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"Moral Hazard, Market Discipline and Self-Regulation - What Have We Learnt?"

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1 Introduction

Ladies and gentlemen

I would like to congratulate the Bank Negara Malaysia on its 50th anniversary. 50 years of central banking is a time span which allows a central bank to gain experience and to learn from the various challenges it is confronted with. Anniversary celebrations are usually an opportunity to look back on this period, to honour the achievements and remember what might have been done better. However, given the global financial crisis, it is impossible to confine oneself to this retrospective view. We have to find ways of how to respond to today's financial market challenges. This is exactly what the Bank Negara Malaysia is doing by hosting this conference on Central Banking in the 21st century and I am very glad to have been invited to contribute to the discussion by talking about moral hazard, market discipline and self-regulation.

These issues take centre-stage in global talks on crisis prevention. As the current financial crisis dramatically shows, neither market participants nor the global regulatory framework have kept pace with the expansion and innovative forces of the global financial markets. At present, regulators, central bankers, and market participants all over the world are trying to identify the causes of the crisis and search for lessons to be learnt from it. While resolute

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political decisions are indispensable when it comes to immediate crisis management, it will take much more time and effort to identify and remedy the causes of the financial turmoil. For this reason, I will not present you complete formulas today but I will try to highlight some critical issues that need further attention. But first, let me briefly outline the theoretical concepts of moral hazard, market discipline and self-regulation.

2 Theoretical Overview

Moral Hazard - In order to illustrate the concept of moral hazard, I would like to look at the process of credit risk transfer in the form of securitisation, which played a key role in the events leading to the current financial crisis. Principally, credit risk transfer is a very beneficial means of allocating risk in the financial market as it disconnects the originator of a risky asset from the ultimate risk-taker. The downside of this separation is, however, that once the credit risk is forwarded there is no incentive for the originator to monitor the debtor. This is what we call moral hazard and what has ultimately resulted in an erosion of credit standards not only in US subprime but also in other credit market segments. In general, the ultimate risk-taker does not have the necessary information to monitor the debtor and the transfer process unnecessarily complicates the default risk assessment of the securitised assets.

Market discipline - Market discipline describes a mechanism in which market participants have an incentive to monitor the risk behaviour of counterparties with the aim of readjusting their investment decisions accordingly. In the aforementioned case of securitisation, the risk-taker might be penalised by its share holders and other counterparties if a lack of monitoring impairs his ability to assess credit risk properly. Hence, market discipline has the potential to correct inefficiencies arising from credit risk transfer. However, there is a very important prerequisite for market discipline: transparency. Only if the market participants recognise that a moral hazard problem is arising will they have the option of adjusting their investment decisions accordingly. While transparency is a necessary condition for market discipline, it is by no means sufficient on its own. In addition, market participants must have the ability and in-

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centive to use the information. Especially in times of economic expansion, the incentive to acquire and use the information might be low as the general default risk remains relatively muted as long as the upward trend continues. A restraining effect via market discipline is rather unlikely in this case. Therefore, transparency and market discipline can sustain financial stability but they should not replace market regulation. In addition, market regulation itself is necessary for enhancing transparency.

Self-regulation - In general, there are two possible paths that can be followed with regard to market regulation. Regulation can either be imposed on the relevant institutions in the financial sector by regulator agencies or the institutions themselves can willingly agree on regulation. In the second case, we are talking about self-regulation. Self-regulation has the advantage that market participants tend to identify with the self-imposed rules, which should result in a higher acceptance of the regulation. Moreover, market participants might have better knowledge of the market, leading to more flexible and less costly solutions. However, as the current financial crisis underscores, self-regulation bears the risk that regulation will remain too lax or that the market participants will not comply with the self-imposed rules. This is an example of the well-known problem of collective action. Consequently, it has to be decided carefully whether self-regulation can be sufficient for a well-defined field of finance.

3 What have we learnt?

Let me now turn to some specific aspects that I consider to be crucial in the learning process that we are currently undergoing. First, I would like to talk about some regulatory issues, asking how we can enhance transparency and market discipline in the securitisation market and financial institutions. Then, I would like to focus on the role that monetary policy can play in preventing future financial crises.

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3.1 Regulation

Securitisation - The securitisation market has played a critical role in the financial crisis. Prior to the crisis, a lack of transparency in this market aggravated wrong incentives in the originate-to-distribute business model. As credit risk was well hidden in highly structured products, it was easily transferred to other market participants. This in turn increased the incentive to originate credit risk. Consequently, credit standards deteriorated, contributing to overheating phenomena such as those seen on the American housing and loan market. The fact that market participants often relied solely on credit ratings and that these ratings did not always capture the credit risk adequately aggravated the situation. Once the crisis had begun, the lack of information on the risk profile and profitability of the highly structured products increased the distrust among market participants, thus aggravating the financial turmoil.

In order to revive this largely beneficial market, a necessary condition is to restore confidence among market participants by enhancing market transparency. The transparency and quality of credit ratings is definitely one starting point in this process. I would like to stress that credit ratings should never replace the investor's responsibility to evaluate the risk of a financial product. But transparency in the rating process – especially in the segment of often opaque and multilayered structured credit – is a prerequisite for investors to behave responsibly. Only a sufficiently transparent rating process that represents negative incentive effects for rating agencies will enable the investors to make informed judgements about the product characteristics as well as the quality of the rating process itself. It should be mentioned in this context that initiatives led by IOSCO, the international organisation of securities supervisors, point in the right direction. In the course of this month, IOSCO is expected to report on improvements of transparency provisions in individual Codes of Conducts of credit rating agencies.

Another issue at stake is the lack of market standards in the securitisation market. Market participants must have easy access – for example, via a central data portal – to information on transactions in the securitisation market, the underlying asset portfolio and further trans-

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formation of the securitisation. The information provided should include, among other things, details about any retention of a share of securitised products on the balance sheet of the originator. This would reveal the originator's incentive structure and thus unveil possible moral hazard problems. In addition, there is strong need for international harmonisation of common terminology as well as disclosure requirements.

At present, there seems to be a consensus among regulating institutions and market participants about the necessity of these standards. The Institute of International Finance (IIF), a global association of financial institutions, has stressed in its final report on market best practices the need for common information standards in the market for securitised products. Their package of measures is largely consistent with the aforementioned requirements. Moreover, there are initiatives underway from both the American Securitization Forum (ASF) and the European Securitisation Forum (ESF) to develop disclosure requirements for securitisations.

The Bundesbank welcomes these initiatives and is watching the process carefully. We hope that market participants in the securitisation market will agree on and abide by strong self-regulation. Otherwise, legal disclosure requirements will have to be implemented globally.

Financial institutions - Another important starting point for transparency-enhancing regulation is the treatment of special purpose vehicles founded by financial institutions in order to transfer their credit risk off their balance sheets. In the course of the crisis, a significant loss of confidence in the money market resulted from the construction of these off-balance-sheet vehicles. As their business model is built on maturity transformation, they have run into liquidity problems when money market froze during the crisis and, owing to reputation concerns, the banks had to take them back onto their balance sheets. Thus, huge risks that had previously been invisible suddenly reappeared on the balance sheets of financial institutions, revealing a severe case of insufficient transparency.

Transparency requirements for financial institutions arise from accounting standards' disclosure requirements as well as from prudential rules for banking supervision. With regard to

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accounting standards, international and national ambitions are to change the legal framework such that financial institutions must consolidate their off-balance-sheet vehicles. For both the international financial reporting standards (IFRS) and for German accounting rules in accordance with the Commercial Code (HGB), legislation amendments are underway. Additionally, the Basel Committee on Banking Supervision recently proposed revisions to the existing pillar 3 requirements of Basel II, which aim at helping market participants to better understand a bank's overall risk profile, comprising, for example, requirements to disclose involvement in off-balance-sheet vehicles. In my view, these steps are essential for enhancing transparency in the financial markets.

3.2 Monetary Policy

So far, I have focused on regulatory issues that are relevant for the stability of the financial system. I would now like to turn to the part that monetary policy plays in this respect. In order to identify this contribution, an analysis of the monetary policy in the years preceding the crisis is essential. Different analytical methods – such as a comparison of central bank interest rates with the forecast of a Taylor rule – point to the fact that monetary policy in most industrialised countries has followed a rather expansionary stance in the second half of this decade. This was particularly the case in the USA after the New Economy bubble had burst. However, in the euro area, too, interest-based as well as money and credit-based indicators have signalled a long phase of expansionary monetary policy.

Boom-bust cycles in the financial markets cannot form independently of monetary policy. According to empirical results, low long-term interest rates tend to increase the risk appetite of financial market participants and thus contribute to a dynamic worldwide growth in aggregate credit. Why is this the case? Two aspects should be mentioned here. First, low long-term interest rates – which may indeed be justified from a monetary policy perspective – are equivalent to low financing costs in the financial markets and therefore promote highly leveraged business models. Second, in the event that the target rate of returns of financial

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market participants does not take into account that the level of the risk-free interest rate has dropped, a “search for yield” process starts to trigger an increase in risky business activities. This process may come to an end very abruptly when market participants become aware of their high risk positions, for example, after monetary policy puts an end to the phase of low interest rates. Consequently, a whole generation of business models will be brought into question. Moreover, low short-term rates have supported business models that heavily relied on maturity mismatches. These models have run into severe problems when short-term rates rose.

The influence of monetary policy on the behaviour of financial market participants might be especially strong in the event that the central bank follows an asymmetric monetary policy that is lowering rates aggressively in the face of macroeconomic downturns but increasing rates only gradually when downside risks have vanished. Contrary to this approach, there is the idea of a symmetrical monetary policy, which would not consider the boom-bust phases in the financial markets as isolated events, but would try to look through the financial cycle and stabilise monetary policy. Moreover, a symmetrical monetary policy would consider a higher key interest rate in the event of an increase in risk in the financial markets, even in the absence of inflationary risk or macroeconomic risks within the usual time horizon for monetary policy. This does not mean that the central bank would abandon its primary goal of price stability in favour of other intentions. The central bank would rather take a longer-term perspective and include the future consequences of unfavourable trends in the financial markets in its analysis.

Without a doubt, a symmetrical monetary policy will not be able to eliminate future financial crises. But I am convinced that a more symmetrical approach to monetary policy will better alleviate the negative effects of the financial cycle than a monetary policy approach that solely tries to limit the damage in times of a financial downturn by aggressively lowering interest rates. This is even more the case when one assumes that the higher moments of financial cycles are met exogenous to the monetary policy strategy chosen by central banks.

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In this respect, the Eurosystem has a very valuable analytical tool for the medium to long-run perspective: monetary analysis. This tool forces us to extend the analytical horizon beyond the usual time span of two years and to include the low frequency movements of monetary and credit aggregates in monetary analysis and the decision-making process. Hence, the Eurosystem already has an important stabilising element that enables us to counteract procyclical trends in our monetary decision-making. In future, this aspect of monetary policy will need to gain in importance.

4 Conclusion

With this request, I would like to close my speech. In my view, the highlighted issues are crucial in the ongoing analysis and learning process of the financial crisis. I think it has become clear that many promising international initiatives have already been launched. However, further effort is strongly needed in order to enhance transparency, market discipline and financial stability.

Obviously, financial regulation is currently being improved on in other aspects as well, in particular as regards banking regulation. But getting into these details would surely go beyond the scope of my speech.

Thank you very much for your attention.

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