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WHEN BORING BECAME SEXY: LESSONS FROM THE GLOBAL FINANCIAL CRISIS

By

The Honourable Kevin Lynch

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Introduction

It is a distinct honour to be invited to speak at the Lowy Institute, an institution whose reputation for excellence and contribution to public policy thinking extends well beyond the shores of Australia.

Over the last year, the world has experienced the shock of the first truly global financial crisis since the 1930s, and the awe of the first synchronized worldwide recession in generations. Given the perceived sophistication of financial markets and models, the surveillance structures established by major countries and international bodies, and the perception of structural changes in risk absorption, how did this happen? Why didn't economic forecasters if not markets see it coming? And why did some countries, such as Canada and Australia, avoid the full brunt of the financial market disruption?

My topic today, "When Boring becomes Sexy: Lessons from the Global Financial Crisis", employs an adjective that is seldom juxtaposed with Canada, and another that is perhaps overused. I'm reminded of the comment of Fareed Zakaria in Newsweek (February, 2009) at the time of President Obama's first trip to Canada: "If President Obama is looking for smart government, there is much he, and all of us, could learn from our quiet --- OK, sometimes boring--- neighbour to the north." Now, while the boring comment might sting Canadians and amuse others, the context for the observation was the very different experience of the Canadian and American financial systems in the global financial crisis. Paul Volcker, in surveying the wreckage of the U.S. financial sector, stated in the Financial Times (February, 2009) that …"What I'm arguing for looks more like Canada's system than the U.S. one."

Why was the Canadian experience different? What was the role of Canadian public policy, Canadian institutions and Canadian business behaviour in shaping that difference? What elements did countries who avoided the worst of the financial crisis, like Canada and Australia, have in common? All good questions about a truly epochical event; the challenge is the understanding and the learning.

Globalization and the Financial Crisis

While the challenge of setting out the origins of the global financial crisis seems exceedingly complex, and it is, I am reminded of Einstein's' exhortation that "Everything should be made as simple as possible, but no simpler." At a very basic level, the financial crisis would not have been possible without globalization.

Globalization today is about far more that the integration of markets for goods and services and capital, or the collapsing of distance and time, or the emergence of truly multinational marketplaces. It is all that and more; it is about the speed and scope of change, the connected world of myriad interconnections among individuals, firms, groups and nations whose pervasiveness is often underestimated, misunderstood or ignored until it cannot be. A by-product of globalization and communications technologies is the information revolution. Information now originates from anywhere at anytime and is available everywhere, all the time, and through a myriad of new media (internet blogs, Facebook, YouTube, Google, Twitter,?) that are supplanting traditional information channels.

One important consequence of this intersection of globalization and the information revolution is greater complexity and greater uncertainty. Markets no longer align neatly with either regulatory remits or sovereign boundaries. Gaps in financial sector regulation were both domestic and cross-border. The extent of the systemic risk was underestimated because cross-sector and cross-border holdings fell between the silos of regulators. In short, globalization has outgrown the mandates and governance structures of international institutions as well as those of many domestic regulators.

While globalization provided the infrastructure, macroeconomic imbalances provided the fuel for the financial crisis. Macroeconomic imbalances- --both fiscal and current account---in major countries meant that international financial markets were awash in liquidity. As a result, they were desperately seeking yields. And, in a financial market inversion of Say's Law, this demand soon created a supply, namely U.S. subprime mortgages, smartly dressed up for global markets as "structured financial products."

This Time is Different

In a new book entitled "This Time is Different", Reinhart and Rogoff provide a unique historical perspective on financial market crises. A sobering conclusion emerging from this research is that, when financial markets begin to embrace a "this time is different" mantra, it usually is not, and a financial crisis is typically around the corner.

In recent years, fervently embracing this mantra, international financial markets began to believe that business cycles had been tamed, rising debt and global imbalances were tolerable, financial innovations justified quantum leaps in risk taking, and if you put enough bad mortgages together it actually became a good mortgage bundle.

How did this work? Consider the stylized but realistic example of a Frankfurt or Icelandic or Scottish or Latvian bank which has largely ceased lending to its local business and household customers because of toxic assets crushing its balance sheets. These same toxic assets started life as seemingly benign, but very low quality, mortgages in Iowa and Arizona and Florida. These sub-prime mortgages were then bundled together, securitized, and collateralized and became, through the power of statistical models, high quality structured securities, promising high returns and low risk---the true sorcerer's gold. The global financial marketplace, entranced by these structured products, demanded more and more of them, which U.S. financial markets happily provided. A risk assessment of the poor quality Iowan mortgages underlying the structured securities was done by statistical risk models which were unbelievably sophisticated but, as Nassim Taleb points out so eloquently in " The Black Swan", they were largely estimated over benign economic periods, thereby assigning too low a weight to volatility and systemic risk. And did Boards, executives, risk managers and regulators adequately peer inside the models to the extent the massive investments in these structured products warranted?

The answer is that the models and the investments they supported were proved terribly wrong. In so doing, public trust in business leadership has been eroded, particularly in the U.S and Europe. Public distrust in globalization has risen, particularly in the U.S. and many developing countries. Public confidence in oversight bodies has declined, particularly in the U.S and the U.K. And the public faith in forecasters who, to a person and a country missed the timing, nature and incipient severity of the recession, remains as always.

The Canadian Context

While Canada has been hit by the worldwide recession, the Canadian financial system has weathered the global financial crisis relatively well. In Canada, financial institutions were not unscathed by the financial crisis, but none were impaired by toxic assets, no public funds were injected into financial institutions, Canadian banks remained profitable over the last year, and they continued to lend. The sharp contrast with the U.S., as well as much of Europe, reflects different regulatory regimes --- public policy matters, as well as different corporate governance systems, financial institution lending practices and different structures. It is important to remember that, in the halcyon years before the crisis, these Canadian practices were often criticized in New York and London as too conservative, too prudent, too unwelcoming of the new financial innovations sweeping global balance sheets.

On the regulatory side, Canada has integrated regulation of banks and insurance companies and large investment dealers. The Superintendent of Financial Institutions, our regulator, meets regularly with the largest financial institutions, and their Boards of

Directors, to ensure that they are governed to be sound and stable. This regulatory approach is both prescriptive and principles based. However, there are areas which fall under provincial regulation, and the Government of Canada is moving forward with a proposal to establish a National Securities Regulator to ensure comprehensive and consistent coverage of financial market activities.

Capital requirements for Canadian financial institutions prior to the financial crisis were above international standards and significantly higher than adjacent jurisdictions such as the U.S. and the U.K. As well, Canadian banks maintained capital above these minimum requirements. Canadian financial institutions were also less highly-leveraged than their international peers because Canada had a regulatory cap on leverage at an asset-to -capital ratio of 20 to 1. As a result, major Canadian banks had an average asset-to-capital multiple of 18 in 2008, while the comparable figure for U.S. banks was close to 30, and European banks well over 30.

Behaviourally, Canadian banks rely more on depository funds than wholesale funding compared to banks in many other countries. Further, on the asset side, the vast majority of Canadian mortgages are originated by banks to hold (over 80% compared to less than 20% in the U.S.), thereby providing a strong incentive to **not** lend where there is a high risk of default. Government regulations require insurance for high ratio mortgages and impose high credit standards on the eligibility for mortgage insurance. These structural features of Canadian banks are well analyzed by Ratnovski and Huang of the IMF ("Why are Canadian Banks More Resilient").

And this has to be overlaid on a system with strong balance sheets, reflecting a decade of sustained government surpluses and a similar strengthening of corporate and household balance sheets. Taken together, this combination of regulation, governance, structure and business practice has produced what the World Economic Forum rates as the soundest financial system in the world.

The Times, They are A-Changing

The response to the global financial crisis was unprecedented, both in terms of size and international coordination. Central banks provided massive injections of liquidity into financial markets and extraordinary monetary stimulus, while governments provided massive injections of fiscal stimulus into domestic demand. A number of industrial countries also made direct investment of public money into troubled firms judged to be systemically important.

The cyclical implication of the current financial crisis is a destruction of wealth of extraordinary magnitude, while the structural implications will be a shifting of wealth and capital and activities among countries with long-term economic consequences. Fareed Zakaria's "rise of the rest" has been accelerated by this financial crisis and recession. Asia is the global driver of recovery from the worldwide recession for the first time ever. Indeed, within a decade, China could approach the U.S. in terms of the size of its economy measured by purchasing power parity. At the same time, a number of industrial countries have large and unsustainable deficits, and a process of fiscal rebalancing will require expenditure reductions and difficult policy tradeoffs.

In short, the times they are a-changing. Part of that change is in public expectations for governments, setting in motion changes in the role of government. These expectations do not suggest a lessened role for government, nor do they necessarily suggest larger government; rather, they point to public expectations for governments to better prevent and protect. Pervasive globalization and its attendant challenges. The domestic and international financial system in the aftermath of the financial crisis. Transborder security and crime. Product safety and information protection. Aging that will increasingly hit our labor markets, pension systems and health care. Dealing with climate change.

A further consequence of the global financial crisis and globalization is a changing expectation for governments to better cooperate and coordinate beyond their boundaries. Globalization has outgrown the mandates and governance structures of the international institutions. The G20 process, which proved effective in marshalling a common understanding of the magnitude of the global financial crisis, in helping to coordinate monetary authority responses and in providing a political and policy rationale for a large collective fiscal stimulus, is evolving. The September 2009 Pittsburgh Leaders Statement denoted the G-20 “as the premier forum for our international economic cooperation” The financial crisis has also provided impetus to reform of the International Monetary Fund, its mission and its collective ownership. Similarly, how countries deal with climate change cannot be done solely on a national basis as the potential for arbitrage among national systems makes a doable, enforceable, and comprehensive international system essential.

Some Lessons Learned.

So what lessons are to be drawn from the global financial crisis, both from those countries and financial systems that avoided the worst of it like Canada and Australia, and those that did not?

First, macroeconomic behaviours and microeconomic systems don’t exist in splendid isolation from each other. Prudent, long-term, fiscal and monetary policies impact positively on financial sectors; conversely, macroeconomic policies that contribute to imbalances will eventually negatively affect financial markets no matter how sound the regulatory systems.

Second, understanding the pervasive interconnections of markets, both within and across national boundaries, should inform the structure and operation of regulatory systems. It also underscores the importance of effective international cooperation and coordination among national regulators and supervisors. It requires getting the “perimeters of regulation” right, both sufficiently broad to avoid both gaps and regulatory arbitrage, and comprehensive enough to cover all systemically important firms. And, it suggests a focus on the regulatory levers that can best contribute to the objectives, rather than a myriad of prescriptive rules. In the Canadian experience, limiting leverage, healthy capital buffers, mandatory mortgage insurance for high ratio mortgages and the absence of a tax subsidy for mortgages were four such measures.

Third, prudence may be boring, but it pays off, particularly when viewed over the complete economic cycle. This is true at the level of individual institutions; it is equally true at the level of setting the appropriate regulatory standards. Regulation and business planning should presume economic cycles as the norm, not just benign growth. Economic cycles have not been banished to the dustbin of history; booms are invariably followed by more challenging times.

Fourth, communications matters. Financial institutions in Canada are less averse to working with regulators and the government than in many other countries, and this helps spot incipient challenges given the degree of inherent complexity and uncertainty in global financial markets. There is also a close and ongoing working relationship between the central bank, the prudential supervisor, the market conduct regulator and the Ministry of Finance, something we have learned from experience to be valuable.

Conclusion

To conclude, the world economy is now in the transition from crisis to recovery. It has been an extraordinary 14 months. Recovery in most major economies is beginning to take hold, but its vigour and speed will vary considerably.

The key policy requirements, as the October 2009 IMF World Economic Outlook sets out succinctly and starkly, are "to restore financial sector health while maintaining supportive macroeconomic policies until the recovery is on a firm footing. However, policymakers need to begin preparing for an orderly unwinding of extraordinary levels of public intervention."

All-in-all, a non-trivial policy challenge ahead for all of us. In moving forward, we need to guard against a returning sense of normalcy leading to complacency. The cyclical recovery is a welcome sign, but the structural work to deal with the problems in the financial system is still very much a work in progress. A work where countries like Canada and Australia have much to share with other nations given our different experiences during the financial crisis. A work at the international level where our countries can play a leadership role to build a more effective system.