



BANK OF ENGLAND

Speech

Regulatory work underway and lessons learned

Remarks given by

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Six years ago when the financial crisis was in full force, the G7 met here in Washington. We backstopped our entire financial systems.

The G20 then committed to its fundamental reform.

The first objective was to fix the deep and varied fault lines that caused the crisis.

We are now in prospect of substantially completing that job at the Brisbane Summit.

Core financial institutions are more resilient.

Effective bank capital requirements have increased seven-fold. Major banks are on track to meet these requirements five years in advance. And for the first time liquidity standards have been established.

There have been fundamental changes to banks' relative incentives to engage in proprietary trading, market-making and lending, as well as restrictions on contingent exposures to off balance sheet vehicles, such as SIVs.

Shadow banking is being transformed into resilient market-based financing.

Minimum margin requirements have just been agreed for the repo market, and a variety of shadow banking institutions, including money market funds, have been reformed.

Derivative markets are safer.

Trading is now simpler and more transparent.

Central clearing and trade reporting requirements are coming on-stream, backed up in over half of FSB jurisdictions by capital requirements and, from December 2015, margining requirements.

Half of interest rates swap transactions are now centrally cleared.

Ending Too Big to Fail

Those are significant achievements but the job of fixing the fault lines cannot be complete without ending Too Big to Fail.

Operating in a heads-I-win-tails-you lose bubble, the world's largest banks threatened the stability of the global financial system. Their bail-out using public funds undermines market discipline and goes to the heart of fairness in our societies.

This cannot be allowed to continue.

It is essential that all systemically important financial institutions can be resolved when they fail:

- Without the need for taxpayer support.
- And without disruption to the wider financial system or real economy.

Tackling the rampant moral hazard at the heart of the financial system hasn't been easy. And our success can never be absolute. Specifically, we can't expect to insulate fully all institutions from all external shocks, however large.

But we can change the system so that systemically important institutions bear the cost of their own actions and the risks they take.

After much hard work, and extensive cross-border co-operation, the FSB is on track to agree proposals that, once implemented, will be decisive in achieving that.

The use of statutory resolution powers to resolve global systemic banks will finally be possible.

The proposals will be presented to the Brisbane G20 Leaders summit in November.

That Summit will be the watershed in ending Too Big to Fail.

The first is an internationally agreed standard on the total loss absorbing capacity (or TLAC) that globally systemic banks must hold.

It will be based on clear principles. But it will be much more than a list of aspirations. It will include a detailed indicative term sheet that will cover the amount; the type, and the location of that loss absorbing capacity.

It will establish a level playing field between global systemic banks, while taking into account differences in national resolution regimes.

It will ensure globally systemic banks finally have the quantum of total loss absorbing capacity that extensive analysis show balances the benefit of greater resilience against the higher funding costs for the banks that results from the removal of public subsidies.

It will set clear roles for home and host regulators in a resolution.

It will give host nations the confidence that they won't again be side-swiped by the failure of a large foreign bank.

And, by removing the implicit subsidy that systemic banks have long enjoyed, it will re-establish market discipline.

Once implemented, it will make our financial systems more resilient and our economies stronger.

The proposal will be subject to a rigorous consultation and Quantitative Impact Study and market survey in 2015 and will take into account insights from the FSB's ongoing Resolvability Assessment Process for every systemic bank's resolution plan.

The TLAC agreement will be complemented by another agreement just announced yesterday. This initiative of the private sector sets out the terms under which the 18 largest dealer banks, which represent 90% of derivative activity, would stay cross-border derivative contracts temporarily when a global bank fails.

This is a fundamental step to closing off the risk that foreign counterparties take their money and run.

By agreeing to a short stay, cross border resolution becomes much more realistic and achievable.

Once this agreement is concluded, other market participants must be brought onto similar terms to those of the 18 big dealers, and FSB members must deliver on their commitments to establish regulatory requirements for contractual stays.

There is more to do. Resolution plans must be finalised; we must systematically remove remaining legal and operational impediments to resolvability, we must think through mechanisms to ensure firms have adequate funding in resolution, and we must ensure resolution regimes for systemic non-banks are as effective as they are for banks

But make no mistake. Brisbane will be the watershed in our collective effort to end Too Big to Fail.

Building an open, global financial system

Fixing the fault lines behind the last crisis isn't enough.

The second objective of the G20's efforts is to rebuild trust in an open, global financial system.

Trust between financial institutions.

Trust between regulators.

Trust between industry and finance.

And most fundamentally, trust between the public and the financial system.

That trust is essential to maintaining a truly global financial system that integrates all major economies.

Only that system can serve all economies.

Only that system can support the investment and trade necessary for strong, sustainable and balanced growth in advanced and emerging economies alike.

Trust can only be restored if completing one job isn't equated with downing tools.

Policymakers must now begin to look beyond how they will reform the core of the system to how they will regulate and supervise it.

That approach has three elements.

First, intensive co-operation.

That is essential if national authorities are to continue to resist temptations to safeguard markets unilaterally through ring-fencing, compulsory subsidiarisation or extra-territorial application of domestic rules.

Of course, national authorities need some scope to develop measures tailored to their own jurisdictions. Circumstances sometimes differ across jurisdictions, whether because of the stage of an economy's development, its degree of integration into the world economy, or specific features of a local legal system.

But the impact of these measures must be monitored closely for spillovers to others and – where there are not detailed international standards - authorities must resolve cross-border issues by applying the principle of deferring to each other's rules where those rules produce similar outcomes.

The second involves rigorous and transparent peer review and assessment processes.

That commitment is vital not just to ensuring that agreed standards are being applied consistently, but also to allow policies to be adjusted where material unintended impacts are identified.

Through such work we've already learned about unintended consequences, and are now addressing them.

For example, we amended the liquidity coverage ratio to take into account unintended consequences under stress on core markets such as commercial paper and to clarify that liquid asset buffers are there to be used in times of stress.

We changed the leverage exposure measure, for example by recognising that cash variation margins are effectively pre-settlement payment of the fair value of the derivative. In doing so, we reinforced banks' incentives to centrally clear their clients' derivative trades. In other words, we simultaneously reduced bank leverage while increasing the robustness of derivative markets.

And we've learned about the unintended consequences of prudential capital and retention requirements on the securitisation market.

Regulatory changes arguably treat asset-backed securities in ways that appear to be unduly conservative, particularly relative to other forms of long-term funding.

Efforts to rebalance these incentives are now a priority.

As the Bank of England the ECB have argued, there is a strong case for differentiating between securitisations that are simple, transparent and consistent, and those that are not.

The regulatory treatment of those securitisations should reflect their lower risk profile.

By making changes, policymakers are applying a mature approach. We're learning and adjusting. We will continue to do so, in a thoughtful, open, and deliberative fashion.

The third element of the new approach is turning our attention to new and emerging vulnerabilities.

Work to assess new market developments and co-ordinate responses will become increasingly important as macroprudential risks arise from outside the traditional banking sector.

In some economies, such as the UK, the biggest risks are associated with the housing market, which is why macroprudential actions have been taken.

More generally, as the FSB has recently concluded: “there are increased signs of complacency in financial markets, in part reflecting search for yield amidst exceptionally accommodative monetary policies. Volatility has become compressed and asset valuations stretched across a growing number of markets, increasing the risk of a sharp reversal.”

Those risks arise against a backdrop in which assets managed by investment funds have reached almost 90% of global GDP – more than two thirds the size of the commercial banking system.

The growth of the asset management sector brings welcome diversity to financial intermediation.

However, there must also be a focus, as there has been with banks, on the systemic risks it could create.

Although the sector is becoming more concentrated, the risks don't simply arise from the size of asset managers.

They arise from the particular activities some in the sector undertake. The biggest risks arise from combining high levels of leverage with holdings of illiquid assets and commitments to provide liquidity at short notice.

In the current environment, those types of activities need careful monitoring, and possibly a deliberate policy response.

Conclusion

There is no doubt that the reforms made thus far, along with a stronger framework for global co-operation mean we are in a better position to face new risks.

But as we move to the next phase of post-crisis regulation, many commentators find it tempting to succumb to world-weary arguments.

That any reform will be arbitrated

That any insurance will promote risk taking

That there is a trade-off between stability and growth

And that there will always be financial crises.

We were right to reject such fatalism when we embarked on reform and we are right to reject it now.

While all recognise that future crises cannot be ruled out, the steps taken in the past six years have certainly reduced the likely frequency and severity of such crises.

Where banking systems have raised capital and restored trust in their creditworthiness, access to credit has returned. This central lesson from the US and the UK recoveries could not be clearer.

Publicly provided insurance is being removed from the system as the Too Big to Fail problem is addressed and the public subsidy for globally systemic banks is eliminated.

Market forces are being restored. The system is more transparent. It is clear who bears risk.

And the scope for arbitraging new regulation has been reduced through a global approach to reform that has established common standards and encompassed shadow banking.

In short, any serious look at the experience of post-crisis reform shows that reform and regulation support – not damage – long-term prosperity.

As I said in Washington three years ago: in no other aspect of human endeavour do men and women not strive to learn and improve.

The crisis showed that there was ample scope to improve the efficiency and resilience of the global financial system.

Through clarity of purpose and resolute implementation Brisbane will mark an important milestone in our efforts.

That we have reached this point is a triumph of the optimists.

But we must not stop work. There is still much scope to improve.

The process of reform is not over.

We will continue to learn and adjust.

And we must continue to manage the system effectively in the face of new risks.

With that we can deliver the open and resilient financial system that can support strong sustainable balanced growth around the world.