BANK OF ENGLAND

Speech

Financial Stability: Maintaining Confidence in a Complex World

Speech given by

Sir Andrew Large, Deputy Governor, Bank of England

At City of London Central Banking Conference, National Liberal Club

17 November 2003

I am often asked what we mean by financial stability and what the Bank, or "the authorities" generally, are doing to maintain it.

Let me start with the observation that maintaining financial stability is different in a number of important respects from conducting monetary policy. There is no quantified target; no foolproof way of deciding where to look for potential threats; and no fixed timetable for policy decisions. Financial stability is altogether less tangible and more elusive. But it is nevertheless extremely important - as the substantial costs associated with financial instability demonstrate.

The Bank of England has had an interest in financial stability for a very long time. But for most of that time its interest was implicit rather than explicit. In the more formal structure put in place in 1997, after the Bank was granted operational independence on monetary policy, our financial stability role was laid down in a published Memorandum of Understanding between HM Treasury, the Bank and the FSA. Today I would like to make a few observations on some of the issues at the top of our current agenda.

Financial crises are nothing new. Indeed the Bank has been handling them since the eighteenth century. Some are signalled well in advance. Others are more of a surprise, such as LTCM. What is certain is that financial crises can be very costly. For sovereign debt crises they can run to a loss of 15-25% of GDP. For Chile in the early 1980's they were closer to 40%. So the art of minimising the emergence of crises, and mitigating their effects when they do nevertheless occur, are matters of public importance.

For us in London the challenge is particularly real. Our focus must clearly be on the stability of the UK financial system. But markets have globalised; and they have also become more complex. With London a pre-eminent international financial centre, contagion from just about any significant financial crisis anywhere in the world has the potential to threaten financial stability here.

In a broad sense, I like to think of financial stability in terms of maintaining confidence in the financial system. Threats to that stability can come from shocks of one sort or another. These can spread through contagion, so that liquidity or the honouring of contracts become questioned. And symptoms of financial instability can include volatile and unpredictable changes in prices. Preventing this from happening is the real challenge.

So how do we fulfil our responsibility for the "overall stability of the financial system as a whole"? The Bank's role is set out in the MoU. How do we approach the tasks of reducing the threat of crises and of coping with them if they actually occur? We have a three-pronged approach: surveillance, strengthening the financial infrastructure and, as a last resort, crisis management.

We start with surveillance. We need to keep a watch on the institutions in the financial sector and their interactions, both amongst themselves and with lenders and borrowers outside the financial sector. The soundness of individual banks is a key area of the FSA's activities. And we are in daily contact with them. Reassuringly at present this area of threat looks quite remote – in the UK itself at least. Supervision has come a long way in the past five to ten years as have the banks' risk management systems.

But nowadays financial crises do not necessarily just involve banks. There is an increasing overlap and interaction between banks and securities markets, and between both of them and the insurance sector. A problem in one can have a knock-on impact in the others. Most of these organisations are prudentially supervised by the FSA. But there are also organisations that are not supervised but which could be of systemic importance. The case of the hedge fund LTCM is perhaps the most notable example in recent times. And one to which I will return.

But it is not just the wide range of institutions that potentially play a part in the emergence and propagation of financial crises. You also need to consider the wide range of instruments. Some of them are extremely complex. Derivatives, structured products, and so on are now centre stage in all areas of financial intermediation. We need to understand their implications and the threats they may pose as well as the benefits they can bring and we have accordingly increased our emphasis on market intelligence in this area.

We also have to monitor the systems which underpin the functioning of markets, notably payment, clearing and settlement systems. CHAPS and BACS may be unknown acronyms to you. But they are the essential plumbing in handling UK cash payments. Without these systems the financial machinery as a whole could not operate. If any of them failed to perform this could rapidly lead to a liquidity crunch. So we need to understand how they operate; how robust they are; how good their risk management processes are; and how effective their corporate governance is. The Bank has a specific oversight responsibility for UK payment systems.

And beyond the payment and settlement systems we need to understand the financial infrastructure more generally. I don't just mean physical infrastructure such as stock exchanges and other trading platforms. I mean also the plethora of prudential, accounting and legal standards and conventions, such as the prudential capital rules as per the Basel II agenda; International Accounting Standards – due to be implemented in Europe in 2005; standards of good audit practice. I could go on. We need to consider whether people have confidence in the standards themselves, and are they fit for their purpose? And are the potential vulnerabilities of the networks they help to create properly understood and contained?

Threats can emanate from many areas: and you can see we could keep armies of people active scanning the horizon in real-time. We have all heard about the butterfly's wing-beat in Bali causing a hurricane in the Gulf of Mexico. And we all know that there are lots of butterflies! So we need to have some way of distinguishing between those threats which are of real significance and danger and those which are less pressing or more remote. What we do is to subject each of the potential threats that we can identify to regular scrutiny. So we prioritise the areas where we see real problems emerging, or weaknesses which make us think that the infrastructure could buckle under shocks.

But it is not sufficient just to be aware of the threats; we need to take action to mitigate them. Our second objective is, therefore, to do what we can to strengthen the financial infrastructure. And we design deliverables - work programmes and projects – to address important emerging dangers. Each deliverable will imply a response of some type.

Let me give you some recent examples of work we've been involved with.

On the domestic front, we gave just completed a programme to dematerialise Money Market Instruments. These are now integrated into the main CREST settlement system, enhancing market infrastructure and thereby reducing potential settlement risks. The settlement of transactions in these instruments can now occur with Delivery-Versus-Payment.

Internationally, we have contributed expertise and advice to the standard setting process via bodies such as the Basle Committee and the International Accounting Standards Board. And we contribute actively in the work of official international bodies like the Financial Stability Forum, the Group of Twenty and the G10 central banks' Committee on the Global Financial System. On a separate tack, we have also increased our focus on insurance, where the FSA is developing a prudential approach along the lines of Basel II for insurance companies. We recently led work in the CGFS to better understand techniques of credit risk transfer and their implications – particularly important for reinsurance. We also wanted to obtain better data on who was shedding and who was taking on what risk. This should in due course allow more effective monitoring of the transfer and accumulation of risk.

And earlier this year, I was myself heavily involved in drawing up the Group of Thirty study "Global Clearing and Settlement: A Plan of Action". It detailed 20 recommendations in relation to interoperability, risk management and governance that once implemented should improve efficiency and reduce risk in securities clearing and settlement. The task now is to get them implemented: and we are involved in that process too.

So in these areas we try to help to influence standards that are being set at a global level. Standards which of course also bear directly on much UK-based activity.

In terms of improved systems to enhance risk management internationally, the Continuous Linked Settlement Bank (CLS) was successfully established last autumn. It was an international response to a well recognised but partly unresolved risk: risk to foreign exchange settlement which goes back to the Herstatt crisis in 1974. CLS now settles FX transactions in eleven major currencies. And total daily values of transactions settled now exceed $1 trillion: a figure that is likely to grow further.

These are examples of ex-ante steps to reduce both the <u>emergence</u> of threats and their potential impact. But the third leg of our work is to consider what to do if there <u>is</u> a problem. What happens if a threat materialises?

Firstly there is what I might call a "traditional" financial crisis involving one or more banks directly. All such crises ultimately manifest themselves in a shortage of liquidity, which can easily spill over from one bank to another. Clearly we need the market intelligence, expertise and operational experience to handle the liquidity aspects of such an event.

Secondly, there is the possibility of what I would call an LTCM type problem. In autumn 1998 the creditors of LTCM – mainly banks and investment banks – became concerned by LTCM's financial position. The concern was partly that even though LTCM may have been short of bankruptcy, there could be attempts by its creditors to reduce their exposures, and thereby to set off major market disturbances. A crisis was narrowly averted when the counterparties were persuaded to purchase LTCM. I might say that in due course they got their money back: which only goes to show that a liquidity crisis can arise even when the solvency position of the institution remains positive.

Thirdly, we cannot ignore the threat of a "Major Operational Disruption" (MOD). What I mean by this is a natural disaster, a major act of terrorism like 9/11, or an IT catastrophe such as we sought to mitigate in the Y2K preparations. Considerable time has been devoted to work in this area, on ex ante mitigants to provide predictability and help to enable the system to get back to work quickly. You need robust back-up sites, operating procedures, personnel regrouping plans and so much more.

We are not on our own of course if a financial crisis does occur. Clearly we would work closely with FSA and the Treasury both directly and through the Tripartite Standing Committee. The Standing Committee of representatives of the Bank, FSA and Treasury meets on a monthly basis and of course ad hoc. We discuss both individual cases of significance and specific threats which could be relevant to financial stability. The Committee covers surveillance, strengthening the infrastructure and crisis management. For the latter, the objectives and roles of each party are outlined on the Financial Sector Continuity Website. The Bank's roles relate to ensuring the orderly functioning of the UK markets, including the maintenance of adequate liquidity and the functioning of payment systems. So we would act as the point of contact on operational and liquidity issues which might affect participants. Meanwhile, the role of the FSA is naturally to monitor the health of the institutions which fall within its supervisory remit, and consequently any concerns or questions in this area will naturally be addressed to them. And the Treasury will ensure that Ministers are kept up to date so that government is able to act promptly. It also undertakes to ensure coherence between the financial sector and the operation of public sector continuity arrangements more generally.

A current example of such co-operation between the three authorities and the private sector is the Taskforce, on Major Operational Disruptions, of which I am the Chair. The Taskforce was asked by Treasury Ministers to assess whether we need more statutory powers in this field, and it so what they should be. Our findings will be published in the next few weeks: so please watch this space!

I thought in closing that you might also be interested in a few observations on several issues which confront us today. These range from very high level issues such as leverage, to much more specific questions such as complex financial instruments.

So firstly, leverage. Leverage is not itself a threat to financial stability: indeed banking practice relies on leverage. But leverage can become a vulnerability once it ceases to be sustainable. And here we need to assess the global picture at several levels: not just that of the UK. Firstly, we need to consider the sovereign level. Both in the developed and emerging worlds, government debt levels have risen to unusual heights. Second at the corporate level, where current levels of borrowing both to banks and through securities are high. And thirdly we need to consider household debt. You have only got to read the newspapers to know that in the UK the level of debt to income has risen significantly. In the USA it is even higher and other countries such as Australia and Holland, which are subject to a similar low interest rate environment, are seeing similar trends.

The question is just what are the vulnerabilities? We are now at historically low rates of interest. Servicing high levels of debt seems quite realistic. But a variety of things could get people to behave differently. To save more, or to repay debt. This could come if they felt that interest rates might rise – and we did raise them modestly earlier this month. But it could also come for other reasons: a wish to save more for retirement for example. If a substantial change occurred it would, in the first instance, impact on monetary policy and our ability to meet our inflation targets. From a financial stability perspective too however we would clearly need to follow the evolution of any reactions and their consequences very closely. In the first analysis there is comfort from the improved risk management and supervisory processes that have been developed over the past decade. But we need vigilance in terms of the possible knock-on implications for the financial systems.

Moving to a more specific, and very topical, example I would like to mention complex financial instruments. We have all read alarmist stories. But Alan Greenspan often makes the point that one may over estimate some of the risks and under estimate the benefits. Shocks such as the Asian crisis, LTCM, 9/11 have been successfully absorbed by the financial system. The fact is that they have not triggered a systemic financial crisis and the instruments themselves contribute to flexibility and resilience in the system. They enable financial institutions such as banks to transfer or diversify risk to a wide variety of participants including mutual funds and insurance companies, and hence reduce concentration. My own view is that this may be true but equally we would be unwise to take too much comfort for granted.

At the Bank, we certainly feel the need for vigilance. We need to understand the implications and threats of these instruments. We start by breaking down the whole area of complex instruments into a more granular form. We focus specifically on four key aspects. Firstly there is the question of opacity and data. It is very hard to know both where risks have been transferred from and who is now on the receiving end. A dilemma of today's world is that despite attempts to improve transparency the new instruments themselves can actually make it more opaque. Secondly there are questions of pricing and valuation. Accounting standards have a vital role to play here. Meaningful disclosure requires a common approach to valuation of contracts across the whole financial sector and the achievement of standardised accounting requirements.

Thirdly there is the importance of risk management processes within firms. Do firms understand the implications of the use of models in controlling their risk? And fourthly there is the area of legal risk. Will untested contracts "close out", particularly in adversarial circumstances? If not this would be an area that could lead to liquidity concerns.

Then of course there is Basel II: an essential ingredient in the prudential standards being developed to strengthen the supervisory architecture. Today's near final accord might not be ideal – and it is more complex than we wanted. But it is a great advance on the status quo in terms of aligning capital to actual risk; and over time it can be improved. It is important to meet the 2006 implementation deadline and for agreement on the framework itself to be reached next year. Banks have invested much in their implementation systems already and delay would set back progress and add to costs. Clearly both the EU and the US need to go through a domestic rule making process but surely this can be fitted within the timetable. By 2006 planning for Basel II will in fact have taken 8 years!

Finally, an issue with which you are I expect all familiar – the EU Financial Services Action Plan. I would like to echo the views expressed recently by Callum McCarthy, in his speech to the European Policy Forum. The FSAP is an important initiative aimed to create a single market, and it promises many benefits. But the implementation of such changes over a short period of time raises some concerns; and while considerable progress has been made in addressing the 42 Directives under the FSAP umbrella there is still much to be done. Over the next few years we need to implement fourteen significant EU legislative measures, including for example the International Accounting Standards Regulation – the importance of which I highlighted earlier, as well as the new capital adequacy regime. We need to achieve so much so quickly, that there is a danger that people will take their eye off the ball. This is relevant not just to the authorities but also the firms and institutions who need to introduce new systems and new procedures. All this needs to take place in parallel in the course of the normal business day. And in doing so we need to ensure that the changes which are being introduced to enhance the EU financial sector do not themselves threaten the stability of that system.

I have this morning traversed a broad territory. Firstly, what is financial stability? Secondly, how do we at the Bank of England fulfil our role to maintain the stability of the financial system? And finally, highlighting some of the key areas that are currently active on our agenda. As you see, we have to extract from the global canvas the issues that pose the greatest threats and to then focus on them. International cooperation is the key to this, and events such as today's conference with its range of distinguished speakers and attendees from across the globe can only help this process.