BANK OF ENGLAND

Speech

View from the macroprudential bridge

Speech given by

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Global Alternative Investment Management conference, Monaco

20 June 2012

Ladies and Gentlemen: good morning. My name is Robert Jenkins. I have been a trader, money manager and industry lobbyist. I am now a regulator. Specifically, I am a member of the interim Financial Policy Committee of the Bank of England. The "FPC" is the focal point for something called macroprudential policy. The objective is to identify and mitigate threats to the financial system of the UK. At the moment, our priority is to protect the banks from the financial system – and the financial system from the banks.

This morning's session promises to be particularly interesting. I have the honour and pleasure of acting as "MC" for the proceedings. But before presenting our presenters, allow me to offer three observations from the macroprudential bridge as seen through the eyes of a former global macro manager. Note that my remarks now and throughout the morning are my own.

Let us start with the euro zone. I leave it to our guests to debate the likelihood of a Greek exit and the degree to which damage might be contained. The point I would like to stress here is that *containment is not enough*.

Since the advent of the single currency the financial fabric of the euro zone has been woven with the assumption that "cross border risk" was absent. Cross-border risk is the risk that a borrower might not be able to repay his euro lender in full for reasons more related to the sovereign than to the corporate borrower himself. It is the risk that the counterparty to a trade might not deliver - not because he *wishes* not to but because he is *prevented* by his government from doing so. Currency re-denomination could be one threat; exchange controls another.

In the absence of cross border risk, deposits in Dresden could fund assets in Athens. Trading books could boom confident that counterparty risk was free from concern for capital controls. The Greek turmoil has of course introduced a degree of doubt. The spectre of cross border risk is back. Its impact is difficult to quantify but must not be underestimated. Creditors in the north are cutting back facilities to the south. Company treasurers sweep their euro balances daily. Float has fallen. Trade terms have tightened, security holdings have shifted, and direct investments delayed. Meanwhile, concerned citizens are withdrawing their euros - just in case. Many appear to be concerned. Have you tried to buy a flat in London lately? You have competition. Property agents openly refer to the "Bank of Belgravia." Want to open an account in Lugano? Get in line.

Banks can manage cross-border risk in two ways. In the long run, they can balance loans to local borrowers with deposits from local savers. Should a currency change cause the asset to fall in value then at least the liability declines as well. If one changes they both change. The interest rate spread remains. However, achieving asset / liability matching may require a sharp expansion of the lender's local deposit base. This can take time. In the short run – and until local assets and liabilities are in balance, the bank can limit the degree of mismatch. Unfortunately, this means limits *on* or cutbacks *to* lending into a region funded from deposits taken outside.

So here's the problem: capital is leaving the very countries that need it – and flowing to the countries that don't. At the same time financiers are cutting back on credit while they determine and manage their cross-border risk. To date, the ECB and other public entities have helped to plug the gap.

So my first observation is that it is not enough to contain an accident. The challenge is no less than to restore faith in the entire euro construct. Confidence must be such as to completely banish cross-border risk from financial planning. Until and unless this is accomplished the euro zone credit system has the potential unravel, the free flow of capital will be impaired and the economic recovery constrained.

My second observation is that our global financial system is accident prone. This is partly because the numbers have become too big and partly because big number pools of capital are so interconnected.

You all know the numbers. The recent LTRO: euros 1 trillion. China's FX reserves: $3.2 trillion. US federal debt outstanding: $15.8 trillion. Assets under management worldwide: $60 trillion. Globally traded derivatives (notional) outstanding: $600 trillion - minimum. Yes billions are for babies. You are the trillion dollar generation. But just how big is a trillion? Well, one observer (Bill Bryson) put it like this. Imagine he says that you are in a vault surrounded by the whole of America's debt – or more appropriately, the foreign exchange reserves of the Peoples' Republic. And let's say that you could keep every dollar bill that you initialled; that you could initial a dollar bill every second and that somehow, you could work straight through without stopping. How long do you think it would take you to accumulate a trillion dollars? Take a guess: 5 weeks? Six months?

Well, if you could initial a dollar bill every second and work without stopping, you would acquire $1000 every 17 minutes. After 12 days you would be a millionaire. Thus in 120 days you would reach $10 million and after 1200 days - $100 million. After 31.7 years you would be a billionaire. After 1000 years, give or take, you would be as wealthy as Bill Gates. But not until 31,708.8 years would you reach a trillion – an amount equal to 1/600th of the estimated size of the global derivatives market. In short, a trillion is a big number; and the numbers swirling in the system are in the trillions.

Now there are two problems with the size of these numbers. The first is that they are so large that even a small percentage of a big number is a big number. Thus every one per cent rise in US interest rates will eventually add some $150 billion to the annual US budget deficit. A one per cent shift in global asset preferences generates $600 billion of security purchases *and* $600 billion of security sales. And what if our global payments processing capability or collective risk management prowess were to get it wrong by a fraction of a per cent of the global derivatives book? Well, a mere ½ pct error rate could translate into losses of $300 billion. No doubt about it. The numbers are big.

But they are not only big in absolute terms they are also big in relative terms – thus the aggregate balance sheets of Britain's biggest banks are some 4 times the country's GDP. The recapitalisation of Irish banks has so far amounted to nearly half that nation's Gross Domestic Product. And needless to say, these big pools of capital are interconnected more than ever before. The degree of asset correlation in 2008 is one example; the euro zone's trials another.

Not to worry: regulators have responded with rising capital requirements for banks and a push for derivatives to be centrally traded and cleared. Bankers have fought it every step of the way. Well congratulations. The new tougher Basel III rules will ensure that banks confront this ever more complicated world with a minimum loss absorbing equity equal to some 3 ½% of assets and a cap on leverage at 33 times. 33 times leveraged! It's a hedge fund manager's dream – or nightmare.

Now ladies and gentlemen: what is the golden rule of trading? It is that you must keep risks within your risk-taking ability. It is time to ask the question: have systemic risks exceeded the system's ability to absorb the potential losses from the risks it is taking?

My third and final observation is that the days of instant market pricing and limitless liquidity may be fading. The "great moderation" conditioned many to underestimate credit risk. It also bred a generation of traders, money managers, bankers and risk officers to presume an unfettered flow of capital and instant access to narrow bid/offer spreads. Those of you who operate in less liquid instruments do not need reminding. You deal with it daily. Those of you who traded asset backed securities in 2008 can testify to the speed with which liquidity can disappear. Yet despite these examples, many continue to assume that at the currently liquid end of the trading security spectrum "liquidity" is free and will be freely available. Short term traders count on it; algo-trading depends on it. Long/short strategies presume you can short. Stop-loss disciplines demand you can cover – and cover quickly.

But here's the thing: confronted with sudden surges in cross border flows, elected governments will attempt to intervene in the interests of stability generally and to protect their taxpayers specifically. They may not succeed, but it is their right and duty to try. Needless to say, your well timed trading strategies will not be allowed to get in the way. Short-selling bans in Europe and bond purchase penalties in Brazil are a foretaste of the future. I recommend that you send your best and your brightest to the library to research state intervention in the post war period. It could come in handy. For like clean air and water, market liquidity is no longer limitless and no longer free.

And with that let us now turn to our first guest....