Paul Tucker: The programme of reform

Remarks by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the Institute of International Bankers' Annual Breakfast Regulatory Dialogue, Washington DC, 11 October 2010.

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Thank you very much to our hosts.

I might start by saying that I believe that a material contributor to this crisis was the failure of the official regimes for overseeing the financial system – the intellectual framework, the machinery, and regulation and supervision – to keep up with the extraordinary evolution of our capital markets over the past two decades or more. The programme of reform is, accordingly, formidable. It will also be transformational.

There is no doubt any more that the global financial system, regional financial systems and national financial systems are going to be transformed in the years ahead. And if there was any doubt in the market 18 months or so ago, I don't think there can be doubt now that the energy behind reform hasn't flagged. That is unsurprising given that unemployment remains intolerably high throughout the western world.

Many of us have already had to take national measures, make national reforms. But, of course, it was a global crisis, and so it is essential that we also take measures at the global level, through the G20 and the Financial Stability Board. Whatever our national or regional approaches, we have to be part of that global agenda.

Capital and liquidity

We've got our first landmark: the new Basel Capital Accord. The UK, the Bank of England, would have liked it to be more rigorous in some respects, but we most certainly think that it is an Accord worth having. It is a significant stiffening of the regime which has prevailed up to now – perhaps more in some respects than commentators immediately appreciated. It remedies problems not spotted in Basel I.

Finding remedies for some of the problems with Basel II remains work in progress. The BCBS's "fundamental review" of capital requirements for trading book positions will be one of the most important endeavours of 2011. Its main objective must be to tackle two things. The venal regulatory arbitrage that existed between the "banking book" and the "trading book". And requiring capital to be held against the risks of violent swings in liquidity premia for instruments that are not resiliently liquid. That was how the drying up of liquidity in ABS markets undermined the (accounting) solvency of many trading books.

Speaking in the USA, I should stress that it is tremendously important that the US, as well as Europe and Asia, do implement the Basel Accord faithfully and promptly. It is also important that the EU Directive implementing Basel leaves flexibility for supervisors to apply supplementary requirements based on the condition of individual institutions and, separately, taking into account cyclical circumstances.

The other big step in this space will be a Liquidity Accord from Basel. This will be a *new* Accord. It is a quarter of a century late, as the need for an agreed international approach to the regulation of liquidity was first discussed in the mid-1980s. There remains a great deal of work to be done on this front but no-one should underestimate its importance. This is a package that is likely to change the shape of capital markets by effectively charging banks for the liquidity lines they provide to other parts of the financial system. For that reason there will be what the Governors and Head of Supervision call an Observation Period. But some change will be acceptable, as it won't do for parts of the financial system to subsist on the basis of liquidity lines from commercial banks against which the banking system itself does not actually hold any liquidity buffer. That is not a bad definition of an unsound financial structure.

Beyond that staple diet, I want to pick out four things – two of which are central to what has been going on already at the G20 Financial Stability Board work programme, and two of which lie a little bit ahead. The first two are the work on systemically important financial institutions (SIFIs) and on capital markets.

Too Big to Fail: resolution regimes

This wasn't a crisis that revolved in every single degree around institutions that were Too Big Too Fail but, my goodness, they were at the heart of it. And it is intolerable for our societies, it is intolerable for capitalism, that we should continue to have institutions that are too big to fail. The Financial Stability Board will, therefore, be recommending to the G20 a package on this. It will include greater loss absorbency for the largest and most complex firms whose distress would inevitably spillover into the global system – probably in a way that can, in degree, be implemented in different ways in different countries and contexts, subject to a meaningful process of peer review to avoid free riding.

But absolutely central to this is resolution regimes. Too many countries do not even have the most elementary resolution regime for their national commercial banking institutions. Perhaps partly for that reason, many people, when they talk about resolution, slip after about 15 seconds into talking about enhanced supervision and early intervention. To be clear, resolution is about when everything else has failed. It is about when early intervention and higher capital requirements, better risk management and more resilient capital markets let us down, and we are in "the last chance saloon". The distressed institution is no longer viable, and officials are presenting our political leaders with a ghastly choice between chaos from straight liquidation and, alternatively, taxpayer support to prevent the system imploding. That is a truly terrible choice and so the key thing is to find a new set of measures that can be deployed to give us a tolerable course. That set of measures is what constitutes a resolution regime. It is not about making things perfect. It is about coping. We can all learn from the US's special resolution regimes in this respect, including the extensions in scope to bankholding companies and non-bank financial firms affected by the Dodd-Frank Act.

But there are things being debated in Europe and in the international community that may even supplement the toolbox that exists already in the United States. One of them is the potential ability for the resolution authority to haircut creditors and partially convert debt into equity in what is otherwise a firm with a viable underlying franchise and so potentially a going concern. This would be an adaptation of Chapter 11 regime in the US rather than the standard special resolution toolkit for banks.

This set of issues is, at its very core, a cross-border endeavour. We will not get far on this front without much more intimate and trusting co-operation between *home* country supervisors and resolution authorities and *host* country authorities. We should not exaggerate the extent to which this has worked well in the past. Supervisors even admit that behind closed doors. There seems to be a reluctance, perhaps just about understandable in some respects, to share information amongst home and host authorities and to co-operate when regulated firms are distressed, which of course is when it matters *most* that they *should* co-operate. The FSB needs to ensure that we confront and fix this. But a solution cannot emerge without political leaders making space for – indeed, without them positively encouraging – officials to cooperate properly.

Capital markets: the financial network

The second key plank of the FSB's existing programme has been to mitigate the complexity of the financial network. We do not just live within a world, a financial system of massive but independent firms; we work in a financial system where everything is connected to everything else. That has been the case for long as I can remember.

Central counterparties

The use of central counterparties in over-the-counter derivative (OTC) markets is long overdue. But we will also need to ensure that these counterparties are robust. If ever a central counterparty fails, it will be a gigantic mess. Two have failed significantly over the past 30 years: a relatively small one in Paris, but the other was a significant one in Hong Kong during the 1987 market crash, which caused the Hong Kong equity and futures market to close. They were hard to reopen. And their securities markets and regulatory regime had to be completely overhauled as a result.[1] There are lessons to be learnt from past crises as we build stronger central counterparties. The Basel Committee on Payment and Settlement Systems (CPSS) and IOSCO are working on this.

But we need to go further than that. We need to think – and we are thinking carefully – about how to put more of the OTC market either on to exchanges or through trading platforms with greater transparency. In this particular area the United States is acting ahead of Europe. That doesn't matter. It is not a race and there is co-operation going on through IOSCO, with central bank support, that should reach fruition over the next few months in a report to the FSB.

Large exposures

Central counterparties are one way to mitigate the interconnectedness. Another, complementary route would be regimes that are more attentive to the network of *large exposures* that exists between our banks and dealers etc. The EU has been taking a step forward internationally in applying large exposure restrictions to interbank exposures for the first time. This is a big step; one that is welcome to the Bank of England. The question I would like to pose is whether, globally, we should go even further in respect of large exposures amongst the largest institutions in the world. One of the greatest worries under stress is the size of the exposures amongst the biggest and most complex firms. BCBS are contemplating it.

Use of CRA ratings in regulatory regimes

We will also need to revise the extent to which we as a regulatory community use rating agency ratings. The official sector can't express concern – at times indignation – about the performance of rating agencies, valid concerns, and then at the same time continue to build rating agencies ratings umbilically into our regulatory regimes. Over the past few months, I have been chairing a working group of the FSB developing proposals on that, which will go to Ministers and Governors shortly. I think Ministers in Europe are attentive to it as well. Changes in this area will take time and will not be easy, but they are being planned.

The underlying purpose of securities markets regulation

Going beyond that, the final thing I would say in this area is that the conceptual framework for securities regulation, especially in the USA, has over the past 30 years or more

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[1] For more information, see the report of the Securities Review Committee (1988), "The Operation and Regulation of the Hong Kong Securities Industry".

essentially made a distinction between *public* markets and *private* markets, public issuance and private issuance. That is basically because it has taken an investor protection approach to securities regulation. The investor protection objective remains valid of course. But in a systemic sense, private placements, private markets – what goes on beyond or behind the transparency of our public markets – that too can be threatening to stability; and so we need to find a way to bring daylight into those markets and network of exposures without interfering with the efficiency of some private transactions. I am not convinced that we have really even started to think through what that means in practice. We should do so. This signals that the traditional financial stability authorities – including central banks – need to take a greater interest in some aspects of securities regulation than for a long time.

So far I have covered the two broad areas where work has been actively underway. Now I shall say something briefly about two areas where, I hope, work lies ahead.

Shadow banking

First of all, shadow banking. I spoke about it at the beginning of the year,[2] and I and others have been pushing it behind the scenes. Mario Draghi, Chair of the FSB, flagged it in an article in the FT a few weeks ago.

As we restructure the banking system, directly and indirectly, we have to keep firmly in our minds the pervasive effect of *regulatory arbitrage*. The sponsors and the framers of the first Basel Capital Accord – Paul Volcker, Robin Leigh-Pemberton, Bill Taylor, Brian Quinn, and their generation – were not unaware of regulatory arbitrage. But I don't think they appreciated, or could reasonably have foreseen, the extent to which it would become absolutely endemic. People around the world now will already have groups working on how to arb Basel III. This is part of freedom; it's part of capitalism. But it means that the official community needs to be rather more nimble and savvy; knowledgeable about and alert to the byways as well as the highways of our capital markets. That doesn't mean regulating everything that moves, but it does mean having a capability to adapt our regimes when truly stability-threatening activities move beyond the existing regulatory perimeter. This needs very careful thought.

Macroprudential

And that brings me to my last heading, which is macroprudential. This means many things. I want to suggest that, most important, it means taking a *system-wide perspective* to micro regulation; the view that my Bank of England predecessors of 20–25 years ago would have taken. Today there are three elements to it.

One, as I just implied, is equipping ourselves with the ability to move the perimeter of microprudential regulation to keep up with the effects of regulatory arbitrage and innovation. The plans that the UK government have in this area would enable the planned new Financial Policy Committee of the Bank of England to make recommendations to government to change the perimeter of financial regulation.

The second dimension of a macroprudential regime is maintaining a resilient infrastructure, in the widest possible sense, for our capital markets and banking system to be resilient. The debate about putting more activity through central counterparties is an example. Frankly, it could have taken place a decade ago, and it is a crying shame that it didn't. The reason it didn't was that no one came into work thinking that it was *their job* to think about that and that they had a *responsibility* for taking a system wide perspective and actually *doing* something.

[2] See Tucker, P M W (2010), "Shadow Banking, Financing Markets and Financial Stability" at BGC Partners Seminar, London, January 2010.

Institutions are now being created around the world – the Financial Stability Oversight Council in the US, the Systemic Risk Board in the EU, the Financial Policy Committee in the UK – which I earnestly hope will bring that kind of perspective to our work.

And the final area is leaning against the credit cycle *when it threatens stability*. The zeitgeist embraced the seductive idea that either there wasn't a bubble or if there was a bubble that there was nothing you could do about it. Which was dangerous nonsense, as events have proved. This is *not* about fine tuning the credit cycle. But we do need to be prepared to take the punchbowl away before the party gets completely out of control. That was the view 50 years ago. Forward to the past.

This will have a national dimension to it, a regional dimension in Europe through the EU's new Systemic Risk Board, but it will also have a global dimension too. The extent of co-operation between nations will have to intensify in this area. In the monetary policy area, it is important that we listen to each other and understand each other but in a world of floating exchange rates we can, on the whole, go back to our countries and make our own decisions. In the financial stability area, I won't say we have to *co*-ordinate with a capital "C" but we are going to have to move from listening to each other towards co-operation. That will be healthy, but not easy. And it might entail rethinking the division of labour between host and home prudential regulation.

These areas of shadow banking and a macroprudential approach to supervision and regulation lie ahead for the FSB agenda and for the G20 agenda. They will sustain important parts of the reform programme into next year and beyond.