BANK OF ENGLAND

Speech

Three principles for successful financial sector reform

Speech given by

Chris Salmon, Executive Director of Banking Services and Chief Cashier

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The City has long played a pivotal role in the provision of financial services, both domestically and internationally. From raising money for the railway and shipping companies in the 19th Century, through the growth in metal trading and Eurodollars in the 20th, the City has been at the forefront of the evolution of global financial markets. And today it continues to occupy a pre-eminent role in many markets, accounting for example for over a third of all foreign exchange turnover and nearly half of all interest rate derivatives turnover.

A modern market economy will only flourish if the financial sector reliably provides vital economic functions: the efficient allocation of savings to investment projects, insurance for households and firms against losses in bad states of the world, and the ability to make and receive payments safely. Hence, the sector's effectiveness has been and remains integral to the success of the economy more generally.

But equally, as the crisis has vividly demonstrated, the financial sector is perhaps uniquely able to inflict damage on the broader economy. The past five years have not been a happy period for the financial sector or the economy as a whole. That reminder has motivated intense debate about the role of the financial sector and has prompted a concerted regulatory response.

I will focus my remarks on that regulatory response, starting by briefly re-capping its over-arching objectives and the key building blocks through which it will be implemented in the United Kingdom. Given the complexity of the businesses involved and the cross-border footprint of many financial firms and of much financial regulation, it is not straightforward to go from objectives to implementation. Any significant reform of the financial sector carries the risk of failing to achieve the intended changes and instead having adverse unintended consequences. So having summarised the objectives, I will discuss at more length the approach the Bank is taking to ensure successful implementation. Finally, and changing the focus somewhat, I will spend a couple of minutes on some of the opportunities that structural change may offer the City in the medium term.

Turning first to objectives, stated most simply the aim of the reforms is to fix the flaws which started to become evident during the summer of 2007. With the benefit of hindsight, it is all too easy to see that banks, as well as 'shadow banks' had become over-leveraged, significant funding vulnerabilities had developed, and the system had become too inter-connected and opaque, so that the distribution of risks was unclear. Moreover, the public authorities did not have the ability to resolve banks in an orderly manner when they failed. In summary, the system was extremely fragile to shocks and the authorities lacked a comprehensive toolkit to deal with the consequences.

To fix those flaws we need to make institutions individually safer, by making sure that they hold sufficient loss-absorbing capital and liquid assets to guard against cash squeezes. We need to reduce the scope for shocks to be transmitted unexpectedly around the financial system, for example by promoting clearing through central counterparties. It also involves making sure that risks do not build-up at the level of the system as a whole, say by monitoring overall credit creation from a prudential perspective. And we need to make sure that resolution regimes are fit for purpose. If we achieve that, then the risk of firms getting into problems or of abrupt system-wide adjustment should fall, providing a more secure basis for financial stability. And it should be possible to achieve orderly resolution if firms nevertheless get into distress, banishing the spectre of tax-payer bail-outs.

Most financial regulation is conducted in the context of internationally agreed standards. Following the crisis most of the rules applying to financial market behaviour are being changed, and these amendments are one of two important building blocks in the reforms affecting the UK financial system. In particular each of Basel III, being implemented in Europe via CRD IV, Solvency II, EMIR and MIFID and new CPSS-IOSCO[1] principles for financial market infrastructure will affect the regulation of the UK financial system. The crisis has also prompted important international coordination in new areas. Most obviously, the Financial Stability Board has been leading work to agree how the systemically important financial institutions – the so-called SIFIs – which have cross-border presences can be resolved in an orderly manner. This is a problem which cannot be resolved by national initiative alone.

In tandem with these international efforts there has clearly been a significant domestic reaction, providing the other key building block for the reforms. In terms of the regulatory architecture, the key domestic changes will be contained in legislation. This includes the Financial Services Bill which was introduced last month, and legislation which the Government has said it plans to bring forward to implement the recommendations made by the Independent Commission on Banking.

As I am sure most of you know, the new bill will significantly alter the way the UK authorities and particularly the Bank seek to safeguard financial stability. First, the job of prudential regulation is being re-stated to 'promoting the safety and soundness of regulated firms ... primarily by seeking to minimise any adverse effects of firm failure on the UK financial system", with responsibility transferred to a new subsidiary of the Bank, the Prudential Regulatory Authority. Second, a Financial Policy Committee (FPC) has been established within the Bank, initially on an interim basis. The FPC will be the UK's first macro-prudential authority. It is tasked with monitoring and assessing risks across the financial system and with bringing about a macro-prudential response when appropriate. This could include making recommendations to regulators or, if it identifies risks outside the regulatory boundary, making a recommendation to Treasury to shift the perimeter.

Given the severity of the crisis few, if any, now argue against the idea that some reform is needed. A more common refrain, however, is that the planned reforms are too ambitious and should be watered down. One argument is that the cost of the transition to the new regime will prove prohibitive, particularly after taking into account the headwinds blowing from the euro-area sovereign debt crisis and unwind of the excesses

[1] Committee on Payment and Settlement Systems and International Organisation of Securities Commissions.

before 2007. Another argument is that individually sensible reforms will prove to be collectively incompatible, a risk which is probably heightened given the complex web of sponsoring bodies. The concern is that the reforms will not achieve their intended aims or will have serious unintended consequences. There is clearly some basis for these concerns, and risk of flawed implementation cannot be dismissed out of hand.

Short of abandoning ambition, what then is the strategy for managing for this challenge? The FPC has recommended that banks should build up capital levels where possible, and prioritise doing that over distributing earnings, in order to increase their resilience to the risks created by difficulties in the euro area. Beyond dealing with the immediate challenges posed by the euro-zone crisis, the Bank's approach and, I believe, UK authorities' more generally, to successful implementation has been guided by three main principles.

First, in general it is better to manage the costs of change by having a long-transition period to achieve the preferred outcome, than it is to water down the reform so that change can be implemented more quickly. In that regard, the Bank was, and remains, supportive of the long implementation timescales set out for Basel III, but would be opposed, for example, to any proposals to broaden the definition of capital, to include instruments which are not truly loss-absorbing. To date, the Basel III discussions have achieved something akin to the opposite of the US congressional-style pork-barrel politics, with countries agreeing to remove special capital definitions which had existed in Basel II in order to protect their banks from the need to hold genuine real capital. We should not give away this success in order to ease the transition.

While basically being supportive of long-transition periods, it is worth recognising that moving towards the new requirements can also yield shorter-term benefits as well as costs. There were howls of protest when the FSA introduced liquidity guidance ahead of the Basel III timetable. But the higher liquid asset buffers which resulted have been helpful for UK banks during the most recent phase of the financial crisis.

And there is one area the Bank has tended to be less persuaded by the benefits of transition periods: transparency. The costs of producing information are obviously much less than those associated with changing balance sheet structures, and lack of transparency was an important factor in the run up to and during the crisis.

To give a specific example where a relatively speedy move to greater transparency may help, the FPC has recommended that banks publish leverage ratios from the start of 2013, ahead of the Basel III timetables. These would act as a backstop to capital ratios, which are affected by the risk weights applied to bank assets. In making this recommendation the FPC drew on market intelligence which suggested that the opacity of the methods used to calculate risk weights has dented confidence in the published data.

The Bank hears multiple arguments against producing data like leverage ratios, ranging from the idea that investors will have difficulty interpreting the data, so disclosure could be destabilising, to the suggestion that investors could calculate simple ratios like this themselves, so they add little value. And sometimes both arguments are put forward at the same time! In the Bank's view investors need to be presented with a range of information, which allows them to build their own picture of a firm. Some of these may be less sophisticated investors than others, but if we are to reduce the dependence on ratings agencies, more data, must in general be a good thing.

As a second guiding principle, we need strong dialogue between public authorities to maximise consistency of approach. Internationally the UK authorities are very active in seeking to maximise the consistency between various international regulations and actions affecting the UK. In the Bank's case that involves, notably, participating in the various Basel committees, contributing to the Financial Stability Board's work on resolution regimes, and participating in European Systemic Risk Board, to coordinate macro-prudential policy across the European Union. Domestically, the composition of the FPC, which will include members from the Bank, PRA, FCA and Treasury (as well as external members) will support coordination, while the set of MoUs recently published alongside the Financial Services Bill all place a strong emphasis on information sharing and cooperation.

In tandem with this, the public authorities need a strong and open dialogue with market participants to understand the potential impact of proposed reforms, and the scope for tension between different reforms. The Bank is well-placed to undertake such dialogue, given the importance of the City as an international financial centre, and the Bank's long tradition of gathering market intelligence from its extensive network of contacts and its various markets committees. As and when these discussions convince the Bank that a genuine conflict exists, the Bank has, and will, privately make the case in official circles to modify aspects of planned reforms.

Third, we need to recognise the limits of our foresight and build in mechanisms so that rules can be amended, recalibrated or adjusted to take account of future developments. One of the responsibilities of the FPC will be to scan the horizon for just such developments – for example the build up of risks in the non-regulated financial sector – and if necessary it will recommend to the Treasury that the regulatory treatment of such activities be changed.

The case study of clearing through central counterparties provides a good example of challenges involved in getting the reforms right. One lesson from the crisis was that a rise in counterparty exposures had increased the vulnerability of the major financial systems and the point of the G-20 promotion of clearing through central counterparties was to reduce that vulnerability. But, as Paul Tucker noted in a speech last year[2], that only really makes sense if the central counterparties themselves are sufficiently robust; if they approach their roles, in his words, as 'systemic risk managers'. That requires conservative liquidity management and margining policies, complemented by appropriately-sized default resources. And it requires effective

[2] "Central Counterparties: the agenda" http://www.bankofengland.co.uk/publications/speeches/2011/speech524.pdf

loss-sharing or resolution mechanisms in the event that a CCP nevertheless gets into difficulty. Instead, it is not impossible to imagine CCPs being tempted to use the G-20 announcements to compete for the new business opportunities by, say, lowering margining requirements. Over the past two years a committee of regulators has been working to update the international standards for financial market infrastructures to ensure that they remain fit for purpose and the Bank has been actively participating in that work. These new standards are due to be published in the spring. It is likely that a number of CCPs will need to modify their operations to meet these new standards, and it will be the job of supervisors internationally to hold their feet to the fire. From next year, as part of the regulatory reforms, the Bank will assume that responsibility for supervising UK-located CCPs.

Then we need to identify which instruments should be centrally cleared, given the objective of reducing systemic risk. The Bank is devoting considerable time to this question and will feed our conclusions into the international discussions taking place in ESMA[3] and IOSCO. A number of factors, such as the liquidity in the underlying market, standardisation of legal terms or degree to which trades are straight-through processed, will be relevant to determining where central clearing would be helpful. A key consideration is whether the CCP can safely manage the risk exposures it incurs. We have also been engaging in Basel negotiations to seek to ensure that the capital charge on banks for their exposures to CCPs is proportionate to the risks they bear. Excessive charges would just encourage the transfer of business to non-standardised, less liquid products that could be traded bilaterally under the rules, defeating their purpose.

Looking forward, even if the capital charges are set appropriately, it may well be that some activity does migrate in this manner in future years, as market participants seek to circumvent the intent of the CCP reforms. In the new regulatory world, the FPC, amongst others, will be alert to the emergence of any such trends and will be able recommend corrective action through the appropriate competent authorities.

Clearly this approach will not avoid transition costs entirely; that is not possible. Nor will it be possible to create a jigsaw in which all of the individual reforms affecting firms operating in the UK fit together completely seamlessly. But I see no reason why the approach outlined above should not succeed in delivering a coherent set of reforms which have not been watered down, creating a more durably safe financial sector, while keeping unintended consequences acceptably small.

If that is the key long-term challenge facing the public authorities, then the task facing market participants will be to adjust their businesses to the opportunities created by the new regulatory framework and other structural changes affecting global capital markets. Recognising that this is a perilous business let me nevertheless suggest three possible sets of opportunities for the City.

[3] The European Securities and Markets Authority

One possible theme is that demand for some intra-financial sector services will grow. Specifically, if it is no longer possible to use leverage to boost headline returns, then tighter cost controls and efficiencies may provide a more-traditional if less glamorous way of securing a return on assets. To give one example, greater use of central counterparties is going to result in greater collateral demands, probably substantially so. Firms are going to have to learn to manage their collateral more efficiently, and that in turn could well stimulate demand for new collateral management services. And more generally, a drive for efficiency across the sector might create new opportunities for ancillary back-office service providers, many of which are located in the City.

A second theme could be an expansion in the range of firms accessing funding directly from capital markets. There have been some moves in this direction in recent years, with asset managers setting up loan funds to lend directly to companies. Any shift by investment banks to increase the fees they earn from advisory services to compensate for what could well be lower propriety trading revenues could act to reinforce this tendency. The City, with its deep and liquid capital markets, and predominance of asset managers and investment bankers would seem to be a natural place to benefit from such developments.

A third possibility is that structural changes in the global economy could create new opportunities for the City. This includes the much discussed possibility of developing an off-shore renminbi (RMB) market in London. The development of euro-bond markets in the 1970s is taken as a blueprint for what could happen in the 2010s in relation to RMB. There might be scope for the official sector to play a catalysing role at the margin, but the key arbiter in determining if such a market develops will be whether the private sector can identify and satisfy any underlying demand for RMB denominated securities.

A Bank official speaking at a conference such as this a couple of decades ago might have referred to the Bank's then third core purpose – to promote the efficiency and competitiveness of the UK's financial services. That, rightly, is no longer a distinct objective for the Bank. In 2012, given its twin core purposes of maintaining monetary and financial stability, the most effective way we can support the City, or non-financial services, or manufacturing is to create the stable financial and monetary conditions which will allow them to prosper.

Well thought through and effectively implemented reforms can help to rebuild the trust in the financial system that is necessary for a sustained economic recovery. Scaling-back our ambitions for the reforms, for example by blurring capital definitions as some have suggested recently, or weakening the thrust of the new liquidity requirements, would involve sacrificing long term gains and missing the great opportunity that we currently have to refashion the financial system. Sticking to the task, and delivering the intent of planning changes is a key challenge facing the official sector, here and overseas, over forthcoming years.