BANK OF ENGLAND

Speech

“Investors: speak now or forever hold your peace”

Speech given by

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Mr. Chairman, distinguished guests, members of the UK Society, fellow Fellows: good evening. Thank you for the opportunity to speak to you tonight.

As Richard indicated [Richard Rothwell, Society Chair], I have been both banker and fund manager. I am now a regulator and teacher. I teach investment management at London Business School and I am an external member of the Financial Policy Committee at the Bank of England. The "FPC" is the focal point in the UK for something called macro-prudential policy. Our objective is to identify and mitigate threats to the financial system. At the moment our priority is to protect the banks from the financial system – and the financial system from the banks. But the end game is financial stability. And this is where we need your help – and where you can make a difference.

That a regulator should seek your support may strike you as rich. Since the advent of the troubles the investment community has been both harangued and harried by the authorities. Indeed, the first reaction of Brussels to a *banking* crisis was to launch a Directive aimed at private equity and hedge funds. Never mind that neither caused the collapse. Like a bar room brawl, some legislators lashed out at the fellow in the room they disliked the most rather than strike the one who had actually tagged them. Ever since, waves of rules, regulations, and consultations have washed over the financial sector carrying you along in their wake. It sometimes seems that neither the public nor its representatives differentiate between investment management and investment banking.

We are all investment bankers now

Why? Well, one reason is ignorance. The niceties of the "buy-side" versus "sell-side" are lost on the layman. A second surrounds issues of stewardship. But at the end of the day you are guilty by association. You are members of the financial sector and the financial sector has wrought much damage. Bankers, money managers, and yes financial regulators as well – in the eyes of the public we are all investment bankers now.

How might you correct such mistaken identity? Well, you need to speak up and you need to stand out. As it happens the podium is vacant and the arena is waiting. We are currently engaged in the regulatory reform debate of a lifetime. The rulebook that results will frame the financial system for decades to come. Should investment banking be separated from commercial banking? Are banks too highly leveraged? Will Basel III succeed where Basel II failed? Too big to fail; too big to save; and too big to manage: these are key questions of our time.

Now some of you will say that these are matters of *banking* reform. True. No doubt that is why neither you nor your trade associations have gone out of the way to jump into the ring. Yet fundamentally these are problems and proposals whose objective is the restoration and preservation of global *financial stability*. And no other sector of finance has a greater stake in stability than the investment profession. It is in your interest that banking reform succeeds. You and your clients will suffer yet again if we fail.

Where are the investors?

To date this titanic tussle has been left largely to the formidably funded banking lobby in one corner and the authorities in the other. Academics have weighed in with truth and light – but although their intellectual capital is great their political influence is not. So you are the missing piece. What stakeholder group other than the investment management industry has the combination of financial expertise, credibility and clout sufficient to counterbalance the banks and so better shape the outcome of the debate? None. Alas, no stakeholder group has been more silent.

Yes, you have taken a stand on some issues. I shall not forget the courage with which the CFA stood up to be counted in 2009 on the question of fair value accounting. And the IMA [Investment Management Association of the UK] has been active in the consultation process and vocal on Vickers. A number of industry leaders have rallied round audit reform. More recently, a US hedge fund took a public stand in favour of a more highly capitalized banking sector. This is all encouraging. But the fact that the latter made front page news speaks to how unusual it is to hear from the investment community on issues of *banking* reform.

Where to focus?

So where to start? May I suggest that you give priority to the issue of leverage and its mirror image – bank equity capital. Why? Needless to say, we are coping with the aftermath of the biggest credit bubble in history. Now bubbles are not new. They are always the same and always a bit different. In each instance one finds a heavy dose of greed, stupidity and leverage. What distinguishes our recent trauma from other such episodes is the extent and degree of leverage. Ladies and gentlemen: we will not abolish greed and we cannot outlaw stupidity. But we can and must limit leverage.

Betting the banks on Basel

So what has been done to date? How have policy makers in Basel addressed this key issue? Well, the good news is that the new rules will limit leverage in banks. The bad news is they will do so at 33 times. Thirty-three times leveraged! It's a hedge fund manager's dream – or nightmare. (I believe that the average hedge fund operates at less than 3 times – but of course, they don't benefit from a taxpayer backstop.)

Now I don't know about you. But given that the balance sheets of many banking behemoths exceed the GDP of their host countries I think that gearing of thirty-three times is sailing a bit too close to the wind. By what percent would today's banking Brahmans have to get it wrong to bring down the system and your clients along with it? Not much. Not worried? Perhaps you believe bank management to be infallible. Perhaps you have complete faith in their risk management systems. Or perhaps you are confident that the regulatory establishment will spot the next bubble and prick it with precision – all in the nick of time. No? Not entirely? Then why on earth would you want such a highly leveraged system? Why would you *not* want a better capitalized banking sector? What is the downside? The upside for financial stability is clear.

Ladies and gentlemen, I could happily go into more detail. I have done so in other published pieces. I am hardly alone in my concerns. Suffice it here to say that the old financial structure has crumbled and a new edifice is rising. But its foundation is flawed, the walls are thin and the beams are brittle. You did not design it. You are not building it. But you and your clients will have to live in it. So please check the plans and the motivations of those influential in its fabrication. The bad news is that the delivery date is seven years off. The good news: there is still time for you to weigh in and strengthen the structure. Begin with the foundation. The foundation is capital. And on this you are uniquely qualified to opine. Please, please do so.