BANK OF ENGLAND

Speech

Taking the long view: how market-based finance can support stability

Speech given by

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At the Chartered Institute for Securities and Investment, Liverpool

28 March 2014

Good afternoon. It is a great pleasure to be here today at the Chartered Institute for Securities and Investment and to be speaking to you about the work of the Financial Policy Committee, on which I sit as an external member; not least because it's always great to get out of London and speak to those who experience the effect of our policies on the ground. But also because, given its evolution from the London Stock Exchange and its important work, the CISI is part of a place close to my heart. The theme of evolution, and growth in particular, is something I will return to later, but first, I'd like to spend a little time telling you more about the Committee (or 'FPC' for those of you who like an acronym!), and the regulatory framework within which it operates.

You and your members will have had a particular insight into the financial crisis and the urgent regulatory response that should ensure that we never see another. The FPC is an entirely new part of the regulatory architecture that fills an important 'gap' in the framework that was revealed in 2008.

We are the policy body that focuses on the identification and mitigation of *systemic* risk – or in other words, we dedicate our time to looking across *the financial system as a whole* for the build-up of potential vulnerabilities and risks. This might be the build-up of excessive debt, leverage or credit growth, or it could be more structural in nature, such as the risks that arise from the interconnectedness of important elements of the global financial network.

The primary responsibility of the FPC, as set out by legislation, is to contribute to the achievement by the Bank of England of its Financial Stability objective. In this context the FPC is to protect and enhance the overall resilience of the UK financial system by identifying and taking action to remove or reduce risks that threaten financial stability. But this is not the Committee's only task. Subject to the protection and enhancement of the overall resilience of the system, the Committee has a secondary objective to support the Government's economic policy, including its objectives for growth and employment. Indeed the Chancellor's new remit to us last week reflects the development of its economic strategy, re-defining the fourth pillar on structural reform to include support for business investment and exports. I think we can all buy into that.

In order to meet these objectives, the FPC has been given different policy levers it can deploy to tackle different risks. These powers are broad, including the power to direct the regulators to adjust sectoral or system-wide capital requirements, and the ability to make recommendations to anyone, including government. And in addition, as well as thinking about the 'core' banking system, we also have a responsibility for assessing potential systemic risk outside of the regulatory perimeter – this means we can recommend to HM Treasury that regulatory boundaries be modified, if we deem it necessary.

As you can imagine then, these broad objectives – financial stability and growth - could prompt a range of actions. But it is clear that the primary objective relates to financial system resilience and there is little doubt that that has been the Committee's work so far; delivering a step change in the strength of the UK banking system. As my FPC colleague and DG Sir Jon Cunliffe pointed out last week[1]:

- UK banks are holding £150bn more capital than they did prior to the crisis. Globally, there is around $500bn more capital in the world's largest banks.
- liquid assets for the major UK banks have trebled and
- leverage has fallen to almost half of what it was.

Of course, this intense focus on 'Never Again' was imperative and remains vital. But it is not, in my view, sufficient. Provided systemic risks are being contained, I believe that the Committee can also play a role in supporting the broader work happening internationally and domestically as we attempt to transition to a broader, deeper and stronger financial system – something that is fundamental to sustainable, long-term growth.

In this regard, the Committee is, and needs to be, *strategic* in its approach – with a focus on the future – this clearly becomes more important as we move from a phase of 'crisis response' and emergency repair to a broader forward agenda. In my view, this matters, not just because I believe we have a responsibility to think about the future, or the 'new normal' (as some like to call it) that we are helping to create, but because it reminds us that the purpose of financial stability is to allow sustainable growth. In parallel, sustainable growth will underpin our economic model and its financial stability. Given this, the FPC set out last November its three medium-term priorities for the next 18 months – one of which, importantly, is about reducing impediments to the development of diverse and resilient market-based finance; the focus of my talk today.

The financial system performs vital functions for us all – it exists to intermediate savings and investment, the latter essential to economic growth - and it provides other key services like payments and risk transfer for business. Banks, non-banks and markets all contribute to this, and, as experience of the crisis demonstrated all too well, it is the distortions or interruptions to these functions that cause problems. Given this potential for extreme disruption if things go wrong, it is clear that regulation alone – microprudential, macroprudential and conduct – is not enough. Of course, a proportionate and forward looking approach to regulation is vital because it supports *confidence* in the financial system through the establishment of reasonably predictable rules, reactions and standards. But it cannot be a substitute for *trust* among participants, which speaks to behaviour and accountability, as these are the basis for any satisfactory exchange between two parties. Or, as the Stock Exchange so famously put it: Dictum Meum Pactum.

The language and tone of the debate also matter. The words 'risk' and 'investment banking' are now too easily associated with sunny Monaco. This is unfortunate as effective risk distribution and management are essential to any ambitious export business with its eye on the global market. This is not to diminish in any

[1] Speech given by Sir Jon Cunliffe at the Chatham House City Series Conference, *'Is the world financial system safer now?'* 17 March 2014.
Available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech714.pdf

way the very serious nature of the ongoing conduct issues that confront many of the large global banks, something that continues to be a matter of concern to the FPC. But we also need our companies to be able to secure the financial services they require for future export growth.

Importance of market-based finance

The FPC's actions to date have rightly focused on mitigating systemic risks to the UK financial system – in particular, by improving the resilience of the UK banking system by bolstering capital.[2] This will have indirectly supported economic growth by improving confidence across the economy, notwithstanding the fact that important segments, including SMEs, have continued to face tight credit conditions.[3] The reduction in systemic risk, appears to have encouraged investors to put risk capital to work across the financial system more broadly, compressing excessive risk premia in primary and secondary financial markets. These are welcome signs of a step towards better conditions in UK markets. But we cannot take this improvement for granted - there is much further to go, and the FPC remains vigilant.

It is clear that the financial system can also support economic growth by allowing firms to raise funding directly from investors, through equity and bond markets, since these can be used (directly or indirectly) to finance productive investment. But companies and investors may be dissuaded from participating in capital markets if their availability is reduced in periods of economic stress; persistently making them shallower, more fragile and more expensive than might otherwise be the case. The lingering stigma attached to some private securitisation markets, given their role in the crisis, is a vivid example.

Non-bank and market-based finance widen participation and enhance diversity in the financial system – in the forms of funding available to companies (to complement bank lending) and in the distribution of risk exposures amongst counterparties. Importantly, greater diversity amongst investors tends to reduce the likelihood that their common response to unforeseen events:

(i) transmits distress to the banking system, undermining its ability to lend to other companies; and

(ii) reduces the ability of companies to raise funding directly in primary markets because they are temporarily disrupted.

Among the different facets of market-based finance, my personal view is that it is particularly important that the financial system is able to provide credible *long-term equity* capital to promising companies to support innovation and future economic growth. Committed long-term equity also offers a stabilising buffer against the inherent cyclicality of debt finance – and the adverse externalities that too high a reliance on debt can

[2] Section 4 of the November 2013 *Financial Stability Report* contains a summary of progress against previous FPC recommendations, which includes *inter alia* actions led by the PRA to boost banks' risk-weighted capital resources .
[3] See for example *Trends in Lending*, published by the Bank of England in January 2014, which describes a larger net percentage balance of respondents to the 2013 Q4 *Credit Conditions Survey* reporting falls in spreads over reference rates for large PNFCs than for other companies.

bring. These could arise, for example, through the risk that funding runs lead to widespread asset fire sales (pre-failure contagion), and the deadweight cost of unnecessarily correlated defaults (post-failure contagion).

In a vibrant market economy, we expect returns to accrue to those willing to put capital at risk through investment in new products and ideas, as compensation for bearing the risk of failure.

Impediments to market-based finance and possible mitigating actions

Despite its importance, there are broad impediments to the development of market-based finance in the UK, which the FPC highlighted in its November 2013 *Financial Stability Report*:

1. The mix of temporary and structural factors that may be holding back the re-emergence of safe and robust **securitisation** markets in the United Kingdom, to the detriment of diversity in banks' sources of funding and risk transfer outside of the banking sector. For example, in the United States, some companies finance car loans to consumers via issuance of asset-backed securities (ABS) to end investors.[4]

2. The information gaps and asymmetries regarding SMEs' creditworthiness, narrowing their access to finance – which a **credit register** might alleviate. Information gaps may also be holding back the development of other markets, such as private placements, in which UK institutional investors appear not to invest, in sharp contrast to their US counterparts.

3. Possible **liquidity fragilities** in some financial markets, including securities financing markets, that are important to intermediating risk in capital markets and facilitating global trade flows.

4. Unintended consequences of the necessary regulatory reforms following the crisis, arising, for example from increased demand for **collateral** in over-the-counter (OTC) derivative and repo markets; which may generate procyclicality in economic leverage at the system level. In this case, associated funding risks could be alleviated in principle by backstopping the collateral management of a range of institutions, including non-banks, as the Governor explained in his speech in October 2013.[5]

The wider Bank and the FPC will examine these issues over the next 12 to 18 months. This targeted approach to market-based finance is timely, sensible, proportionate and constructive. I fully support it. By identifying actions that support greater diversity in the financial system, the FPC can enhance the system's overall resilience (its primary objective) *and* create the conditions for sustainable economic growth (part of its secondary objective).

[4] For example, the mechanics of the securitisation financing undertaken by GM Financial are described at www.gmfinancial.com.
[5] Mark Carney: 'The UK at the heart of a renewed globalisation', *Speech at the 125th anniversary of the Financial Times, London,* 24 October 2013. Available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf

Stepping back, I am personally keen to ensure that as policymakers, we are mindful of the particular forces that could undermine the willingness and ability of the non-bank sector to provide certain types of *long-term* market-based finance. This has previously been acknowledged by others including the G30.[6] In my view, long-term private sector investment, particularly in infrastructure and SMEs, is fundamental to our economic future; this was also highlighted by the G20 in its February communiqué.[7] In particular I would like to try to ensure that necessary mechanisms operating in the financial system to address specific risks do not, when taken as a whole, unduly damage the ability or willingness of investors to provide committed long-term *equity* funding.

For example, short-termism can arise from the use of mark-to-market accounting in some industry sectors that should be comparatively well-placed to manage the risks associated with long-term, riskier investment; especially if it prompts herding because of concerns around temporarily underperforming industry benchmarks. This would discourage the commitment of long-term equity by those firms, as they face short-term costs even though their longer-term prospects are sound. Life insurers, for example, are required to mark their balance sheets to market to reflect risk, but this consequently creates procyclical movements in their capital resources (and requirements).

Empirical work by another Bank colleague, Andy Haldane, suggests that equity cash flows may indeed be excessively discounted.[8]

Internationally, there has been increasing investor demand for long-term stable cash-flows to match liabilities. For example, in the United Kingdom, the share of pension fund portfolios held in fixed-income assets has risen from around 10% in the early 1990s to roughly one third today – while the share of equity holdings has declined. This trend towards liability-driven investment among institutional investors, is essentially defensive and, in the circumstances, rational. But, rather than seeking to optimise a risk/return trade-off, it probably has the effect of putting steady upward pressure on the cost of equity, (especially when combined with demographic headwinds in the UK and other developed economies). This shift into more defensive assets has even been characterised as 'reckless prudence'[9].

There are still some in the financial sector, such as non-bank financial investors, who finance long-term 'illiquid' assets with short-term liabilities (whether acting as principal or on their own account). This might naturally encourage investors with similar exposures to hold more short-term, low-volatility liquid assets than would otherwise be the case. That could, of course, be a sensible precaution for firms to take. But the tendency for them to do so could vary procyclically with wider economic conditions and investor sentiment.

[6] Group of Thirty Working Group on Long-term Finance (2013), 'Long-term finance and economic growth'.
[7] See also paragraph 7 from the Group of Twenty communiqué following the meeting of Finance Ministers and Central Bank Governors, Sydney, 22-23 February 2014.
[8] Haldane, A G (2011), 'The short long', *Speech at the 29th Société Universitaire Européene de Recherches Financières Colloquim: New Paradigms in Money and Finance, Brussels*. Available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech495.pdf
[9] Including by Sir Howard Davies in 2010 on the importance of coordinate national responses to the crisis.

And this risks crowding-out longer-term investment, relative to a market where such externalities and the desire to self-insure were smaller.

Finally, of course, in the UK there is a powerful asymmetry in the tax treatment of debt and equity, for example in the coupons paid on debt and the dividends paid on equity – providing a long-standing structural incentive to fund businesses with debt rather than equity[10].

So, assuming that we need a financial system that is well equipped to finance long term, productive growth, my concern is that frictions such as these could mean that the 'low for long' market interest rate environment is masking an underlying weakness in investor appetite for equity[11]. For example, despite the widely-reported search for yield, equity risk premia remain above their long-run averages in the UK, US and euro area, as evidenced by secondary market pricing. And the Bank's market intelligence suggests that recent flows into developed market equities typically reflect consensus rather than conviction, suggesting that these positions could be unwound.

In all of this, data gaps relating to the non-bank financial sector make the task of assessing and weighing the benefits and risks associated with market-based finance difficult for both investors and regulators – in addition to contributing to some specific impediments as I have mentioned. The FPC is keen to address such deficiencies, in line with international initiatives, such as the recommendations of the Financial Stability Board (FSB), and the work of the wider Bank. For example, by allowing investors to exchange a broad range of securities and cash, repo/ securities financing markets play a vitally important role in the smooth functioning of the wider financial system; including facilitating firms' risk and collateral management, and supporting intermediation in secondary markets.

But in some cases, and notably in the US markets in the run up to the crisis, they provided leverage to investors against collateral, with procyclical consequences. The FSB has therefore recommended more granular data collection on these markets by national regulators and regional authorities. That could be useful in providing the information from which to build a wider assessment of market-based financing conditions, including how it could work more effectively to support, or at least not undermine, the markets that finance long-term investment.

Summary

A system with insufficient market-based finance is unnecessarily fragile; exacerbating the risk of impairment in the core banking and financial framework, with adverse consequences for economic growth and welfare.

[10] This issue has been discussed by many. For example, the Parliamentary Commission on Banking Standards received much evidence on the tax treatment of debt versus equity. Their final report, 'Changing banking for good', published in June 2013, can be accessed at: http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27.pdf

[11] Mark Carney noted the need for vigilance given the potential for vulnerabilities to emerge from a long period of unusually low interest rates in his Mais lecture, 18 March 2014. Available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech715.pdf

As a result, the FPC has agreed that ensuring diverse and resilient sources of market-based finance is one of its key medium-term priorities. We explained this in our November 2013 *Financial Stability Report,* saying that we will work alongside the wider Bank to assess and where necessary act to:

- promote a better functioning securitisation market in the United Kingdom;
- consider whether a credit register might support financial stability;
- enhance the resilience of liquidity in those financial markets important to our financial resilience; and
- reduce the risks to the system arising from procyclicality in the availability of finance, including via collateral markets.

I fully support this.

My own view is that it is particularly important that the financial system is able to provide credible *long-term* finance to productive companies – this usually means equity finance, an elegant solution to the pricing and management of long term business investment and its risk. Equity simply is, as our history shows us, the best mechanism we have for matching capital to an opportunity that promises future growth. And sustainable growth will secure our long term economic model, thereby underpinning our financial stability.

But there are pressures on long-term equity investment, as evidenced by the persistent de-equitisation trend we have seen in the UK in the last 20 years. So I am keen that we remain alive to the possibility that the low yield environment may be masking an underlying weakness in appetite for equity that could emerge when economic conditions and market interest rates eventually normalise.

However, regulation alone cannot be the solution to all of the challenges we face. Regulation provides a vital framework for control through the establishment of predictable rules and reaction functions, which should promote *confidence* in the financial system. But it is a complement rather than a substitute for *trust,* which is personal; requiring truth, accountability and a commonality of purpose where there is a contract between individuals. In business, high standards of corporate governance set the tone and should continuously seek to improve the standards of organisational behaviour that will sustain profitability in the long term. The duty of a board to its shareholders is the cornerstone of its credibility and the company's future investibility. Without this, it is questionable whether the equity market would have provided the financial sector with the substantial capital it has raised since the crisis. For example, the four largest UK banks alone have raised more than £50 billion from equity markets since 2008.
Put differently, it is vital that those invested in our financial future engage actively with regulators in shaping the boards and business models that they believe will build a safer financial system, equipped to finance and support broad-based UK economic growth in an ever expanding global market.