avoid a financial crisis in those countries. No Australian bank collapsed or required rescuing, but a few smaller institutions came under stress and were taken over by larger institutions in emergency circumstances. All banks benefited from the Commonwealth government guarantee of their borrowings during the darkest days of the global crisis. This background perhaps explains why Australian authorities, despite participating in the international attempts to develop a new regulatory framework and being keen to be considered as responsible, cooperative members of the international community, have steered clear of the more far-reaching regulatory approaches of countries at the epicentre of the crisis (the United States, for example).

Australia has opted for what the head of APRA describes as a 'fairly straight-down-the-line approach' to adopting and implementing the Basel III prescription, with only minor variations proposed by APRA to exercise national discretion.[2] Thus, Australian banks will be subject to the new capital requirements described above, but with an accelerated timetable of 1 January 2013 for the minimum capital requirements and 1 January 2016 for the capital conservation buffer. Australian banks in fact already satisfy the minimum requirements. APRA notes that at current levels of profitability, the higher buffer is 'readily attainable' by 2016. The maximum backup leverage ratio also will apply. Australian authorities, unlike those from other countries, show no signs of going beyond the Basel III capital requirements. No Australian bank has been designated as a global SIFI (G-SIFI). However, there has been speculation that some of them could be subject to higher capital requirements in the future because of their domestic systemic importance (D-SIFI).

Australian authorities have also said they will in principle adopt a macro-prudential approach to regulation, which will involve the potential for counter-cyclical capital buffers on top of the capital conservation buffer, but the details of macro-prudential regulation are still being developed in international forums.

Apart from the new capital requirements, Australia will also adopt the new Basel III liquidity framework, which comes into effect from 2015. This framework involves a 30-day liquidity coverage ratio and a net stable funding ratio. In recognition of the limited supply of high-quality liquid assets (government securities) in Australia, the Basel committee has agreed to a proposal from APRA and the Reserve Bank of Australia (RBA) for a committed secured liquidity facility with the RBA, to make up any shortfall between the liquid asset requirements of the banks and the availability of suitable securities in the market.

So-called living wills are part of the broad reform agenda being worked on internationally, especially in relation to SIFIs. Living wills cover recovery and resolution plans. Although not yet required by any international mandate, APRA is embracing the concept of living wills; bank boards will sign off final recovery plans by June 2012. Resolution plans will come later. APRA intends making these plans a 'permanent feature' of its supervision.

To date, the Australian authorities have shown no enthusiasm for the more far-reaching reforms adopted in some other countries, such as the Volcker rule or the ring-fencing of retail banking. Treasurer Wayne Swan has ruled out imposing a financial transactions tax or a bank levy on selected liabilities as they are doing some European countries.

ISSUES FOR DISCUSSION

A. To what extent does superior bank regulation and supervision in Australia account for the avoidance of a domestic financial crisis in 2008–09? Why was Basel II effective in Australia but not in other countries? How important was the Commonwealth guarantee of bank borrowings?

B. Given the apparent success of the Australian approach, do we need to adopt the Basel III framework for reasons other than being 'internationally cooperative'?

C. Does Australia need to go further than Basel III, as some countries are?

Too big to fail

Perhaps the biggest problem exposed by the global financial crisis was the centrality of banks that were deemed 'too big' or 'too important' to be allowed to fail, resulting in government and central bank rescue operations. As mentioned above, these have come to be known as systemically important financial institutions or SIFIs. SIFIs of global importance were especially problematic. Australia is not considered to have any global SIFIs, but at the very least the four major banks are domestic SIFIs.

Some would argue that all financial institutions facing insolvency in the crisis of 2008 should have been allowed to fail and there should have been no bail-outs. While it is impossible to say exactly what would have happened had such a policy been followed, it is safe to assume the financial and economic collapse would have been larger than what actually occurred. Given the circumstances governments faced in 2008, it is difficult to sustain an argument that they should have followed a laissez faire approach. The price of capitalist purity may well have been a world economy in ashes, and it is of little comfort to be told a phoenix would eventually rise.

That said, the principle that capitalism works best when firms are allowed to fail applies as much to finance as it does to other industries, and it would be highly desirable to bring about a situation in which any financial institution anywhere in the world can fail without creating a global or domestic systemic crisis, and without triggering taxpayer-funded support. That is the goal of many of the regulatory reforms being implemented or still being developed, but whether they will be successful is another matter. The problem of 'too big to fail' probably looms even larger now than in 2008. Large institutions have become larger by swallowing others. Government bail-outs—although necessary in 2008—have heightened the problem of moral hazard.

Particular features of the proposed regulatory regime aimed at the 'too big to fail' problem are the additional capital requirements for SIFIs and the requirement for living wills. It is not clear, however, whether size per se is the critical risk factor or is it complexity, inter-connections among financial institutions, and the risks banks take. Some of the financial crises in history have had at their core a large number of small institutions rather than a few very large ones. Banking worldwide is not particularly highly concentrated compared with other industries.

ISSUES FOR DISCUSSION

A. The bail-outs of 2008 have increased the problem of 'too big to fail'—but could bail-outs have been avoided?

B. Is size the key metric determining systemic risk, or is it complexity, inter-connections among financial institutions, or risk-taking?

C. Are the policy and regulatory reforms announced and in train sufficient to overcome the 'too big to fail' problem internationally and in Australia? If not, what does that mean for the likelihood and severity of future crises?

Economic consequences of re-regulation

The global financial crisis, whatever its causes, has undoubtedly resulted in massive economic costs in the form of foregone output. The financial and regulatory reforms discussed above are intended to make crises less likely in the future and less severe when they do happen. This is a worthy goal, but it needs to be tempered by realism. As RBA Governor Glenn Stevens said, 'Finance has its own cycle—of risk appetite, innovation and occasional crisis. That won't change.'[3] On another occasion, Stevens said, 'Ultimately, the cycle of greed and fear cannot be regulated away.'[4] History also suggests that riskier activities tend to move outside the perimeter of regulation, wherever that perimeter is drawn.

Even if well-intentioned policymakers succeed in taming the cycle of finance, their success will come at a cost. Financial intermediation and innovation are at the core of the long-term process of economic development. The more finance is regulated, the greater the risk of strangling it and foregoing its contribution to economic growth.

The compliance costs of increased regulation will be a deadweight economic cost. This may be justified if the benefits were large enough. But there is also the economic cost of increased capital, liquidity requirements, and reduced financial leverage under Basel III. Increased reliance on relatively expensive equity financing will lead banks to try to become more efficient and reduce operating costs, but a likely increase in their cost of capital will lead them to shrink (i.e. be less willing to lend) and/or to increase the price of their loans beyond what it would otherwise be. Either way, there is a cost to economic growth.

A recent International Monetary Fund (IMF) study concludes that a permanent, synchronised increase in capital requirements for all banks by 1 percentage point would cause a peak reduction in the GDP of around 0.5%.[5] For Australia, the figure is 0.6%, of which one-quarter comes from international spillovers. The authors of the IMF study argue, however, that much of the impact could be offset by monetary policy.

The long phase-in of Basel III rules could soften the blow, but in practice banks are under pressure to comply more quickly; in any case, the cost must be felt eventually.

There is a counter-argument that banks' cost of capital will not increase because the providers of bank finance (equity, deposits and debt) will demand lower returns as banking becomes safer and less volatile. This requires considerable faith in the efficacy of the reforms. It also assumes that depositors and lenders to banks do not already view banks as 'safe' because of deposit insurance schemes, explicit or implicit guarantees, and perceptions of 'too big to fail.'

ISSUES FOR DISCUSSION

A. How successful can regulatory reforms be in reducing the frequency and severity of financial crises?

B. Assuming some success in taming the cycle of finance, will the benefits offset the costs of the reforms in the form of a higher cost of capital and higher compliance costs?

C. What is the likely effect of higher capital and liquidity requirements on the Australian banks' cost of capital, lending margins, and willingness to lend?

D. What are the likely implications for global economic growth over the next few years and in the long term?

E. Can monetary policy offset the adverse economic impact of higher bank capital adequacy requirements?

Free banking—A radical solution

The policy and regulatory responses canvassed above mostly work within the existing framework. The UK 'ring-fencing' initiative goes a bit further in breaking out of that framework, but it cannot be called a radical change. Radical reforms have, however, been proposed by some academics and think tank writers. A good example is the concept of 'free banking' proposed by Kevin Dowd and others at the CATO Institute.[6] They argue that despite any improvements to the Basel III package, regulatory solutions will always be imperfect because the current system contains endemic incentives towards excessive risk taking, and any regulatory apparatus will invariably be 'captured' by those being regulated.

Dowd, et al. argue that the fundamental problem is the limited liability corporate ownership structure of modern financial institutions, which creates the wrong incentives under a system of managerial capitalism. They advocate a return to the extended or unlimited liability structures that characterised US banking a century ago, and which worked much better because the principal decision-makers bore the consequences of their own mistakes.

There would be no capital adequacy or other regulation, no deposit insurance, no bail-outs, and no central bank—only a gold standard to overcome the problem of accommodative monetary policy.

ISSUES FOR DISCUSSION

A. In principle, would the 'free banking' model lead to a better system of financial intermediation and reduce the risk of financial crises?

B. Is the 'free banking' model a practical guide to action, given that the current framework is the starting point?

Endnotes

1 'Briefing: The Dodd-Frank Act,' *The Economist* 402:8772 (18 February 2012), 17–19.

2 John Laker, 'APRA's Regulatory Priorities—An Update,' address to FINSIA Financial Services Conference (Sydney: 25 October 2011).

3 Glenn Stevens, 'The Role of Finance,' The Shann Memorial Lecture, University of Western Australia (Perth: 17 August 2010).

4 Glenn Stevens, 'Developments in Financial Regulation,' address to the Australian Business Economists Annual Dinner (Sydney: December 2009).

5 Scott Roger and Francis Vitek, 'The Global Macroeconomic Costs of Raising Bank Capital Adequacy Requirements,' IMF Working Paper WP/12/44 (Washington, DC: International Monetary Fund, February 2012).

6 Kevin Dowd, Martin Hutchinson, Simon Ashby, and Jimi M. Hinchliffe, 'Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation,' Policy Analysis No. 681 (Washington, DC: CATO Institute, 29 July 2011).

Analysis of Key Issues

Ian Harper

My thanks to Robert for introducing a historical note into this discussion of banking regulation because it's important to take a proper historical perspective when talking about financial markets and financial market regulation. After all, these issues are hardly new.

I joined the Reserve Bank of Australia (RBA) as a young cadet back in the early 1980s. Some of my younger colleagues here with me today are also former central bankers. They might think the world didn't exist before the 1980s but it did!

The late Austin Holmes, a great economist and well known to a number of people in this audience, made a point of coming down to my office soon after I joined the RBA to hand me a copy of Charles Kindleberger's *Manias, Panics and Crashes*. I well remember him saying to me, 'Glad that you're here. Have you read this?' I said I hadn't and he said, 'Then read it and make sure you understand what's in it. And pray that you don't ever have to live it while you're here.' And off he trudged.

Books like Kindleberger's, and more recently, Niall Ferguson's *Ascent of Money* are wonderful reminders that there are long waves in the history of financial markets: waves, as Robert has just quoted Glenn Steven's as saying, of 'greed and fear' or of regulatory pressure following deregulatory pressure. I like to describe these waves as marking a slow oscillation between concerns over financial stability and concerns over financial efficiency.

I stepped into the story of Australia's financial development in the late 1970s, thanks to the good offices of Tom Valentine, who is also with us today. Tom was the senior economic advisor to the Campbell Committee of Inquiry into the Australian Financial System (1981), and as a student of Tom at the time, I had the privilege of being involved in some work for the inquiry.

The Campbell inquiry initiated what was widely seen as a wave of financial deregulation, particularly when it picked up steam under former Treasurer Paul Keating. This was something we had not experienced for quite some time, basically since the Great Depression, before which financial markets were largely unregulated or subject to minimal provisions.

Even though the Campbell report is often thought of as deregulatory in nature—and it clearly was—there was nevertheless a strong emphasis on what we would nowadays call prudential regulation and supervision. Even Campbell didn't think the financial system should be run completely free of government intervention.

Indeed, the inquiry tried hard to balance the need for efficiency against the need for stability in Australia's financial system. Let me share an anecdote—which I do with some trepidation since John Stone, who is also present in the audience today, was Secretary to the Treasury at the time of the Campbell inquiry.

The Treasury's submission to Campbell, if I'm right in saying so, John, channelled von Clausewitz in using the words, 'fog of war.' The quote might not be exact, but the gist of the Treasury's meaning was: 'in the fog of macroeconomic war, microeconomic efficiency losses are collateral damage.'

Here was one of the two public agencies responsible for advising governments and overseeing stability in the Australian economy reminding the Campbell inquiry that the costs of financial instability weigh heavily, and may well outweigh the costs of financial inefficiency.

Nowadays, in the aftermath of the global financial crisis, we have exactly the same sentiment expressed by no less an authority than Andy Haldane at the Bank of England. Haldane calculates that the present value of the instability which the global financial crisis unleashed is extremely large, and in particular, much larger than the costs that even the more alarmist pundits have attached to the interventions proposed under Basel III.

I'm not here to either endorse or criticise Haldane's calculations, but I make the point that the observation made by Treasury more than 30 years ago has surfaced once again.

Of course, the costs of inefficiency are also large. But with the experience of the global financial crisis fresh in our minds, it's only natural that the costs of instability loom larger. Over time, we will once again become familiar with the costs of inefficiency, especially dynamic inefficiency, if the new regulations do, as Robert suggests, 'strangle' the financial system.

Robert has given us a very helpful framework for thinking about the topic of today's discussion. In the balance of my time, I want to pick off the same set of issues that Robert has brought to our attention and make some comments of my own under each of those headings.

Causes of the global financial crisis

Was regulation to blame for the global financial crisis? The answer is both yes and no. Yes, there were clearly incentives to take risk off bank balance sheets. Securitisation—the movement of risk out of the intermediated financial system into the markets—was aided and abetted by Basel I and Basel II, regulations that essentially taxed intermediated finance and thereby promoted risk being sold off into the market place.

Robert mentioned earlier that I had the privilege of serving on the Wallis Committee of Inquiry into the Australian Financial System, where we spoke a lot about intermediated finance versus dis-intermediated or market-based finance. If we got one thing wrong—and I speak for myself and not the Wallis committee, since my former colleagues are not here to defend themselves—I believe we underestimated the extent to which finance could be moved out of one sector into another, and overestimated the ease with which a clear division between intermediated and non-intermediated finance could be drawn.

The other thing we got wrong, or at least I got wrong, was thinking that the intermediated banking system was the only source of systemic risk—in other words, that systemic risk was essentially about bank runs. The surprise to me, and I think to many observers of the global financial crisis, was that systemic crises can arise and be communicated as easily through financial markets as through the banking system, and indeed from the non-intermediated sector to the intermediated sector.

The essential problem was inadequate oversight of the financial markets. Our error on Wallis was thinking that the financial markets would operate efficiently and in a stable fashion subject only to less intrusive 'conduct and disclosure' regulation compared with the more intensive prudential regulation applied to financial intermediaries. Too many financial market vehicles (for example, the notorious 'structured investment vehicles' (SIVs)) were de facto unregulated banks, and they went the way of unregulated banks down the centuries—they failed, leaving much wailing and gnashing of teeth in their wake.

Why didn't the market do the job we had expected of it? Well, the market went 'missing in action' just when it was most needed. Markets that I thought would always be there to make prices for securities—albeit at abominably low prices—simply closed. And so the weight of financial effort fell back onto the banking system as business was rapidly (and usually ineffectually) re-intermediated.

In hindsight, the saving grace of this story is that even if financial markets had been under-regulated, there was no similar neglect of the intermediated financial system—at least not here in Australia. Elsewhere, of course, banks collapsed under the weight of borrowers and lenders seeking desperately to re-intermediate business from the moribund or severely traumatised financial markets back onto the balance sheets of banks.

So, yes, regulation did contribute to the global financial crisis—but then again, no, regulation was not the ultimate cause. Global structural change associated with the rapid economic development of China and India is the ultimate provenance of the global financial crisis. The savings glut that this produced (at least before the crisis), accompanied by loose monetary policy in the United States aimed at keeping living standards up in the face of enormous pressure on US manufacturing, interacted with the financial system to produce the global financial crisis.

Australia and the global crisis

In our case, the global financial crisis was wholly imported. We were harmed because of the difficulties transmitted to us via global financial markets. And local experience was far less traumatic than it might have been given our close relationship with the economic powerhouse that is China.

I don't believe regulation in Australia had any role in communicating the crisis to us. But did regulation spare us greater trauma? I think I can fairly claim—and I hope I do so modestly as an author of the Wallis report—that our regulatory framework was helpful rather than unhelpful in our response to the crisis. But I would be the last person to claim it was solely responsible for us doing reasonably well by comparison.

Various other factors helped us weather the crisis. Our financial regulatory framework was battle-tested following the failure of HIH Insurance. In particular, the Australian Prudential Regulation Authority (APRA), which the Wallis committee created as a 'light touch' regulator, was reconstituted after the failure of HIH and given revised instructions to be more interventionist, especially in prudential supervision. This revised approach clearly paid dividends once the global financial crisis was upon us.

We have a prudential supervision regime in Australia and APRA is an activist supervisor, not just a regulator. This means APRA is far better informed about what's actually going on and can make sound judgments rather than simply issue directives and stand back.

Again, though, the China story was good news for us. Our financial institutions did not need to leverage themselves to achieve higher rates of return, as did other countries, notably the United States, which are affected very differently by what's happening in China. Our financial institutions were essentially bringing money into the country, not sending money out—and there was plenty of profitable work for them to do at home.

Also important was that we didn't have a housing crisis, again related to China and our population dynamics. If house prices had collapsed in Australia, we would arguably have been in as deep a mess as the United States finds itself in.

Assessing regulation under Basel III

On to Robert's third heading: Will re-regulation through Basel III help? Let's see what the proposed regulations will do.

Raising capital adequacy standards will constrain financial institutions in increasing their leverage. Many of our institutions already meet the basic standard but when you put in buffers and other adjustments, the demand for capital is likely to increase. That will reduce leverage, which reduces the capacity of the system to expand credit.

On the liquidity side, the so-called liquidity coverage ratio and net stable funding ratio will help manage the system's liquidity risk and stabilise funds flows. This is an area where Australia is exposed. It is the one thing the IMF always raises in its financial stability assessment of Australia. Our banking system is heavily exposed to wholesale financial markets. That's how international crises are transmitted to us.

Of course, imposing limits on liquidity coverage comes at the expense of the very liquidity transformation function that banks perform. But there's the efficiency cost of regulations aimed at preserving stability. You want stability so you switch off the very thing that banks do to create economic value. Transforming liquidity, and maturity for that matter, not only exposes you to greater risk but also creates economic value in the process.

And what of macro-prudential regulation? I'm not a great convert to this idea. For a start, it conflicts with monetary policy. We already have one institution (RBA) trying to stabilise the macro-economy through interest rate movements. How do we have another one (APRA) trying to achieve the same end by manipulating capital controls on banks without the two of them tripping each other up?

At the very least, we're going to require very close cooperation between the RBA and APRA—not that we don't have it currently, but it might need to be institutionalised if macro-prudential regulation is taken up seriously. It was the Wallis committee that recommended formally separating prudential supervision from monetary policy, and in so doing, created APRA. In hindsight, perhaps this was another of our errors, and the two should have been left as one. Then again, that's just one aspect of a complex issue, but hindsight continues to be a wonderful teacher!

The difficulty for macro-prudential regulation is deciding when to apply it and with what intensity. We have no experience in that regard at all. I will make the point though, in passing, that APRA already has the power to impose discretionary capital controls on institutions according to its own objectives of protecting their depositors.

So, for all I know, APRA already imposes a form of macro-prudential regulation by altering the capital ratios required of particular institutions at different points in the economic cycle. The difference, of course, is that APRA would do this for all institutions simultaneously if the new notion were to be applied. Simply put, no one knows how this works in conjunction with monetary policy.

Too big to fail

Robert has raised the issue of the so-called 'systemically important financial institutions' or SIFIs—the ones regarded as 'too big to fail.' None of our institutions is a global SIFI, but at least the major banks qualify as domestic SIFIs. Hence, there is a concern that taxpayers are unduly exposed, given that government would be pressed to bail out any one or more of the majors if they came under severe stress.

On Wallis, we tried to deal with this 'moral hazard' by giving APRA no balance sheet and no capacity to intervene and pay off depositors, let alone shareholders of failing banks. They would have to go to the RBA, or ultimately, the government. The global financial crisis changed all that, inducing the government first to guarantee deposits, and more recently, to establish the Financial Claims Scheme.

Again, maybe we were naive in thinking that a degree of separation would deal with 'too big to fail.' Now that we have a more formal system of deposit insurance, how do you protect taxpayers from adventurism among the insured, especially the major banks? Requiring yet more capital to recognise the impact of systemically important institutions may be justified, that is, differential capital controls based upon institutions' systemic significance. It's clear that systemic risk is the big lesson to come out of the global financial crisis, and that our regulatory framework did not prepare us for systemic risk emanating from the financial markets. This issue is one of the trickiest to deal with coming out of the global financial crisis.

Separating commercial and investment banking

What about global standards? The idea of striking a blow against regulatory arbitrage is a positive thing, and I am completely with Robert on this score. My view of 'ring-fencing' and imposing transactions taxes is overkill writ large, however. We've had no difficulty managing banks and investment banks in Australia, even though most of our banks are involved in investment banking.

It is true that the few bank failures we've had have arisen primarily because of shenanigans in investment banks. In both recent instances, they were state banks and not regulated by the federal authorities. Now that they're gone, we can safely claim to have that issue under control. It is a happy coincidence that throughout this period, all our major banks were run by old-style bankers and not investment bankers. The cultures of the two are very different. To that extent, Paul Volcker is advocating the right thing. Had one of our major banks been run by an investment banker, as opposed to a balance-sheet banker, things might have been different.

Benefits and costs of re-regulation

So are the benefits of tighter regulation worth the cost? Actually, all this is about trading off stability against efficiency. There are some numbers that float around. APRA thinks the impact of all this will amount to no more than a 10-basis point increase in the margins of banks. Maybe, maybe not.

What we do know is that tighter regulation will increase the cost of intermediated finance. Indeed, that is the whole point. And to the extent that it increases the cost of intermediated finance, it will induce borrowers and lenders to seek alternative means of meeting their needs outside the intermediated financial system.

The most obvious way that might occur is through foreign direct investment. So as we close off or occlude the intermediated channel into the Australian economy, the money will find its way in via another channel—including via equity and debt markets. After all, Australia is a capital-importing economy and the current account deficit has to be financed one way or another.

But the biggest losers from this process will be borrowers who can't access funds through these alternative channels, including primarily small- and medium-sized enterprises. Many of the bigger enterprises will go to the equity and bond markets. Indeed, I think these developments will give a fillip to the corporate bond market in Australia.

But lending to the SME sector may become an issue. The 'bad old days' of people going to their bank manager cap-in-hand, and possibly receiving only a fraction of what they asked for, and needing to secure their loans with all sorts of things—all of that, I suspect, will return in some form. Is that price worth paying to secure the stability of the financial system? In the end, that's a judgment call only the voters can make through the political mechanism.

Could Australia go it alone?

Finally, can or should we turn our backs on the international re-regulatory effort and go it alone? Frankly, I don't think we have any choice but to comply. We are a capital-importing country. Yes, it's true we did not need many of these changes, and we already abide by some of them. But we are dependent upon foreign capital inflow, and quite simply, we cannot afford to have a label saying 'non-compliant' emblazoned across our file.

So I don't believe we have any choice. Yes our officials have done a sterling job in trying to hose down the more enthusiastic proponents of change by petitioning (successfully) for various carve-outs for countries like ours and Canada. But is it possible for us just to turn our backs on all this? I think the answer is firmly in the negative.

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Regulation or Strangulation?

Banking After the Global Financial Crisis

Rightly or wrongly, inadequate regulation of finance has taken much of the blame for the global financial crisis. International organisations and governments around the world have spent the past three years designing a new regime of regulation. In Australia, the Basel III measures are being implemented. Other countries are going much further. Many of these measures may be warranted, but there are also concerns that the increase in regulation is misconceived and will act as an avoidable brake on economic recovery and long-term growth.

A roundtable discussion hosted by The Centre for Independent Studies in March 2012 examined issues such as the part played by banking regulation or regulatory failure in the global financial crisis, the suitability of regulatory responses announced in recent times both internationally and in Australia, the 'too big to fail' syndrome, and the economic implications of the new regulatory drive.

This volume brings together the two speeches delivered at the roundtable.

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was Executive Director, Economic and Fiscal at the NSW Treasury from 1998 to 2006; before that, he was with the Commonwealth Treasury, the World Bank, and the International Monetary Fund.

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