

# RISK AND THE FINANCIAL SYSTEM

*Remarks by Mr GR Stevens, Deputy Governor<sup>1</sup>,  
in response to Distinguished Lecture by  
Mr Timothy F Geithner, President, Federal Reserve  
Bank of New York, co-organised by the Hong Kong  
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It is a great pleasure to be asked to speak in response to the distinguished lecture by Tim Geithner. As always, Tim's remarks are at once thoughtful and thought-provoking, and contain much wisdom.

In charting the evolution of the US and international capital markets over the nearly a decade since the Asian financial crisis, he notes the strengthening of the core banking system in terms of profitability and capital, the growth of securitisation and the development of a plethora of derivative instruments which allow finer unbundling and re-allocation of risk. A striking feature over the past several years has also been the way in which a succession of events which might previously have triggered a significant disturbance in financial markets have been absorbed relatively easily.

There is no doubt that the core of the US financial system – the commercial banks and major investment houses – have done well in strengthening their balance sheets and developing risk management over this period. I could echo this for the banks in my own country, and I suspect that in a considerable number of other places the story is similar. It ought to be recorded, as well, that the long night for Japan's banking system seems at long last to be over.

But rather than celebrating this for too long, Tim points to issues for the future which go to the heart of the functioning of financial markets and the challenges with which regulators and policy-makers grapple.

One of the biggest elements of the picture is the ongoing growth of lightly regulated, often highly leveraged institutions, including hedge funds. Their record of rapid growth and high reported returns on average – with the odd period of very poor returns – has attracted a lot of attention by investors. Ten years ago, hedge funds were regarded as an exotic asset class, but now they are increasingly seen as part of the main stream for pension funds, university endowments and the like. Financial institutions are also increasingly in the habit of establishing in-house vehicles to tap the appetite for hedge-fund-type investments on the part of investors. Even some large privately owned non-financial companies operate internal investment funds that are, for all intents and purposes, hedge funds. Indeed, the very term 'hedge fund' seems

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<sup>1</sup> Mr Stevens was appointed Governor with effect from 18 September 2006.

to be used rather more loosely than it used to be: we are really talking about any investment vehicle which is willing and able to take advantage of the vast array of financial products, 24-hour trading and ample liquidity to expose the funds of sophisticated investors to virtually any conceivable type of risk.

The growth of such funds is an aspect of globalisation – that process in which the national barriers to trade in goods, services and capital are eroded and in which economic and financial activity is increasingly organised on a trans-national basis. But like many aspects of the modern globalisation phenomenon, hedge funds leave people with mixed feelings.

We could debate the merits or otherwise of hedge funds and other highly leveraged institutions (HLIs) at length. Here in Hong Kong it would be, I suspect, a fairly robust discussion! Their defenders claim that, by exploiting (and thereby eliminating) pricing anomalies and by being less encumbered by prudential controls than most other financial institutions, hedge funds promote efficiency in the allocation of capital by searching out returns more effectively than others. On the assumption, moreover, that those who put money into hedge funds know what risks they are taking – which might, increasingly, be a big assumption – people might take the view that what investors do with their money is their own business.

Critics, on the other hand, claim that hedge funds can overwhelm and distort small markets. A tendency for herd behaviour, and application of leverage, amplifies the problem, in the view of these critics. When hedge funds decide simultaneously to get into or out of a position, they can disrupt market functioning. Small countries, including Hong Kong, have on occasion felt as though hedge funds were singling them out for rough treatment, and that the resources available to hedge funds far exceed those of a small country seeking to maintain, for macroeconomic management reasons, a particular constellation of interest rates and exchange rates.

I suspect that both the supporters and the critics have, at times, overstated the arguments. But, in any event, like them or not, hedge funds and other leveraged entities are here to stay.

For the most part, the entities in question are essentially those financial investment vehicles which are outside the normal prudential regulatory net. And the point is that there will always be some set of such entities. For if there is a certain degree of risk-taking behaviour that investors wish to engage in, they will find a way of doing it. If the regulatory net moves out, the activity will move beyond it. That, I believe, was a lesson hard learned in the regulated environment that prevailed in most countries for the bulk of the second half of the 20<sup>th</sup> century. It is certainly one I carry clearly in my mind from watching, early in my career, the heavily regulated Australian financial system of the time. My guess is that if hedge funds as we know them did not exist, or were regulated to behave differently, they would be invented under some other name.

This has to colour the way we approach questions of regulation. Specifically, in relation to hedge funds, there are essentially two issues that regulators need to address:

- The position of investors who are entrusting their money to these funds. In our view, this is essentially about ensuring there is sufficient disclosure to allow investors to make informed judgments about the risks and returns. In Australia, the regulatory authorities draw no distinction between hedge funds and other investment managers; the regulatory regime is determined by what the entity does, rather than what it is called. This ensures a level-playing field.

- Ensuring that the activities of investment managers which are not subject to prudential supervision do not threaten the financial viability of firms, such as banks, that are. This approach emphasises to the counterparties of hedge funds and other HLIs (that is, the prime brokers, banks and investment houses) the importance of strong risk management, collateral, knowing their customers and so on. The aim here is to preserve the prudential strength of the core part of the system in the interest of economic financial stability, while allowing the part beyond the prudential net to play its role in taking on risk.

But such an approach, relying a good deal on market discipline, is not getting easier to implement. As Tim notes, the increasing complexity of the activities of various investors makes it hard for any one counterparty to know whether they really have a good understanding of their customers' business (including with their competitors) and therefore their own exposures. Their direct exposures might be considerably smaller than the indirect ones, which will perhaps only come to light under conditions of duress. It is under abnormal conditions, when liquidity in markets is under pressure, that the leverage employed by some of the funds will be at its most damaging. It is at those moments that markets are most prone to freezing up, as all participants, wary of the unknown exposures of all others to the leveraged risk-takers, pull back. But this maintenance of liquidity and the smooth functioning of markets has become central to financial stability because even as regulated institutions have become more sound, they and other participants have come to rely more on markets for their own risk management. Hence dislocation can have serious consequences.

I am sceptical, incidentally, of the argument that hedge funds and the like necessarily add to liquidity. Liquidity means being able to change a position without affecting the price, and depends on someone being prepared to make a price. Hedge fund activity adds turnover, which probably means that in good times there is more incentive for price makers. But under conditions of pressure, leveraged investors are more likely to need to use the liquidity of the market than to be able to contribute to it. On such occasions – which is when liquidity is needed most – these funds surely are liquidity takers, not providers.

Additionally, there is, as Tim acknowledges quite clearly, an inherent conflict over certain time horizons between market discipline and competition for business. Precisely because hedge funds *et al* do add to turnover, they have considerable business to direct to financial intermediaries. When the money is flowing into the big funds, and returns have been high, they are more likely to be able to dictate the terms on which the various banks, investment banks, prime brokers and so on can get a share of that business. At those times, market discipline is likely to be eroded.

In fact, this raises much broader issues of risk perception and management than hedge funds *per se*, and here Tim makes some very good points. In particular, the emphasis on tail events, and on the uncertainty which surrounds estimates of potential losses, is very well targeted. Risk management techniques need to extend beyond calculations of VARs and the like – as complex as such calculations already are – and to think about whether the possible size of losses associated with the one-in-a-hundred event really are well described by standard distributions drawn from recent history. They need also to contemplate the possibility that the correlations between portfolios will in the future be different from those in history.

This point takes on more importance, in my judgment, against the backdrop of the remarkably benign environment of the past decade in many countries. As Tim notes, a succession of financial events have been absorbed by capital markets with apparent equanimity. Simultaneously, macroeconomic performance in a number of industrial countries has been characterised by greater stability – the so-called ‘Great Moderation’. These two factors – macroeconomic stability and financial resilience to shocks – must surely be related, and will have been mutually reinforcing. It can plausibly be argued that risk genuinely has been lower, in some respects and to some extent, over that period.<sup>2</sup>

But behaviour adapts to the perception that economic risk is lower, often with the result that more risk is taken on in the financial structure. Lower macroeconomic volatility has surely been one factor, for example, encouraging a marked increase in the debt that households are content to carry in many countries. This has been most marked in the US and my own country but is apparent in a number of others, and that number will grow. If it has not made its way to Asia yet, it will before long. To be sure, financial innovation and competition have also been at work here on the supply side of the capital market – which means that we have to be wary of eroding credit standards – but that macroeconomic backdrop was critical. How households will behave under conditions of greater macroeconomic stress, which surely will one day occur, we cannot yet know. It is a fair bet, though, that the historical loss experiences in these types of lending, both directly and indirectly via business portfolios, are probably not a good guide to the future.

More generally, a long period of interest rates being low and fairly steady, however well justified it might apparently be by short-term macroeconomic fundamentals, also causes behaviour to change. The search for yield eventually explores some fairly remote territory – be it more pension fund or retail money going into hedge funds, the rise of private equity funds, or the use of ever more exotic strategies by various managers to generate returns. The real question here is whether investors are consciously accepting higher risk in order to keep the sorts of nominal rates of return that were characteristic of a different era, or whether they are, in fact, not cognisant of the degree of risk they are taking on.

Those and other issues remain for the future. I think Tim Geithner has put the spotlight on many of the right questions. It is up to supervisors and those charged with financial stability to try to foster a climate in which the risks are managed in a way which does not quench the competitive inventiveness of markets, but still secures resilience when, inevitably, more difficult times arrive. ✎

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<sup>2</sup> For an elaboration of this theme, see an earlier speech ‘Risk and the Macroeconomy’, available at <[http://www.rba.gov.au/Speeches/2006/sp\\_dg\\_270506.html](http://www.rba.gov.au/Speeches/2006/sp_dg_270506.html)>. (Reproduced in the RBA Bulletin, June 2006, pp 8–17.)