Paul Tucker: A protracted "peacetime"

Remarks by Mr Paul Tucker, Executive Director and Member of the Monetary Policy Committee of the Bank of England, at the Chatham House Conference on "The new financial frontiers", London, 29 April 2008.

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The turmoil and stress in the global financial system has now been going on for nine months or more. Much has been said about the "wartime" conduct of the authorities, the banking industry and asset managers. But the seeds of the current stresses, and many of the remaining risks, lie in the preceding period of "peacetime". The main purpose of my remarks this morning is to underline that the community must not in the future lose sight of the need to head off the risks that can creep up during a prolonged period of "peace".

The recent period of peacetime was long enough for substantial macroeconomic imbalances to build up, globally and domestically.

Long enough for innovations in financial intermediation to mask, from many, the degree of leverage in the system.

Long enough for many to assume that funding structures could be chosen on the basis of deep liquidity being maintained in a range of new asset markets.

Long enough for most with long memories to be tending their gardens.

Long enough for the international authorities to think they would get time to fix problems in the regulatory capital regime before they gave rise to serious problems (such as the zero-weighting of 364-day lines of credit, which underlay the profusion of bank-like conduits etc).

Long enough for many to proceed on the basis that "it couldn't happen" or, indeed even after it began, "wasn't happening".

Long enough, crucially, for investors to get too used to elevated returns. Those returns came largely from two sources. The fall in risk-free rates, brought about by an *ex ante* imbalance of global savings and investment; and the fall in risk premia, which may in part have flowed from improved monetary policy regimes around the world. The ensuing Search for Yield can be thought of as asset managers and bankers wanting to sustain into the future the fabulous ex post returns "achieved" as asset prices rose. Its main engines were leverage, and maturity transformation. A cocktail that not only raised private risks for asset managers and lenders, but also systemic risks.

The upshot has been a protracted, and not yet concluded, period of deleveraging. That, in the great scheme of things, relatively small US subprime mortgage delinquencies could set this off shows just how fragile the system had become.

Structural changes in the financial system really matter

As commentators struggle to make sense of this, a lot has been said about the "originate and distribute" model of financial intermediation. Three comments on that.

First, not enough was done to reflect changes in business models in disclosure regimes and practices. In some distant world, banks in, say, Germany were exposed largely to German companies and households; and similarly Californian banks to Californian borrowers and projects. So if conditions deteriorated in Germany, California or wherever, the markets would be alert to the need to scrutinise the "home" banks operating in those regions or sectors. In today's world, the markets knew that risk really had been dispersed. But they did not know where it might be concentrated; and, crucially, did not know how or how far it might flow back to the banking sector and so towards the core of the payments system that supports our monetary economy. It is in the interests of banks themselves – and certainly in the interests of their creditors and shareholders – to make those risks clearer in future; and if they do so, they will face stronger incentives to avoid risk concentrations.

But my second point is that talk of the shift to “Originate & Distribute” can be overdone. Many of the largest global banks seem to have occupied a half-way house. They retained large positions on what amounted to a view that macroeconomic conditions could never get so bad as to cause material impairment, but booked them to portfolios that were marked-to-market (or to models). That left them exposed to a deterioration in financial conditions, particularly in liquidity, and so to a fall in “market” prices way beyond anything they contemplated, or perhaps still contemplate, for fundamental impairment. This is the mentality of traditional “banking book” risk assessment grafted on to post-Glass Steagall “trading book” valuations and financial accounting. As the regime currently works, mark-to-market is not – or, rather, cannot be – just an accounting convention; it needs to be a culture, or way of life, for those who adopt it. The dynamics of a financial system in which the vast majority employ MTM accounting, irrespective of their declared holding periods, are fundamentally different from one in which just a few “market-makers” do so.

Third, therefore, the rules and infrastructure supporting the financial system need to help it withstand stress. Accounting and valuation policies is one such area, now being debated. Another is the trading and clearing platforms themselves. The authorities must do what they can to encourage the industry to focus on whether more wholesale market activity could and should be conducted across central trading and clearing platforms rather than OTC. In the past, intermediaries have tended to be doubtful about this. But it is plausible that the system would have been somewhat more resilient if “vanilla” products had been subjected to the minimum standards, greater pre and post-trade transparency, and centrally set margin requirements that accompany transacting across central infrastructure. The underlying point here is that the bodies providing such central infrastructure have a clear interest in effective system-wide risk management and stability, and can be monitored by the authorities.

For the authorities internationally, the moral of the story is that they must take an interest, from a systemic perspective, in the regimes which govern, and drive changes in, the structure and behaviour of the financial system. That means maintaining that interest during peacetime, not just a necessary rush of activity after crises occur.

In setting the rules of the game, the authorities need to strike a trade off between risk and efficiency. We could reduce the risk in the system by stifling innovation. But in order to choose to tilt the balance towards innovation and efficiency, the authorities need to be confident that they have regimes that, amongst other things, (i) are effective in mopping up the mess, and (ii) do not create bad long-term incentives.

Orthodoxy is to cut off incipient systemic stress at the pass: intervene early, and decisively, but leaving losses with the private sector and afterwards rejigging the structure of the system to contain the implications for future behaviour. For that, tools are needed. In very broad terms, this is precisely what the Special Resolution Regime for banks and improved deposit insurance proposed by the UK authorities are about. They are tools the authorities need to contain the disruption caused when bank failures occur and so to make such individual firm failures tolerable.

But we also need policies for containing systemic stress more generally; and, if possible, for heading off the risk of systemic problems in the first place. Like others, in speeches I have identified three elements in that armoury: monetary policy; central bank liquidity policy; and policies towards bank capitalisation and liquidity.

Monetary policy

I have for some years openly queried the notion that it is enough to rely on monetary policy “mopping up” after the event.

The "mopping up" doctrine came out of a view that monetary authorities could not spot bubbles but that policy could cushion the bursting of what turned out to be a bubble. The doctrine effectively assumes that, faced with the possibility of systemic stress, the monetary authority can always reduce its policy rate without taking risks with inflation. The current conjuncture tests that assumption. There is a nasty shock to demand from tightening credit conditions, here and abroad. And that may get worse rather than better in the coming months. So far, the financial system has faced a "trading book" problem; but we cannot rule out a "banking book" problem caused by rising defaults. We face a race involving whether the deleveraging process can be sufficiently advanced for financial conditions to stabilise before macroeconomic slowdown, here and abroad, raises loan defaults and so brings a new dimension to the challenges in the banking sector and so to the supply of credit to the real economy.

But, absolutely crucially, we also face a nasty shock to costs from rising commodity prices and sterling's depreciation. That is going to push up UK inflation over the next few months, creating a risk of upward pressure on pay and higher inflation expectations.

The MPC's strategy to date has been clear: to offset part but not all of the shock to demand, consistent with an overriding determination to maintain medium-term inflation expectations anchored to the 2% target. The path of rates will depend on judgments about the balance of those risks to the inflation outlook. And, in the context of my remarks today, that is different from a "mopping up" strategy involving simply reducing rates enough to offset estimates of the effect of the demand shock plus some insurance on top of that.

Central bank liquidity policy: the Social Contract

If monetary policy has been constrained in alleviating the consequences of the financial turmoil, so too, for different reasons, has central bank liquidity policy in many centres.

For over a century – coincident with the development of central banking – there has effectively been a Social Contract between the banking system and the authorities. On one side of the Contract, commercial banks have been permitted to profit from maturity transformation, turning liquid savings into illiquid loans. Commercial banks' ability to do this relies on their deposit liabilities being a universally acceptable means of payment, money. But maturity transformation – borrowing short to lend long – is risky; it relies on confidence. And if that confidence cracks, the costs are felt not just by the customers and shareholders of the banks concerned, but more widely in the economy given the potential disruption to the payments system. Our monetary economy relies on stability in the banking system.

The other side of the Contract has, accordingly, had three elements designed to protect the economy from those risks. First, prudential regulation of banks, to contain their risk taking and so reduce the likelihood of confidence cracking. Second, deposit insurance, to make retail depositors more or less whole in the event of failure notwithstanding that regulation. And thirdly, central bank liquidity policy. Essentially, central banks have stood ready to provide unlimited amounts of liquidity against good collateral at a rate above the market rate prevailing during peacetime.[1][2]

During the recent turmoil, that last part of the Contract broke down because borrowing from the central bank via premium-rate facilities became stigmatised.

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1 In Lombard Street (1873), Bagehot talks about high rates of interest rather than penalty rates as such. This is in part because he was writing in the context of the gold standard regime, in which systemic stress was often associated with an external flight of credit and so rising short-term interest rates (see pages 56 and 57); in part because Bagehot thought about the premium in terms of comparisons with normal conditions (page 197).

2 This is to be distinguished from support operations for individual institutions.

This could not have been more important. It has made innovation in central banks' liquidity provision imperative during the turmoil. And, when we regain peacetime, reforms will be needed to avoid a recurrence of this problem. Open-market operations (or auctions) against wider collateral, and the Bank's Special Liquidity Scheme launched on 21 April, should both be seen in that light. Such measures need to be constructed so that they do not interfere with the implementation of monetary policy, which depends on the central bank's net supply of reserves matching demand in the economy so as to stabilise (risk free, or secured) overnight money market interest rates broadly in line with the policy rate.

The monetary part of central banks' market operations is simply the injection of reserves. The other characteristics – counterparties, maturity, collateral etc – are essentially non-monetary interventions. In most circumstances, central banks want to make them as neutral as possible, so as not to interfere with relative asset prices in the economy. When markets break down, however, central banks may need to calibrate their interventions to contain the spillovers to the economy. Thus the SLS is designed to underpin the liquidity of the banking system, and so confidence in the system as a whole.

Taming the credit cycle

But can we, the authorities, do more to avoid the system getting into such a fragile state in the first place? We really must consider how to do that.

At the level of the system, the underlying issue is not that bankers are wicked or stupid. There is, though, a nasty collective action problem. In the period leading up to the turmoil, many market participants on both sides of the Atlantic thought financial risk was under priced, especially in credit markets. But they did not know when the correction would come, or indeed that it would definitely come abruptly. Each feared that by "stepping off the bus" before their competitors, they would crystallise "business risk" as customers and activity flowed away from them. This seems to point to the need for some kind of intervention by the authorities. And, perhaps with hindsight, it is baffling that the authorities internationally contented themselves with issuing warnings.

What instruments might the authorities have? There are already welcome exercises underway to make the Basel Capital Accord less procyclical. The accountancy world is also moving towards understanding that its policies affect behaviour and so system-wide conditions. On both these fronts, the design of micro measures affects macro outcomes.

At a more macro level, we need to debate whether or not it would be feasible to design discretionary levers that the authorities could employ as credit-cycle circuit breakers. Candidates include the authorities adjusting industry-wide benchmark capital requirements or margin requirements to slow commercial banks' supply of leverage to the financial system during the upswing. The debate needs to be international, as capital flows freely across borders and so the capability of national authorities to act alone is constrained.

Conclusion

Interest in the issues I have touched on this morning must not ebb when peacetime is eventually regained.

Parochially, there has been massively more public interest in the Bank of England's financial stability role during the period of turmoil than over the preceding years. But what we all do in peacetime will affect how the next "war" plays out. We must not forget that. Central banks can play a role because they can bring together and synthesise analytical and practical expertise in macroeconomic conditions, financial markets and the financial infrastructure. That synthesis is rather special, and should be at the service of the system as a whole.