Paul Tucker: Financial crisis and G20 financial regulatory reform – an overview

Remarks by Mr Paul Tucker, Deputy Governor of the Bank of England, at the Financial Stability Board (FSB) and Korean G20 Presidential Committee Conference, Seoul, 3 September 2010.

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Being a Western financial official, one comes to Asia with some humility in truth. This has been a financial crisis born and bred in the Western world, but inflicted throughout the world.

That makes it all the more important that Korea and the other countries in Asia and elsewhere in the emerging market world are involved in the reform efforts. The reforms are not simply going to be cooked up in the West where the problems were bred. In Korea, you have to play a really important leadership role, especially in steering us through the next couple of months.

Much of the work towards the Leaders summit is being handled in the Financial Stability Board. And here is a very brief overview of what is going on in the FSB contribution to the G20 effort, under the following headings: 1) surveillance; 2) bank capital and liquidity; 3) too big to fail; 4) capital markets; 5) incentives; and finally the regulatory perimeter.

1. Surveillance of the system

Very obviously this was a crisis that was not spotted – in the most important sense of being prevented – ahead of time.

People did issue warnings about developing leverage in the system and accumulating macroeconomic imbalances. But no one ***acted*** to make the financial system more resilient to those vulnerabilities. This was not just an intellectual failure, as is widely discussed and recognized now. It was also partly a failure of machinery.

The FSB has been encouraging new machinery to survey and head off risks. The FSB itself has created a vulnerabilities group. It is probably the least prominent part of the Financial Stability Board's effort to date, but it could have enduring significance over the years and decades. It is paralleled in various regions.

Europe is setting up a Systemic Risk Board, which will be supported by the ECB but involve all of the EU. The USA is setting up a Systemic Oversight Council; and in the UK, the government is establishing a macroprudential Financial Policy Committee in the Bank of England. Maybe something is needed in Asia, too. Martin [Wolf] talked about complacency; for the machinery I have described to make any difference, people will have to stick to it year in and year out.

2. Supervision of individual firms

One of the things that should not be neglected is that the severity of this crisis was as great as it was partly because a large handful of individual massive firms failed due to poor management and weak balance sheets.

Part of the solution lies, therefore, in much better microprudential supervision and regulation of individual firms. The Basel Committee has had Core Principles for Effective Banking Supervision for some considerable time now. But, going beyond that, the FSB has encouraged and is sponsoring an exercise on effective supervision of SIFIs, Significantly Important Financial Institutions.

A remarkable fact is that although the style of banking supervision varies enormously across the world, almost nothing seems to have been done to get to the bottom of the question of which approaches are the more effective – having an army of on-site examiners, such as for example in the United States; or relying on offsite analysis, which tends to be the pattern in much of Europe.

An exercise led by Julie Dickson for the Financial Stability Board is producing an evaluation of what is needed to supervise the largest firms in the world effectively. The idea is that that will either get encapsulated in an FSB code or in a re-draft of the Basel Core Principles for Effective Supervision.

3. Capital and liquidity

The third element is capital and liquidity. Virtually all crises have at their root over leverage in the financial sector and excessive maturity mismatch. We need to overhaul the corresponding policy instruments –capital and liquidity requirements.

On liquidity, Basel is introducing an accord for minimum liquidity requirements for the first time; this is about a quarter of a century after it was first contemplated and so rather overdue, but therefore very welcome. There is an awful lot of debate around this still. Many in the industry – in the banking industry – have been resisting it. But this will happen. It will lay down minimum standards for banks to hold some resiliently liquid assets and about the funding of illiquid assets.

To date, much more prominent has been the work on capital. Although there has been some dilution of the proposals from a few months ago, real substantive progress is being made in reforming the ***minimum*** standards and in introducing various buffers, taking into account credit cycle conditions and the circumstances of SIFIs. The key element of the overall package is that “capital” will mean capital. The world of hybrid instruments – pretending to be so-called capital instruments but which in fact cannot truly absorb losses in a going concern – should become more or less a thing of the past. The Bank of England would like it to be completely consigned to the past. Only equity can absorb losses.

For that reason, in calculating regulatory capital, deductions from capital should really be from equity. As part of the emerging compromise, there will be some derogations from that, but the derogations should be transparent. Markets should learn to evaluate bank’s capital adequacy on the basis of what is made transparent about the makeup of that capital.

The other really key change will come in stages – partly in the package this autumn and partly during next year and beyond – which is reducing the pernicious regulatory arbitrage that has existed between “banking book” capital requirements and “trading book” capital requirements. Far too many instruments that were held in the trading book were subject to low capital requirements but actually could not be traded, leaving values exposed to big swings in liquidity premia. This was a fatal design flaw in the existing regime, and it is one which I hope should be fixed over the next year or so though the Basel Committee’s “fundamental review of the trading book”.

4. Too big to fail

At the centre of the reform effort in the FSB work is “Too Big To Fail.” If one of the largest firms in the world got into trouble right now, in almost every country in the world we would not be able to cope with its demise other than through fiscal support.

This is completely unacceptable.

If there is one thing that I think unites the members of the G20 – at the political level and at the official level – it is that this will be consigned to the past. We will re-introduce market discipline back into the financial system, which really means re-introducing capitalism back

into the heart of capitalism. The acid test has to be whether, for every financial institution in the world, it could be resolved if it faces distress in a way that does not disrupt the flow of essential financial services to the economy and ***without*** state solvency support. That is the single goal in this area. When achieved, it can transform the global financial system more than anything else.

It's not for me to set out the ideas today (Svein will do so later), but there ***are*** ideas developing that I believe will, in at least some key centres, become concrete policies for putting losses in the largest firms in the world not just onto shareholders but onto their unsecured, uninsured creditors rather than onto taxpayers. I would expect that over time to lead to adjustments in the business models and organization of the most significant firms in the world. What's more, on the whole, I think they will welcome that.

5. Capital markets

The next element of the reform programme is capital markets. Too much of the reform debate has probably revolved around banks, both in response to this crisis and in response to earlier crises. We live in a world where financial intermediation does not just go via banks and insurance companies, but it goes via capital markets and the vast array of institutions, investors and issuers that the capital markets encourage into existence.

I will highlight just two key changes on this front. One, there is a determination that a lot more OTC (over-the-counter) derivative activity will go through central counterparties, rather than being settled bilaterally. This can have enormous benefits in terms of laying down standards for collateralisation, valuations, and ensuring transparency of what is going on in those markets. There is a residual question about how much of that activity should go via exchanges or via other trading platforms. That's something which I doubt will be completely resolved this year. I think it will remain part of the G20 and the FSB agenda going into next year. But it is a very important part.

Another key element of changing capital markets is much greater transparency around, and much reduced reliance on, credit rating agency ratings. One of the problems in global capital markets has been that too many investors and banks have given up on reaching their own view on borrowers and on instruments, but have effectively subordinated their own judgment to the judgment of credit rating agencies. The FSB is sponsoring and leading work in order to reduce the extent to which credit rating agency ratings are inscribed into, or embedded in the regulatory fabric of our capital markets.

6. Incentives

The sixth thing is incentives. The issue that gets most attention here is compensation or pay, on which the FSB issued a code. The essence of that is that more pay should be deferred. I would add that perhaps part of deferred compensation should be in the form of a debt contract, so that the managers and workers in large firms eventually become creditors of the firm and so they themselves have the same risks as other debt holders. That works only if we can develop resolution regimes leaving debt holders taking risks in our largest firms. So that comes back to whether or not we can resolve the largest firms in an effective way and so can reintroduce market discipline through that route.

7. Concluding remarks

Let me conclude with something on shadow banking.

Martin [Wolf] talked about the grave problems that are present in the global financial system through global imbalances. I completely agree. To the extent that we do not solve the global

imbalances problem, our financial system will need to be more resilient than otherwise. That must be understood.

Global capital flows are one of the givens of the world that we will continue to live in. The other given, in my view, is regulatory arbitrage. The biggest misjudgment that our predecessors made in the 1980's and 1990's was to underestimate the ferocious ability of capitalism to arbitrage regulatory rules. That will not change. Therefore, whatever rules we put in place now, capitalism will find ways around them.

An important element of the reforms therefore has to be a much greater consciousness of regulatory arbitrage and a willingness to do something about it. This must not mean charging after windmills. It means identifying where something is happening that could threaten stability from outside the regulated sector, and being prepared to move the perimeter of regulation in those circumstances. The authorities ***must*** be more interested in shadow banking. That is something that the FSB, I believe, should focus on next year.

I hope that brief overview of the FSB's work can help our deliberations and exchanges today.

Thank you.