South African Reserve Bank

The financial crisis and the crisis of trust in the banking sector of the advanced economies

Address by Gill Marcus, Governor of the South African Reserve Bank to the Rhodes University Business School strategic conversation series,

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Thank you for the opportunity to address you in this beautiful city of Grahamstown. Your city may be out of the hustle and bustle of the financial markets, but that does not mean that you have been spared the fallout of the continuing global economic crisis, which is now well into its fifth year, and many commentators are now talking about the possibility of a “lost decade”. The Eurozone contracted by 0,7 per cent in the second quarter of 2012, with 12 out of the 17 members experiencing negative growth. US economic growth is below potential and the prospect of a significant fiscal contraction early next year - the so-called “fiscal cliff” - looms large. Unemployment in the advanced economies has on average more or less doubled, with both Spain and Greece reporting rates of just over 25 per cent. The sovereign debt crisis in Europe remains unresolved, and continued fiscal austerity continues to retard growth prospects. Compounding this bleak outlook in the advanced economies and in the Eurozone in particular, is a banking sector under stress, characterised by shrinking lending or deleveraging, as they adjust to new regulatory requirements, amid increasing reluctance to lend outside their own countries.

The travails of the Eurozone are likely to last for some time, and it is ordinary people around the world who are suffering, who have lost their jobs and future dreams, and are losing confidence and trust in economic and political institutions. Trust and alignment of purpose are essential ingredients of a harmonious economic and political system, and while the crisis has had a number of dimensions, one of the

aspects often forgotten or not talked about is how it has undermined trust and how critical restoring confidence is to the success of any initiatives taken.

Barry Eichengreen notes that everyone talks about Europe's deficits, southern European external deficits, and the Eurozone's institutional deficits. But, he argues, none of these is the deficit that really matters: "the deficit that prevents Europe from drawing a line under its crisis is a deficit of trust". He identifies a number of levels where trust has been undermined. Firstly, there is a lack of trust in leadership, where leaders say one thing when everyone knows they mean something else, and eventually they will have to acknowledge reality. He points to the example of German leaders promising their citizens that no extra money would be spent on erecting firewalls for Eurozone countries.

Secondly, there is the lack of trust between European states: northern European countries do not want to bail out the peripheral countries because they do not trust them to use the money wisely, and cause them to relax their reform effort. As a result, he argues, the core countries are prepared to provide just enough assistance "to keep the ship from capsizing, but not enough to set it on an even keel." And finally, he argues that there is a lack of trust between social groups called on to make sacrifices. If I have to make sacrifices, will I trust others to do the same? Furthermore, research has also shown that inequality within society reinforces lack of trust and lack of cohesion.

While these trust deficits are critical, I will focus on another element of trust, and that is lack of trust in the global financial system in general and in banks in many of the advanced economies in particular. It is important to stress that, without being complacent, the South African banking system remains sound and well capitalized. The South African authorities have not had to assist any bank, nor provide liquidity to prop up the system.

The anger that has been exhibited against the banking sector in various countries, for example the on-going "Occupy Wall Street" campaign, is indicative of a lack of trust in the financial system, and the recent revelations of Libor fixing and allegations of possible money laundering and fraudulent activities reinforce that lack of trust. The issue of distrust in the advanced economy banking system was exacerbated by at times obscene severance packages paid to bank CEOs after the banks were

bailed out by public funds. These golden handshakes were in effect excessive rewards for failure. In the past few days we have seen the New York Attorney General filing a civil fraud lawsuit against JPMorgan over mortgage-backed securities packaged and sold by Bear Stearns, which JP Morgan bought in March 2008.

The importance of trust in the financial system cannot be over-emphasised, because without it the financial system breaks down, and without an efficiently working financial system, the economy will not operate effectively. A lack of trust in banks or in financial markets can undermine the system as a whole. If clients do not trust their banks they will not borrow from them; if banks do not trust their customers they will not lend to them. The development of relationships and trust between bankers and their clients leads to the build-up of what Bernanke has referred to as knowledge or informational capital. As bankers get further away from their clients and trust is lost, this knowledge is lost as well. A New York Times columnist David Leonhardt, in commenting on the vanishing of trust in the banking system, wrote: “Banks now look at longtime customers and think of that old refrain from a failed marriage: I feel like I don’t even know you.”

Much has been written in the economics literature about the central role of the financial and banking system in the economy. Real investment in an economy, which generates economic growth and jobs, requires funding. Similarly, households require funding to finance housing and other forms of expenditure, whether of a longer-term investment nature, such as education, or more consumer-type expenditure. Banks and other financial intermediaries play a unique role in channeling savings to investors. Both savers and investors face risk and uncertainty: savers cannot always easily assess the risk of an investment, and by pooling savings, banks allow for increased returns for savers. Investors, on the other hand, who require funds for investment projects, can take advantage of pooling of savings and the intermediation services of banks or other financial intermediaries.

It is generally accepted that a healthy, well-functioning financial sector is essential for growth. It is also the case that when the banking sector becomes dysfunctional and stops lending, the implications for the real economy can be extremely serious. Bernanke, for example, has argued that the so-called “lost decade” of Japan can be

attributed substantially to the financial problems banks faced with nonperforming loans and insufficient capital. Furthermore, the financial sector is not only important for the smooth channeling of savings to investors, it also has an important role in propagating business cycles. According to the “financial accelerator” theory, which helps to explain the procyclical nature of bank lending, adverse conditions in the financial markets impact on the real economy, which in turn reinforces the negative conditions in the financial markets. This negative feedback loop propagates and amplifies the downturn. The opposite is true for favourable feedback loops.

This accelerator principle implies that there are disproportionate increases or decreases in credit extension in response to changes in underlying conditions. For example, during a boom, asset prices rise, and this increases the value of collateral available, allowing for increased leverage and credit expansion. More investment is undertaken and more jobs created, which in turn leads to further expansion in the financial sector. Conversely, when asset values fall, deleveraging occurs as the value of existing collateral declines, with negative implications for the real economy.

Related to this is the work of Reinhart and Rogoff in their book “This time is different” where they show that the recovery from a financial crisis takes much longer than that of other crises. Unlike normal economic cycles or recessions, financial crises are protracted. According to their research, conventional recessions involve a relatively quick return to normalcy, and generally the economy makes up the lost output and resumes its pre-recession growth trend within a year. A recession involving a financial crisis involves not only loss of output and employment but applies to debt, credit and deleveraging, which takes much longer to work through.

Their work shows that the aftermath of severe financial crises share three main characteristics: that asset market collapses are deep and prolonged; that such crises are associated with profound declines in output and employment, with the latter being particularly protracted; and the real value of government debt tends to explode, on average almost doubling over a short period. This debt increase is apart from possible banking bailout costs, and is a result of an inevitable collapse in tax revenues as well as countercyclical expenditure policies. Their findings also not only show that banking crises do not discriminate between emerging markets and developed markets - leading them to label such crises as equal opportunity menaces

– but developed countries generally take much longer to recover than emerging markets, possibly due to greater wage flexibility in some emerging markets.

Normal cyclical downturns are often reinforced by tight monetary policies in response to an overheating economy and inflationary pressures, and the downturn can be effectively moderated by a reversal of the monetary policy stance. Unfortunately we are not in a normal cyclical downturn, and as we have seen, despite the extraordinary efforts of central banks, the crisis cannot be solved through monetary policy alone. Households in the advanced economies are still in the process of deleveraging and repairing their impaired balance sheets, and monetary policy can only help to a certain extent. In the context of weak property and other asset markets and stubbornly high unemployment, rebuilding of household balance sheets may take a protracted period of time.

There are differing views as to the origins of the global financial crisis, but it is widely accepted that that a combination of weak or light-touch regulation of the banking system, coupled with some rather questionable innovations in the banking sector, were at the epicenter of the crisis. The sub-prime crisis which originated in the United States showed how such innovations could have global repercussions. It became clear in the aftermath of the crisis that many of the senior bank executives did not fully understand these complex products and the risks associated with them. This led to a breakdown of trust between banks, as they did not know what was lurking on the balance sheets of banks they were lending to in the interbank market. It also became clear that in some jurisdictions, prudential oversight was inadequate and that the “light touch” regulation approach did not work. But with the increased complexity of products it was little wonder that the regulators could not keep up with financial innovation.

The real impacts of the crisis were amplified by financial flows, where the motto was “bring cash home”. Fund managers in the advanced economies repatriated their investments, and a study by Philip Lane has argued that the most dramatic turnaround in capital flows took place with respect to banking-sector flows, with foreigners draining liquid funds from local stressed banks, and domestic investors draining foreign liquid assets. As Lane notes:

"In both directions, banks were the main proximate investor in other banks, so were instrumental in the cross-border retrenchment as part of the general breakdown in interbank markets during the crisis. While individually rational, the collective exit from these markets contributed to the illiquidity problems that defined the acute phase of the crisis. Given the lack of an adequate international regulatory framework, cross-border liquidity runs were more difficult to forestall than domestic liquidity runs."

Other research also showed that banks were most likely to withdraw capital from countries that were geographically more remote from the home market.

The global nature of the financial crisis also meant that solutions needed to be global, with a reversal of the lax regulatory environment that emerged in the years preceding the financial crisis. Banks and other financial institutions had become larger, and they crossed national boundaries with branches and subsidiaries all over the world. This made it more difficult to regulate them, as different countries had different regulations, and banks often engaged in regulatory arbitrage. In an attempt to restore trust and to ensure that banking excesses would not be repeated, various fora, including the G20, the Basel Committee for Banking Supervision and the Financial Stability Board (FSB) engaged in revising regulations and standards. Regulation has become more stringent with the impending introduction of what is known as the Basel III framework.

There was, however, always a concern that the regulatory pendulum would swing too far in the other direction, and there is the danger that their implementation may further impede the slow global recovery. In the Eurozone for example, the need to increase bank capital has contributed to the reluctance of banks to lend. Higher capital adequacy ratios are ideally achieved through raising capital, but in the prevailing economic climate this is difficult and expensive. Banks have consequently been adjusting to these tougher ratios either through selling off some of their assets or by reducing their lending or both. The continuing crisis in Europe is in part a function of continued bank deleveraging, and has required at times extraordinary intervention from the ECB. Mario Draghi, for example, reported in Davos earlier this year that a "major, major credit crunch" had been avoided in Europe, following the €489bn emergency loans to Eurozone banks in December 2011.

Our concern has been that changes to the Basel Committee rules to which South Africa subscribes, are intended to solve problems in the banking systems of some of the advanced economies, but would apply equally to countries such as South Africa, that did not experience these excesses. In other words, the changing regulation would solve problems that we did not have, and could in fact cause unnecessary difficulties for the banks and for the broader macroeconomy. To some extent the revised principles have proved to be challenging, but we are nevertheless expected to abide by them as members of the FSB and the G-20. Some aspects of these changes could have significantly negative implications for our banks and for the economy in general if applied in the forms that are currently being proposed. We are committed to meeting the Basel III requirements, and are actively working with the global policy makers to see how these proposals can be modified or allow for country discretion in their application. But this is an example of how global solutions if applied indiscriminately to all countries, even to those such as South Africa that did not experience regulatory failures, could have adverse consequences for some.

The Basel III Accord provides for high capital ratios in order to ensure that banks are adequately capitalised. In this respect South African banks more than comply with the provisions. Currently banks' capital adequacy ratios are well above the requirements, and our banks have a relatively low leverage ratio.

Other provisions, however, will be more challenging, and South Africa, along with other countries in a similar position, has actively participated in these discussions in order to avoid possible unintended consequences. An important provision relates to the liquidity coverage ratio (LCR), to be implemented in 2013, which requires banks to have sufficient high-quality liquid assets to survive a month-long significant stress scenario. Studies by the Bank for International Settlements showed that South African banks generally would be short of such liquid assets by virtue of their dependence on wholesale, short-term funding, which means that there would be a shortage of assets that satisfy the prescribed criteria. The Basel III liquidity framework does however give discretion to national supervisors to make available to banks a committed liquidity facility (CLF) at a fee. In May of 2012 the registrar of banks announced the introduction of such a facility, which will be provided for an amount of up to 40 per cent on any particular bank's net cash outflows under stressed scenarios. This access will be against acceptable collateral. The facility was

introduced to prevent excessive increases in the cost of funding of banks and possible distortionary effects on the domestic financial markets, and takes account of the structural features of our system.

We are, however, still concerned about the impact of the proposed net stable funding ratio (NSFR) which is expected to be implemented in 2018. Again, the structural features of our financial system may pose a challenge, given that most long-term saving in the economy is done through the non-bank financial institutions, which in turn provide short term deposits to the banks. To achieve the required ratios would mean that banks to try to attract more long term deposits, or need to reduce the maturity structure of their lending. Such adjustments could have adverse consequences for the economy. However, we are not the only country with such concerns, and discussions with the Basel Committee on Banking Supervision are ongoing.

Our banking system was one of the few that emerged relatively unscathed from the crisis. At no stage did the Reserve Bank have to take any extraordinary measures to protect the banks, and the interbank market ran smoothly. Prudent banking practices and oversight by the bank regulator meant that our banks did not create the type of toxic products that were central to the crisis. In general, our banking system has not suffered the same excesses that I have described. That is not so say that everyone trusts their bank, and there are some who, because of the actions of banks seen abroad, tar all banks with the same brush. There are also, no doubt, many people who can tell you stories about their negative experiences with their banks. But in general the conduct of our banks and financial system over the past few years has been very different to that in a number of the advanced economies.

However, we cannot be complacent and for this reason there is ongoing work to strengthen the regulatory architecture with the move toward a twin peaks model of financial regulation. This approach will see the consolidation of all prudential regulation of financial institutions within the Bank, while market conduct regulation of the financial sector will be consolidated within the Financial Services Board.

In conclusion, it is important that banks around the world try to regain the trust of ordinary people. The lack of trust is epitomised in a recent article by Financial Times columnist John Gapper who notes that “if regrets, apologies and promises to behave

better were redeemable for cash, the world's banks would be rolling in it … But what are the odds of these noble promises enduring past the usual period of sackcloth and ashes at the bottom of the banking cycle? Not very high, I'm afraid. Although the new generation of bank leaders probably has good intentions – as well as needing to assuage public outrage – these pledges will be difficult to enforce, or even recall, when it matters." The banks have a lot of work to do to change the culture that has crept into the sector.

Fortunately our banking sector does not appear to have been prone to the same excesses, although they are by no means perfect. As I have outlined, it is critical for a growing economy to have a vibrant, stable banking sector, and given the importance of this sector it is imperative that it be appropriately regulated and supervised. Given their important role in the economy, banks have a particular responsibility to act is such a way that engenders trust. I have focused on the issue of trust in the banking sector. But the issue of trust must permeate society in general. If we want to nurture a stable democracy, we need to behave in ways that will create trust in our political, social and economic institutions, and between social groups. Such trust cannot be demanded, it needs to be earned through appropriate actions and behaviour. During the current difficult times that we are experiencing in our country, the building up of trust takes on even greater importance.

All of you who have taken the time and made the effort to be here today, both from schools and Rhodes University, are the ones who will be entering the labour market in the near future. It is you who will need to grapple with the very complex world of the 21st century. Nothing can prepare you for all eventualities, but the fact that you have a sound education will provide you with the knowledge essential to navigate into unknown territory. Remember, while certificates are important, it is the knowledge that goes with the certificate that will bring you the life you want to live. There is no substitute for hard work, for seeking knowledge, and using your drive and sense of purpose for the greater good of society and fellow human beings. Your future also depends on you. As South Africans, let us work together, young and old, across all our historic divides of race and gender, to build a future that belongs to all of us.

Thank you.

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