Paul Tucker: The state of the markets – four issues

Remarks by Mr Paul Tucker, Deputy Governor, Financial Stability, of the Bank of England, at the Association of British Insurers 2009 Biennial Conference, London, 9 June 2009.

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Many thanks for the invitation to be here today. The Bank greatly values its relationship with the insurance industry. We are just immensely grateful for the intelligence you provide, as asset managers and insurers; and for our constructive dialogue on policy issues.

I have a few brief remarks on four broadly linked issues.

The macroeconomic outlook and bank lending

Since the beginning of the year I have felt that it will take until late autumn at least to have any kind of a handle on broadly what type of outlook we face. My view on that hasn't really changed. Of course, over recent weeks near-term indicators, notably the business surveys, have improved a bit. Confidence seems to have stabilised. And that has been most obvious in the financial markets, where the really good news is that firms on both sides of the Atlantic have been raising funds in the equity and bond markets.

But a sense of perspective is needed if those apparently small steps forward are not to be frittered away. Inevitably the medium-term outlook remains highly uncertain, and the path back to anything like normality can only be gradual I'm afraid.

In particular, for the moment it is unclear – as, I must say, it is bound to be at this stage – whether the financial system can generate the expansion of credit that will most likely be necessary to support recovery. The reopening of high-grade bond markets has definitely been encouraging. But in most countries, including the UK, bank lending remains subdued. It is hard to disentangle how much of that is down to weak demand, and how much to tighter supply conditions from the banks. I would just say this. I truly believe that it is in the interests of the banks themselves to ensure that businesses get the working-capital finance they need. While one can imagine, I suppose, individual banks being tempted to sit it out in order to deleverage their balance sheets in an environment that is obviously tougher for them, there cannot sensibly be free riders. If all banks were to adopt such a strategy, recovery might end up being anaemic at best, which would feed back into the banking system itself – increasing defaults and depleting banks' capital. Not lending would be a counterproductive business and financial strategy. I'm reasonably confident that senior bankers can be persuaded to see that themselves, if indeed they don't already.

But it will, in my view, take until the autumn at least to gauge whether tolerable progress is being made on this front. Without it, confidence could ebb away. But with it, recovery will have a fair chance of becoming rooted.

Risks will, I should be clear, persist from the international environment and, in particular, the pattern of international saving. If the Asian economies were to continue to save at an extraordinary rate but the Western economies increase their saving, as over time we must in order to repair national and sectoral balance sheets, longer-term risk-free rates could again fall in order to bring about the counterpart expansion in investment. And, although it may seem far-fetched right now, that could give an upward impetus to asset prices over the medium-term. We would need to be careful not to mistake any such future developments for a miracle improvement in underlying economic and financial conditions. Indeed, internationally, we need to learn lessons about brewing risks from medium-term imbalances.

The Bank's policy response, and credit markets

Alongside the Government's actions to underpin the capital resources and funding of the banking system, the Bank's policy actions have been designed to assist recovery in credit flows and nominal demand.

The big downside risks to the outlook have warranted a substantial monetary stimulus, which the MPC has provided by bringing Bank Rate down to nearly zero, and by injecting a substantial amount of money directly into the economy. Speaking of course only for myself, I have so far preferred that approach to one where we would instead commit to keep Bank Rate low for a specified extended period. It would be hard to avoid the country misunderstanding that any such commitment was conditional on the outlook; in other words that our plans could and would change as the outlook changed. And the current strategy has been consistent with a mildly upward-sloping money-market curve, which signals that the market is confident – as it should be – that the MPC will retighten monetary conditions when in due course that is warranted by the medium-term outlook for inflation. Our 2% target is a valuable anchor in shaping and implementing our strategy.

In this, insurance companies are by no means on the sidelines. By focusing our purchases on medium and long-maturity gilts, we are aiming in part to shift the composition of the portfolios of long-term investment institutions. And it was encouraging, therefore, that the money holdings of non-bank financial institutions expanded recently. Some economists argue that gilts and central bank money are near perfect substitutes, so that the effect of our Quantitative Easing will be negligible. They may well be close substitutes for traders. But I doubt they are perfect substitutes for insurance companies and pension funds, many of which probably don't participate in the secured deposit "repo" markets for switching gilts into cash; and which in any case desire assets with a longer "interest-rate duration" than money. If so, holding zero-yielding money balances will not suit them, and we could reasonably hope for increased demand for, perhaps, corporate bonds and other financial assets. Risk premia might decline slightly. And the flow of credit outside the banking system may improve, helping to support a recovery in nominal demand. Over the next quarter or so, amongst other indicators I will therefore be looking at what happens to firm and household money holdings, as well as credit flows and risk premia.

The Bank's Asset Purchase Facility schemes for corporate paper are designed to help catalyse that process. The fact that the Bank is buying relatively small amounts of paper may have been misunderstood by some. As the central bank, we are not operating the schemes in order to lend in scale to the real economy, but rather to help revive the markets. Some have described this variant of liquidity insurance as acting as "Market Maker of Last Resort", and I recently aired some thoughts on the kind of principles that might guide central banks in this area.[1] They include consistency with monetary policy; avoiding undue risk to the central bank; acting as a catalyst; and avoiding attempts to prop up markets that would not be fundamentally viable once peacetime resumes.

Yesterday, the Bank issued for consultation some ideas on how we might be able to extend our liquidity insurance, through the APF, to facilities for working capital finance. They cover a possible facility for secured commercial paper, where the underlying assets would be portfolios of SME trade-finance credit, and a facility for supply chain finance. I would hope that the insurance industry, and the liquidity and investment funds you run, might be investors in such paper, whose liquidity would receive some underpinning. Certainly you will

[1] For example, see Buiter W (2009), "Central banks and financial crises", paper presented at the Federal Reserve Bank of Kansas City's symposium at Jackson Hole, Wyoming and Tucker (2009), "The repertoire of official sector interventions in the financial system: Last resort lending, market-making and capital" paper presented at the 2009 International Conference: Financial System and Monetary Policy Implementation, Bank of Japan.

be an important part of the Bank's consultative process led by my colleagues Paul Fisher and Sarah Breeden.

Addressing trade and working capital finance has become all the more important given the reduction in the availability of trade-credit insurance, which our regional Agents hear quite a lot about. We therefore welcomed the initiative of that relatively concentrated industry to release a code of conduct, supported by the ABI, for handling difficult cases where unnecessary firm distress could be avoided. The Bank has followed this carefully given our role as midwife for the London Approach designed to help facilitate the orderly resolution of creditor/debtor problems. In a few cases over recent months, as well as over the trade-credit-insurance code, my colleague Andrew Bailey has played a behind-the-scenes role – the traditional role of providing the Bank's good offices where (and only where) we can help, and where help is desired by those involved. Effective resolution mechanisms are an important back-stop when the system's resilience proves wanting, as recently.

Developing more resilient capital markets

Over the medium term, we of course need a much more resilient financial system. This is not just a matter of a better structured, better capitalised, more liquid, more prudently risk-managed, more transparent, and better regulated banking system (and I emphasise system). We also need more resilient capital markets. In the 1980s and into the 1990s the authorities here and elsewhere helped to bring about a number of important structural changes in the market infrastructure: LIFFE; reforms at LCH; book-entry transfer, and later delivery-versus-payment, settlement systems; a wholesale payment system designed to withstand bank failures; the introduction of the gilt repo market. A lot of plumbing! And proof from the past that, working together, the industry and the authorities can do good. Those initiatives were designed to underpin stability in the rapidly evolving capital markets of the day. The current crisis has reminded everyone of the need for the authorities, occasionally and in a well-targeted way, to help remove blockages or quietly steer private sector initiatives on to a course serving the wider public interest. Entrepreneurial innovation is the life blood of economic growth. But sometimes it outstrips the supporting infrastructure. That happened with some parts of our capital markets over the past decade or more. The recent initiatives coming out of the US Treasury to strengthen markets are therefore to be welcomed in their broad thrust and goals.

In particular, the Bank of England agrees that more of the vanilla OTC markets should be cleared via central counterparty clearing houses. LCH led the way globally in opening up central counterparty services to interest-rate swaps, breaking a mis-think that somehow CCPs could clear only exchanged-traded instruments. And recently it has made the welcome announcement that non-dealers will be able to access such central clearing, at least indirectly via "clearing members", as for exchange-traded contracts. Central clearing can help to provide transparency and consistency in valuations and haircuts. It can help to promote greater standardisation in terms. It makes haircuts more visible to the market as a whole, and to the authorities, who as overseers of the system should be prepared to form a view when haircuts are too low – and the associated market leverage is too high – for system stability to be assured. The role of the authorities is important. It is absolutely vital that management maintain the integrity and soundness of the key clearing houses as they expand their range.[2] As overseers of the payments systems embedded in clearing houses, the Bank will work with the FSA and our international counterparts on this.

It is often said that dealers resist such initiatives, as it can squeeze their margins. That may well be the perspective at desk level, but I suspect it is unfair to many CEOs, who have a

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[2] As the failure of Hong Kong's futures clearing house demonstrated in 1987, very bad things happen if a central counterparty fails. Many lessons were drawn.

clear interest in the health, safety and soundness of the system. And if some didn't recognise it before, they will now – as their predecessors did in the relatively recent past.

The key industry associations can also play a constructive role in this whole area – as, indeed, they have in the past. This crisis would have been even worse if ISDA and others had not overseen the introduction of the collateralisation of derivatives-related counterparty credit exposures amongst the dealer community. But there are lessons about extending collateralisation, and standardising terms in vanilla instruments, beyond the dealer community in some circumstances.

The debate is not just about clearing houses and post-trade infrastructure. The financial community must also be open to more trading in core, vanilla markets going via exchanges or other well-designed and open trading platforms. If well constructed, that could help to preserve liquidity when times are tough. We would, for example, like to see serious consideration of whether the corporate bond markets could benefit through something along those lines.

Bank capital instruments

The insurance industry is involved, one way or another, in everything I have touched on this morning. But there is one other area – as investors in bank capital instruments. I am therefore sure you understand that the authorities, internationally, cannot avoid reviewing what should count in the medium term as regulatory capital for banks. It won't do for banks to be able to leverage up on subordinated debt (or other forms of hybrid capital) if, just when it matters, the holders do not suffer because the authorities cannot let the banks concerned be liquidated without bringing system collapse down on us all. We either need a system where banks of any type can quietly fail and hybrid capital is actually useful in protecting the deposit insurer; or, more realistically, we shall need a much narrower definition of capital. Only equity can absorb losses and sustain a going concern. Finding a way through that in the current crisis remains a challenge. One helpful step might be for the investment industry to seek out opportunities to convert subordinated debt into equity; or, at a discount, into senior unsecured debt, as has occurred in a few instances already. It would probably entail a haircut, but I wouldn't air it unless I thought it could be in your collective and medium-term interests as investors in our economy and the system of credit that supports and lubricates it. The new Special Resolution Regime for banks may create healthy incentives in that broad direction.

In concluding, can I thank you again for inviting me to join you today. Authorities everywhere are having to innovate to help get us through this crisis. And we will need to innovate to build a better system for tomorrow. Our dialogue with you can only help that. We are very grateful for it.