Keynote address: Have we fixed he fractures in the global financial system revealed by the financial crisis?

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As prepared for delivery

I am honoured to have been asked to speak at the Financial Stability Institute's 20th anniversary. The FSI has done great work over the last two decades. I was a regulator when it was born, and have admired the work done under its two Chairmen, Josef Tosovsky and Fernando Restoy, ever since. Sadly, there has been no shortage of issues to address.

The Financial Stability industry has expanded greatly in the last decade. As well as the Institute there is of course a Board. The IMF publishes a six-monthly Global Financial Stability Report. Every self-respecting central bank publishes one, and some regulators do too.

I have never sought to claim personal responsibility for this industry, but perhaps I can immodestly mention my part in it today. I am as certain as I can be that the first Financial Stability Review to be published was the one I launched at the Bank of England in 1996 (ref 1). (Slide 2). In a review of FSRs Martin Cihak et al (ref 2) credit it as the first edition. The first editorial was signed 'Prudence', which was an in-joke: Prudence was the name of my wife. Indeed it still is.

The Bank's FSR was both successful and unsuccessful. It has inspired a huge number of followers, over 50 of them by 2012 according to Cihak. But at the time our objective was to show that the Bank was concerned about financial risks. In 1996 we knew there was a chance that an incoming Labour government would strip the Bank of responsibility for banking supervision. It had not covered itself with glory in the Baring's debacle. So we thought it a smart move to publish a new report, in partnership with the Securities and Investment Board, then the UK's principal securities regulator, to show that we could do joined up analysis of markets. In that sense it was a failure. The Labour government did move supervision out of the Bank in 1997. Of course it has since returned there, but that is another story.

Enough prehistory. That was eleven years BC – before the crisis. Now in AC 12 we are still trying to understand what happened and why. I teach a course on the subject at Sciences Po in Paris. The ten year anniversary of the Lehman collapse late last year stimulated an outpouring of reminiscence, analysis and pet-theorising. Perhaps surprisingly, as time goes by there is if anything less and less consensus on the causes and appropriate responses.

Very few people are prepared to say that they think all the problems revealed have been solved, in spite of the wave of re-regulation which has washed over financial firms and markets – though there are some who insist that they themselves are now in fine shape, though sadly others are not yet in a state of grace.

Amidst this outpouring of commentary I identify three strands of opinion. At the risk of shocking this earnest, high-minded audience I have characterised their views by reference to three popular songs.

The first argument, which one does hear from some bankers, owes a lot to the Pink Floyd song 'The Wall' with its memorable refrain 'We don't need no education. Hey, Teachers, leave our kids alone' (slide 3)

The drift of the argument is that we banks have had a little shock, we have learnt our lesson, we have understood the importance of a bit more capital, and the regulators can leave us alone, safe in the knowledge that we will not misbehave again.

There is some substance behind this argument. Certainly it is true that banks' capital ratios have been greatly strengthened (slide 4). In many cases banks now operate with 4 or 5 times the capital they had at the onset of the crisis, and it is better quality capital too.

But I am not in the Pink Floyd camp. (I was never much of a fan in fact). Perhaps that is because RBS was one of the worst affected banks. Indeed some might argue that it was the worst affected. (slide 5). There were many ways of getting into trouble, from operating with a very thin capital cushion, through making unwise acquisitions, to simple bad lending. RBS managed a full house of problems, so we know that higher capital is not the answer to all problems. I am mindful of Bagehot's observation that 'no amount of capital will rescue a bad bank.' There is more to bank reform than higher CET1 ratios, and some of the cultural changes needed are far harder to implement.

But nor am I in the group which camps at the other end of the spectrum, who regard the increase in capital so far implemented as hopelessly inadequate – the school represented by Anat Admati, Martin Wolf (ref 3) and others. We might call this the 'Too much is never enough' school (slide 6). In fact the words of the Loren Allred song 'Never Enough' are remarkably apposite. She sings 'Towers of gold are still too little, those hands could hold the world but it'll, never be enough.' Not all bank capital is held in physical form these days, but let that pass.

I am not persuaded that it would make sense to impose further significant increases in required capital for banks. The Basel Committee's own analysis suggests that the additional insurance protection bought against potential defaults would come at a high price. Severe stress tests in several jurisdictions suggest that banks could now survive adverse scenarios which Mark Carney has described as 'biblical.' He asserted recently that 'Banks in most regions are now more likely to be stabilisers rather than amplifiers of shocks' (ref 4).

But there is one aspect of the argument that should give us pause. It is true that investors have not yet been fully persuaded that banks are good homes for their money. The price to book ratios of most international banks have remained stubbornly low. Larry Summers has argued (slide 7) that the franchise value of banks has declined (ref 4). My own view is that the decline has more to do with a changed competitive environment in which new competitors with better and cheaper technology are competing business away from traditional banks. Profitability has declined (slide 8) (ref 5). That, combined with very low interest rates for a long time, explains much investor reluctance.

A third strand of argument, with which I have more sympathy, is sometimes described as the Whackamole theorem. Pursuing my popular song theme I prefer to characterise it as the 'close the door they're coming through the window' argument (slide 9). In other words, by clamping down on banks, forcing them to hold far more capital and reducing their ability to supply credit and take risks, regulators have pushed credit creation into the shadows, or to what the FSB now say we should call the NBFI sector (ref 6).

The Non-Bank Financial Intermediation sector has expanded greatly in recent years (slide 10). The total balance sheet size of the universe monitored by the Board has gone up by 9% a year in the last five years and now totals over $116 trillion, or 30% of all financial assets. Most of that expansion has occurred in Europe and North America (slide 11), which account for 60% of the total. In terms of the type of institutions involved, the FSB describe the fastest growing subsector unhelpfully as 'other investment funds' (slide 12). These are funds which are not classified as hedge funds or Money Market Funds.

The FSB does a thorough, meticulous job of aggregating the data, and monitoring the interconnectedness of NBFIs and banks. It says those connections are growing, and that the scale of NBFI means we must certainly monitor its development and maybe, probably, sometimes worry about it. Quite where that exercise in worrying might lead us is less clear. The regulatory environments in which these other institutions are differ from place to place and the powers regulators have to monitor them and intervene in their affairs vary greatly.

There are, however, some elements of the growth of non-bank credit which have been attracting more attention recently. That is true particularly of leveraged loans. In a speech in London (ref 4) a month ago Mark Carney drew attention to a worrying development. He pointed out that 'relative to earnings, aggregate corporate debt in the US and UK is nearing its pre-crisis peak, and the distribution is worsening. In the UK, the share of highly leveraged companies is above pre-crisis levels. This is despite the very modest growth in investment.' One often-quoted measure is that BBB-rated bonds are now about half the market, compared to just a quarter in 2007.

Mark Carney points out that these trends are accelerating. (slide 13). The ratio of debt to EBITDA has risen remarkably in the last year. Where are these risky obligations held? That also differs from place to place. In the US, he tells us, 'banks and insurers own around one third of CLOs (usually the less risky tranches) compared to only 6% for European firms and 2% for UK firms'. For the most part they are held by funds which can afford to lose money, so do not pose systemic risk in the way banks subprime holdings did. But a bursting of that bubble would be troublesome nonetheless. And McKinsey analysis (slide 14) shows that overall market-funded corporate debt has risen sharply.

We should welcome the diversification of funding for corporates, which spreads risk around the system and enhances resilience, but the scale of indebtedness is striking. Of course the tax treatment of debt over equity encourages that growth. I was pleased to read last week that Randy Quarles has announced an FSB review of this part of the market.

Mark Carney is less concerned about the growth of debt in China, which has figured prominently in recent IMF reports (slide 15). The growth rate has fallen back recently.

Public debt globally, however, does remain elevated post-crisis. (slide 16) Modern Monetary Theorists would have us view that as benign or even positive. Having lived through UK public expenditure crises in the 1970, and buyers' strikes in the gilt market, I am conditioned to regard high public debt as a problem that has to be dealt with one day.

So my whackamole worry list includes leveraged corporate debt, and public sector debt.

I also worry about the impact on the financial system, and on financial stability, of a number of new developments which cannot be regarded as crisis-related. Among them I include cyber risk (slide 17), the impact of fintech on the viability of traditional banks, and particularly the impact of Big Tech. The FSB last month published a very interesting report (ref 8) on the potential impact of large technology companies like Amazon, Google, Alibaba and Ant Financial, with their huge financial resources and ability to cross-subsidise, on the business of banking. One possible interpretation of the low rating of many large banks is that investors fear they may lose the more profitable parts of their business to these new competitors, leaving them running the financial infrastructure, for which they find it hard to charge adequately. The FSB worry that in these circumstances they may seek out more risky business to compensate for the loss of their past core profit sources. I hope we will be wise enough not to yield to that temptation, but I understand the point. My concern is more that the business models of banks may be threatened.

So my conclusion from a necessarily brief review of state of financial markets is that the banking system is far stronger, overall, but that debt levels remain worryingly high. As Adair Turner has pointed out, (ref 9) a given rate of GDP growth seems now to require a larger increase in debt. He links that to the growth in income and wealth inequality, as richer deciles spend a lower portion of their income.

Growing inequality of wealth, in particular (income inequality has flattened or declined in some countries more recently) is also part of a worrying growth in the share of votes going to populist parties, in Europe in particular, and the associated growth in interest in policy proposals which have been largely off the agenda for several decades. I am thinking most obviously of protectionism and trade tariffs, but there are others. There has, for example, been a backlash against central bank independence in several countries. I will say more about that in a moment.

We can see the aggregate impact of these trends in the growth of uncertainty about economic policy. Baker, Bloom and Davis (ref 10) have developed an index of economic policy uncertainty, which is currently at a record high (slide 18). That is not surprising, and suggests that the most concerning risk is the scope for damaging policy errors (slide 19)

We have moved a long way from the mood in 2008-9 when successive G20 summits agreed a substantial reform programme, and implemented it with enthusiasm, using the FSB as their delivery mechanism; one has to question whether there is the same degree of mutual trust and shared interest today.

It is therefore regrettable that the opportunity to give the FSB a formal legal status, underpinned by an international treaty, was not taken in 2012, when it was under active consideration. At the time, the flexibility allowed by the FSB's informal status was seen as an advantage. That is much less clear today. There has been political pressure on the Fed to withdraw from it and other international bodies – so far resisted (ref 11). That resistance would be easier and stronger were the US and other countries to be signatories to a Treaty on International Financial Co-operation.

My co-author Maria Zhivitskaya and I have written (slide 20) about the limitations of voluntarism in a chapter in a forthcoming Oxford University Handbook on Global Economic Governance. (ref 12) Those limitations are greater when countries lack confidence in each others' regulation.

Andy Haldane at the Bank of England wrote persuasively in 2014 about the need to manage global finance as a system (ref 13). He argued that financial globalisation has created 'larger than ever opportunities, but also greater than ever threats.' We should therefore turn 'the current non-system', replete with informal bodies of uncertain membership and vague powers, 'into one with an identifiable architecture.' Developments in the five years since he wrote that paper have only strengthened those arguments. Haldane was then mainly discussing the provision of financial support, and the possible creation of an international lender of last resort. Barry Eichengreen goes further and has argued for a 'World Financial Organisation' with the power to sanction members whose national regulatory policies are not up to international standards.' (ref 14).

I think it unfortunate that these radical ideas were not taken forward at a time when there could have been the political will to do so. Now we are very far from that situation.

It would be idle, therefore, to advance these forward-looking proposals today. Realistically, we should try to preserve the elements of international consensus and co-operation we have and try to protect against other potentially damaging policy errors (slide 21). These are the biggest worries we face today. They may not be the fractures which created the last crisis, but they could produce a new one.

I have little to say about the first and probably most concerning area – tariff wars. It is not an area of competitive advantage for me. The most recent signs in the US – China relationship are a little more optimistic, but tensions remain high.

The second area of concern is much closer to home. Almost three years on from our referendum the shape of the future relationship between the UK and the EU 27 remains unclear. Even after a withdrawal agreement is concluded, if it is, that will still be the case, as the political declaration which accompanies it is vague and aspirational.

Financial services, and financial stability, have not been as prominent in the painful debates surrounding Brexit as they might have been. Our government has prioritised other areas of the economy. So it is hard to know what new arrangements will emerge to manage the complex interactions between London's markets and the rest of Europe. The Bank of England assess the risk of a major disruption to financial stability of even a disorderly Brexit as relatively low. But they warn that in the longer term, without deep and comprehensive cooperation between the UK and the 27, there is a risk that we turn inwards towards closed markets which 'would, in turn, restrict cross-border investment, fragment pools of funding and liquidity, and reduce competition. The result would be higher costs of financing for households and business, less reliable access to finance and less resilient finance' (ref 15).

One academic study of Brexit and Financial Stability, by Samitas et al. argues that the consequences would be more severe for the EU27 than for the UK (ref 16). That can only be a speculative conclusion, but it is clear that the ambition to develop a fully-fledged Capital Markets Union in Europe has suffered a setback, as a result of a popular vote in which the merits of open Capital Markets did not figure in the debate, and where the campaign revealed that arguments based on those assumptions, widely shared in the financial community and among economists, had no resonance at all. Warnings by the central bank and others were characterised as 'Project fear' designed to distort the democratic will.

More recently, when Governor Carney produced some carefully-worded comments warning against a disorderly Brexit, the Chef de file of the Hard Brexiteers, Jacob Rees-Mogg, characterised him as 'a second tier Canadian politician' and dismissed his arguments out of hand. In the not too distant past a senior spokesperson, of whichever party, would not have criticised a central banker in that way. He or she would have had more respect for the bank's independence, and recognised that ad hominem attacks could damage the credibility of the institution, from which we would all suffer.

But it is evident that the reverence for central bank independence has much diminished recently, and not only in the UK. President Trump has described the Fed as 'loco.' In India the RBI Governor was summarily removed. Mario Draghi is not exactly the favourite son of the new Italian government.

The growth of populist parties, (slide 22) with little commitment to independent institutions, especially where unemployment has remained high, has created a different mood.

A few years ago, we seemed to have reached an 'end of history' moment in which a kind of 'Basel consensus' governed economic policy making. Country after country converged on a model in which an independent central bank was charged with meeting an inflation target, which could be any number you like as long as it was 2 per cent. Fiscal policy was a completely separate matter, generally organised around the principle of a budget balanced through the cycle.

But history has restarted, as it often tiresomely does. On the fiscal side we have Modern Monetary Theorists arguing that fiscal deficits do not matter. Other more mainstream critics argue persuasively for more overt policy co-ordination. Bill White, well known in this jurisdiction, has pointed out that in recent years the monetary policy drivers have had their feet firmly on the accelerator, while regulators have been pressing hard on the brake (ref 17). Does that make sense, he asks? And plenty of voices can be heard arguing that central bank independence has had its day and that the masters of the universe in Basel should be cut down to size.

A recent poll of 70 economists organised by the CFM-CEPR showed that this rethinking has not extended to the economics profession (ref 18). Almost all of them agreed that CBI was still very important (slide 23). But when asked if they thought it could be sustained their answers were very different (slide 24). Almost a third think that it will not be possible to sustain the model we have operated for the last few years into the future, and that CBI will decline in Europe.

Why has the current of opinion turned? There is no single answer to that question. Listening to the critics one hears a wide range of arguments. Some focus on supposed policy errors made by central banks since the crisis – the ECB's 2011 decision to raise interest rates looms large. Others raise various forms of conspiracy theories, with central bankers conspiring to thwart the popular will in the interests of their banking friends. A version of that maintains that there has been 'political capture' of central bank boards (ref 20).

A more persuasive set of arguments focuses on the unconventional policies implemented over the recent decade. Quantitative easing is a cousin of fiscal policy. Should not different forms of accountability and political control attach to QE? In fact that is the case in the UK, where the Treasury sets the quantum, leaving timing and method to the Bank of England. Then there is the argument that QE has a distributional impact, benefiting wealthier holders of financial assets. Central banks argue strongly that the total impact of QE has not increased inequality, but those arguments have not cut through the public debate (ref 19).

There are critics, too, of the central bank role in macro prudential policy, which often focuses on particularly sensitive sectors like the housing market. Stanley Fischer has discussed the implications of that role for independence. The Fed is not fully independent in that area, while the Bank of England and the ECB are (ref 21).

One of the more thoughtful reflections on the change has come from Paul Tucker, the former Deputy Governor of the Bank of England, in his book 'Unelected Power' (ref 22). It is a very careful analysis, leading to some interesting suggestions for a more robust accountability surrounding the central bank. In an interview about it he said 'The more power that you have that you don't really need, the more the political world will lean on you to influence the way you exercise your powers' (ref 23).

This is a persuasive argument. However I would take it further than Tucker himself does. It is very striking that the great winners from the GFC, in terms of power and status, have been the central banks, in spite of the questions raised about their performance in the early years of the century as the tensions built. The Fed has gained responsibilities, the ECB now supervises 85 per cent of the European banking system, while the Bank of England is responsible for monetary policy, QE, macropudential policy, banking supervision and insurance supervision, a remarkable accretion of functions. As Tucker points out, such an accumulation of power creates 'the risk of a backlash.'

I might be thought to have an axe to grind here, as the first Chairman of the Financial Services Authority, since dismembered. Perhaps I do. But my principal concern is that we should protect the core of the central bank independence for monetary policy, which has brought many economic benefits. If adding non-essential functions threatens that independence it may come at a high price.

Certainly if one is to do so, the accountability framework needs to be robust, as Tucker argues. That is harder in the case of the ECB, unless the Treaty is changed, then it has been in the case of the Bank of England.

So to return, finally, to the examination question posed for me, I would answer that many of the problems revealed in the banking system and in traded markets have been addressed. 'Solved' is a dangerous word to use. The 'solutions' have created new incentives for non-bank finance, and the catchily-named NBFI sector needs to be carefully watched.

Furthermore, the broader question of the system architecture of global finance has been ducked. We still rely on a 'non-system'; in Haldane's phrase, and seem condemned to do so. The generally good relations between central banks provide some comfort, but the political pressures on those actors have grown, and their legitimacy is questioned. I applaud the efforts made by some central banks to engage more effectively with citizens in recent years, but the political climate in which they operate remains challenging. As one of the leaders of the UK's Pro-Brexit campaign memorably said 'people in this country have had enough of experts' (ref 24)

If we do move into the age of amateur, populist central bankers and supervisors there will soon be many new fractures in the financial system – and they will not be hidden.

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