Questions and Answers

Following the formal presentation, Andrew Crockett took questions from the audience.

GUILLERMO ORTIZ: Well, thank you very much, Andrew, for this very illuminating presentation. And thank you, Caroline, for joining us today. As you know, Caroline is the President of the Per Jacobsson Foundation, and she is the Director of External Relations at the Fund. And she has come all the way from Washington, mostly for this event. So thank you very much.

Well, this was really a tour de force. Given the very comprehensive nature of your lecture, I'm sure that it's a lot of food for thought. You have practically touched on all the current issues. Not only did you explore the weaknesses that led to the crisis, but you also laid out, I think in a very balanced way, the thoughts that have been distilled with experience. And I must say that the presentation was, in my view, very, very balanced.

I don't want to take too much advantage of my role as the Chairman. But let me ask you one question before opening the floor for questions. And this is something that has to do with the "too big to fail" question and the cross-border issues which are, in my view, the most intractable of this whole panorama that you made.

And let me begin with a very precise question. There is, I think, an ongoing trend or project which is being also discussed in the Financial Stability Board of putting additional capital requirements on systemic and important financial institutions. And I guess this is already taking shape.

My question is, Do you think that this may in some form create a moral hazard? I mean, the minute you have a list of what are systemically important financial institutions, and you put additional capital surcharges—you are actually reinforcing the notion of "too big to fail." And you are probably giving them a funding advantage. Rating agencies are

probably going to treat them with more respect. And well, the question is whether this is not actually reinforcing this perception that you are trying to dispel. I mean, you have laid out a very sensible set of principles for a regime to unwind systemically important institutions, and these principles are very fine. But I think that I'm very skeptical that they actually could be put into practice.

But let me stop here and perhaps you would like to address this before opening the floor, Andrew.

ANDREW CROCKETT: Well, thank you, Guillermo. You wouldn't expect me sitting in the seat I presently occupy at JPMorgan to be in favor of SIFI [systemically important financial institution] surcharges. [Laughter] And any argument you can advance, I'll gratefully use.

I think there is, to be serious, a slight risk that if you designate a list of institutions you will create a presumption that they have got some additional protection. I presume the reason why the Financial Stability Board and the regulatory community more generally has done this is in order to have the double security, if you like, of, on the first hand, trying to reduce the impact of the failure of a large institution and make it more resolvable than in the past, but in the period before that becomes fully credible, to have the additional safeguard of the higher levels of capital that a large institution would hold. I think if you reflect on it, those two things—two approaches: more capital to reduce the likelihood, but also more effort to reduce the impact—are to some extent substitutes. If we could successfully reduce the systemic adverse consequences of the failure of a large institution, it would, I believe, therefore become less necessary to have a special capital regime.

And I think it is the case that most financial institutions—I certainly speak for my own institution—would not argue to have a special implicit government backing, nor would it want to have a special funding advantage beyond that which is derived from the effectiveness and the efficiency with which we run our own institution.

So I would hope in the evolution of regulation that as it becomes more confident in the ability to resolve financial institutions that get into difficulties, there would be an incentive to do so by perhaps providing that the additional capital surcharge would become less necessary and less onerous as the resolvability of institutions gets greater.

GUILLERMO ORTIZ: Thank you very much, Andrew. So let me open the floor for questions.

QUESTIONER: *Thank you. Andrew, first of all thank you for the talk. And I should say, also, thank you for all the help you have given us and many others at the Bank for International Settlements.*

I've got a question which focuses on the interplay that you're alluding to in all of this between financial stability and macroeconomic stability. And the implications that a well-functioning and -regulated financial system in the future will have for requirements for monetary policy adjustment, obviously an area of concern for a lot of us in this room.

Do you think that there are implications from the developments in the financial system for the setting of monetary policy, first of all directly through traditional official cash rate channels, and secondly through other channels that have implications for monetary conditions, asset markets, effects markets, etc.? And could you see this changing in the future with further financial market regulation or innovation?

ANDREW CROCKETT: It's an interesting question, and I'm not sure I've thought enough about it to be confident in the answer I would give. First of all, obviously, greater financial stability in and of itself is an advantage in setting monetary policy. You don't have to worry so much about the implications of a monetary policy action for the stability of the overall financial system.

However, one has to recognize that monetary policy operates through channels which rely on predictable responses that come out of the financial system. There are aspects to which I alluded in the talk that might give one some concern if it were the case, for example, that an increasing extent of credit mediation moved into channels outside the conventional banking system. It may be harder for monetary policy to predict its effects through the traditional channels in which monetary policy operates.

Then, I think monetary policy probably relies for its effectiveness on the degree to which markets are adequately integrated across maturities and across asset classifications, so that an additional monetary policy action, which typically takes place in the short-term overnight markets, transmits itself through the rest of the economy. So I think it's important that one preserves and doesn't try to block off channels that link different markets.

I'm not saying this is going to happen, but there is obviously, following a crisis, a temptation to say, "Where have problems arisen, let's stop it," without necessarily reflecting on how far that would impact on the ability to influence the overall macroeconomic situation.

QUESTIONER: *Thank you, Andrew, for giving us a dream project for the twenty-first century. You have mentioned about this thought experiment. A lot of experimentations are going on all around the world, really not all of them are really documented well. Particularly there is need for process documentation of what is going on.*

Many of the countries like, say, Bangladesh avoided financial crisis mainly because of a lot of indigenous kind of experimentations and also efforts they have taken. For that matter, I thought, BIS or others should put more emphasis on research—more of process kind of documentation, what is going on there.

Say, for example, Bangladesh has one of the finest regulations on microfinance. We have a formal microfinance regulatory authority. And we have avoided much of the pitfalls of the shadow banking on the microfinance, mainly because of strong regulation there. But this story, probably, is untold. It's not documented well.

Similarly, many of us are going into technology-based banking. Say, for example, Bangladesh and many other countries are going quite fast into bank-led mobile banking. So what are the dangers or what are the regulatory requirements for banking like that? Again, other technology-based banking also needs a lot of IT [information technology] auditing. And a lot of experimentation is going on there, we need that kind of oversight.

For that to happen, I think, we need strong research. And I think research in the central bank is not enough. So for that matter, maybe we need to intertwine with the good research in institutions or the universities, or even other central banks. And we are trying to have some cooperation between banks—say, for example, Bangladesh Bank taking advantage of the good knowledge of the RBI [Reserve Bank of India] or the Malaysian Central Bank. So, those kinds of cooperation are also in need.

And I thought we could focus on those areas as well. Thank you very much.

ANDREW CROCKETT: Well, I can only agree with the importance of doing research and sharing experiences. And I assume my former colleagues at the BIS have been listening carefully to what you had to say, and are maybe thinking how it could be incorporated, not only into their own work program, but I think one of the contributions the BIS can make as a forum for central banks to get together is to allow different kinds of experience. And since being from Bangladesh you have probably a deeper experience of microfinance than anywhere else, that would be an important example of where you and the other institutions that are interested in developing microfinance could share experiences.

But as you have indicated, it's by no means limited to that. And I know that the activities of the BIS—I'm sure Jaime would attest to this—are constantly examining ways in which the activities of a forum for sharing information and undertaking research among central banks can be productively employed.

QUESTIONER: *Thank you. I had a quick question. You mentioned that credit risk is usually at the root of big problems in the banking system. And perhaps it's not just credit risk, but more specifically, risk in housing and commercial property. And I wonder what your thinking is about the system of housing finance? Which, of course, in the United States in particular and in some other cases is almost a whole separate system and not at all a market-based system, or at least it has a very particular relationship with the market. And I wonder if one can sensibly think about reforming the financial system of regulation without also thinking how that which was at the root in some ways of the last financial crisis is examined.*

I had another quick question which is just about a financial activities tax. We're all central bankers here, but another way to think about limiting risk and also building up a pile not of capital for the banks, but of money for the taxpayers who ultimately bail out the financial system, has been suggested through a financial activities tax. And I wonder how you see that fitting in.

ANDREW CROCKETT: Well, housing is a specific example, and I couldn't in a couple of minutes do justice to it. But housing has often been a substantial basis of the financial difficulties. And it's rather obvious when you think about it why that should be the case. Because a loan to a residential or commercial property probably lasts 10 or up to 30 years, and it's financed on the basis of deposits that are withdrawable on demand. So there's a huge investment risk as well, an interest rate risk there.

Capital markets are one way in which you can hedge that risk. You can hedge it by buying interest rate swaps, which is one way of doing it, and retaining the credit risk on the balance sheet of the bank, or you can do it by actually packaging the credits and selling them off into the capital markets.

One of my points in the speech was the importance of having information. I think one of the shortcomings of the way in which the U.S. housing finance system worked was that there was inadequate information about the income streams underlying the securities that were packaged and sold.

And I would hope that one of the reforms would be not to abolish securitization necessarily, which I think performs a useful function, but to make sure that securitization has a better basis in information.

With regard to a financial activities tax, I have to say—I'm going to just make assertions rather than debate. I'm not a great fan of the Tobin tax, although I was actually a student of Tobin's at Yale many years ago. It seems to me that throwing sand in the wheels of—in the efficient working of—is always, or almost always, a second-best alternative rather than a first-best alternative.

If it's a question of building up a pile to protect the taxpayers, I think there are other ways of doing that. I mean, we do have deposit insurance. And in the United States, it's been made quite clear in the Dodd-Frank Act that if deposit insurance accumulated ex ante is not enough to save a financial institution, there will be an ex post levy that will be placed.

The disadvantage of an ex ante levy is that it does tend to reinforce the moral hazard point that Guillermo was making: Are you, therefore, identifying these institutions as being likely to be protected if you've got a fund that's sitting there that says, this is to bail out financial institutions in the event of difficulty? So, I do have some questions about that, too.

QUESTIONER: *Thank you, Andrew, for an extraordinary tour de force. I'm sure that all of us will reflect on it for some time.*

I would like to follow on the question of how the design of the financial stability framework is going to impact on the effectiveness of monetary macro policy and the like.

And I would like to put it on its head now by noting that because of macroeconomic considerations, we are finding now that in many countries for reasonably good reasons real interest rates are negative for an extended period of time. And I would like to ask you if you have reflected on how the design of the financial system of the twenty-first century can accommodate such a reality? And is this something that is creating some other difficulties maybe?

ANDREW CROCKETT: Well, negative real interest rates are not necessarily a surprise in a situation of very weak demand. And I don't think in and of themselves they create a difficulty.

What I'm going to say now may not quite respond to your question. But something that does seem likely to be the case is that the restrictions that for financial stability reasons will be placed on the banking system may at least at the margin tend to add to a phenomenon that we used to call "financial repression." You force banks or other financial institutions

to hold safe assets. Safe assets, by the way, usually encompass government securities. And we might ask ourselves whether those are truly safe assets in all foreseeable states of the world.

Even if they are, they give a funding favoritism to governments. And that is quite convenient in present circumstances because there is a huge debt overhang in many countries. I mean, almost all countries have government debt–to–GDP ratios that they feel are too high and they would like to work down. I might say I see a couple of dangers in this situation, apart from the obvious ones. One of the dangers is that it makes inflation look more attractive than it ought to look. And it makes financial repression look more attractive than it ought to look. And I think it will be a challenge to central bankers in the future to resist the tendencies that are going to emerge directly or indirectly to help governments deal with the funding problems through the way in which the more technical problem of making the financial system more safe is handled.

GUILLERMO ORTIZ: Thank you, Andrew. I have about three people on my list and I'm going to close it, because we're going to proceed to the panel and you will have a chance to ask further questions of Andrew.

QUESTIONER: *Thank you. And thanks, Andrew, for a very thoughtful discussion.*

I just want to follow up with the SIFI question, because you mentioned that the risk of raising the cost of capital is that you can move from the regulated banking system to a shadow banking system. Now as you create within the banking system the SIFI—more costly or with higher capital—and the non-SIFI, we can be also moving from non-SIFI to SIFI and—sorry, from SIFIs to less-regulated banks—and I imagine that these less-regulated banks could also become very, very vulnerable and with a lot of systemic implications.

So, my concern is, Why the separation beyond the moral hazard issues that were raised by Guillermo? It would also have implications of creating vulnerabilities in the less-regulated part of the banking system, and why we shouldn't just go to SIFI capital requirements for all the banking system. So, that's one concern that I have regarding your presentation.

And finally, with the other point you mentioned, you mentioned the importance of cross-border banking activities and international banks. And I fully agree, and there are many reasons. But I think also the systemic implications depend a lot on the structure of the banking activities across countries and why we shouldn't just move to a bank across countries to let them be just a subsidiary, a stand-alone corporation.

ANDREW CROCKETT: Well, these almost sound like setup questions so that I can say we don't like the SIFI surcharge. But obviously there is the consequence of moving financial activity, not only, as I said, from the banking system to the shadow banking system, but if you have discrimination within the banking system, from the big banks to the small banks. I mean, as was pointed out, you could also, in theory, have it go the other way, because people may say the large banks are implicitly better protected. Not something that we ask for, so it could go the other way.

I assume within the banking system, however, you say more regulated or less regulated. All of the banking system is subject to regulation. And therefore, the regulators, I presume, will be alert or ought to be alert to the consequences of shifts from large to small banks. And if the small banks become collectively systemically more important, then they would warrant closer oversight.

On the question of cross-border activities and why not simply subsidiaries, I mean, I understand there is a case to do that. One needs to be a little bit careful, because it would not be easy in a crisis for a bank to allow a subsidiary that had gotten into difficulty to fail. The reputational risk that links different subsidiaries of the same group is not negligible, so one has to take that into account.

And there are also costs because of the business model in which different subsidiaries share capital and liquidity. And those would be additional costs to subsidiarization.

But I do think that, as I said, the first-best solution is to have an international regime that effectively manages the globalization of the industry as it has developed. A second best, if that is truly not possible, is to allow banks to be globally active but with the protections that you're alluding to that would be applied in different countries.

GUILLERMO ORTIZ: Let me take the last two questions together.

QUESTIONER*: Thank you, Andrew, for your impressive lecture, and also for carrying forward Tommaso's torch. In this spirit, I would like to try to push you a little forward into the post-Westphalia world that Tommaso outlined.*

You know that Tommaso was focusing much of his analysis on the twin concept of rules and institutions. I think we are probably moving into sort of a more global framework for financial regulations. But we are still, I think, in the early stages in a sort of building institution that can manage and enforce those rules in a post-Westphalia concept. And I'm worried that when people

protest in the public square, as you said, governments tend to turn to a more Westphalia approach. And so I would like to ask your comments on this. Thank you.

QUESTIONER: *Thank you very much, Andrew, for a good paper. I'd like to say a few things, given what's happening in Europe today, and this is the question of moral hazard and perverse incentives.*

If you look at Greece and Portugal and Ireland and Spain and all these countries, the one industry that they have in common is the banking industry. And yet there's this seeming determination all over to make sure that the banks don't pay any part of the cost for the decisions that they've taken. Everything is being done to make sure that the banks don't pay a price. And I wonder if this does not encourage bad behavior in the future.

I'll give an example. In Nigeria, we bailed out the banks. But having bailed out the banks, for the next 10 years the banks are going to pay interest they can pay and fund for the cleanup. Why can't we think of doing something like that in Europe? I can understand saying the banks can't absorb the losses now, but why can't the banks pay in the future? Thank you.

ANDREW CROCKETT: Well, excellent questions to which I don't have excellent answers, I'm afraid. [Laughter] But I would agree with you that the default response of governments and regulators faced with crisis is to retreat to their clearest responsibility, which is to their national economies.

I think it's a matter of leadership, particularly at the political level, to educate countries to the fact that—I mean, Tommaso made wonderful references to various institutional arrangements last time—to make clear that supranational international arrangements are necessary in many spheres. I remember he referred to the navigation on the Rhine, which is perhaps one of the earliest sets of agreements between the countries bordering the Rhine.

And I think we have to realize that not only is financial activity global, but it's also productive to have a global financial institution. The perception now—at least I think in the public mind—is that banks are toxic and, therefore, anything that you can do to restrict their activities is probably a good thing. And we need to generate—at least if people agree with that—the concept of allowing banks to develop in a natural way and in a fashion that enhances the contribution in which they and the financial system more broadly can serve the needs of the real economy. If we can demonstrate that and demonstrate also that in order to do this safely and

efficiently, you need to have a system of international rules, that would be the way to go.

Now, we do have a lot of progress that has been made. When I began my career, nobody would have thought of the Basel Committee setting rules and standards. Charles here is the author of a forthcoming book which will teach us a lot about the origins of that. So I'm not totally pessimistic. But I'm afraid when you get to a bump in the road and there's a crisis, then you get a retreat into national preconceptions.

I don't think I should really attempt to say about Europe what the solution should be. I mean, it's a fascinating question and a very troublesome question. In a general sense, I can remember at the time when the Maastricht Treaty was being negotiated and when the statutes of the European Central Bank were being negotiated, the no-bailout provision—in other words, national borrowers would be on their own—was something that was considered important.

It's obviously the case that the way in which the union developed and the way in which the euro zone developed, they built up an assumption that crises were less likely and would be approached in different ways than turned out to be the case. So, in the Nigerian case after the bailout a much more-disciplined regime was imposed. Maybe it will be the case that once the crisis has been overcome, there will be a greater clarity of the role of market discipline, and the role of official support, something I talked about in a more general sense, will be applied.

But right now, I don't think it's helpful for me or anybody else to muddy the waters of the difficult problems that our colleagues in Europe are dealing with.

GUILLERMO ORTIZ: Thank you very much. Let me bring this session to a close by thanking Andrew once again, and asking the panel members to please come to the forum. [Applause]