Paul Tucker: Building resilient financial systems – macroprudential regimes and securities market regulation

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the International Council of Securities Associations, London, 23 May 2011.

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Thank you very much indeed for inviting me to join you today. I am especially grateful as it gives me an opportunity to air some thoughts about how the regulation of our securities markets fits into the development of macroprudential regimes for preserving stability in the future. In a debate often dominated by concerns about banks, the vital importance of resilient and effective capital markets is easily neglected. This is not at all to diminish the vital lessons from the crisis for banking supervisors around the world, many of whom had lost their traditional system-oriented perspective.[1] But the rules of the game set by securities regulators provide a framework for the functioning of markets that is as important to the operation of the financial system as the regime for banks.

This is especially important for the UK authorities because London hosts the most international capital markets and yet the City is not a hermetically sealed entrepôt. It is bolted into our real economy. And it is especially important for the Bank of England as we establish the new Financial Policy Committee, the UK's new macroprudential committee. But my remarks today are a contribution to the international reform agenda rather than for the UK specifically.

The importance of capital markets

I am guided by my working definition of financial stability. That is that financial stability prevails where the financial system is sufficiently resilient that worries about bad states of the world do not undermine confidence in the ability of the system to deliver its core services to the rest of the economy[2].

As the Bank has set out in its strategy for financial stability[3], the core services are the transfer of payments; the provision of credit and equity; and risk transfer or insurance.

It is obvious that the resilience of ***firms*** matters hugely. But that cannot be all. Firms are linked by markets and infrastructure though a network of contracts covering derivatives; repos and securities lending; correspondent banking, clearing and prime brokerage services etc. Moreover, some markets bring end users together. A financial-stability policy regime that focused solely on the financial soundness of a few firms would, therefore, be myopic. But while nearly all markets are subject to regulation, relatively little thought has been given over the past decade to how different markets matter to stability and, hence, about the role of the authorities in this area.

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[1] On that, see the Bank of England/FSA paper released last week on how banking supervision is being reformed in the UK in preparation for the establishment of the new Prudential Regulatory Authority.

[2] See Tucker P M W "Macroprudential Policy: Building Financial Stability Institutions", 2011 for a discussion of macroprudential regimes.

[3] Bank of England Annual Report and Accounts 2010 pp 26–27.

Markets matter to stability in different ways

As a provisional attempt at this, I think it might be helpful to distinguish between three types of market: infrastructural markets, intra-financial-system markets, and end-user markets.

The first type is those markets that provide ***essential***, quasi-infrastructural support to banking. The obvious example is the ***overnight*** wholesale money markets. They are effectively part of the payments system ***infrastructure***. Banking, which is integral to the provision of all three core financial services, simply could not operate without these markets. They have long been, and will remain, of concern to central banks. I will not return to them today.

The second category is ***intra***-financial system markets (a slightly broader concept than inter-dealer markets). These markets determine the interlinkages amongst financial firms. They matter because banks, dealers and funds rely on them in order to provide services to the rest of the economy, and also because they can increase fragilities in the system. They are perhaps represented best by what have become known as the "financing markets": repo, securities lending, certificates of deposit etc – the markets that financial firms use to access short-term wholesale funding. The authorities' engagement with them is, frankly, patchy. At one end of the spectrum, central bankers in particular have a good track record of ensuring the professionalism of core government-bond repo markets. That was not without good cause. When the US Treasury repo markets started in the mid-to-late 1970s, there was a string of scandals[4]. When the UK authorities opened up the way to a gilt repo market in the early-90s, therefore, we worked with the industry on the supporting hard and soft infrastructure, including a Code drawn up by the Stock Lending and Repo Committee, to avoid a repetition in London of Wall Street's experience. It would be hard for the authorities to claim the same foresight concerning the wider securities lending or repo markets in recent years. The employment by securities lenders of cash collateral became a core but hugely opaque financing market in the run up to the latest crisis[5]. The run on repo, documented by Gary Gorton[6], was how the US securities dealers unravelled. The authorities need to develop policies for monitoring and, where necessary, controlling these markets for providing leverage and maturity transformation. I believe that central banks can play a special role in this area.

Important "intra-financial system markets" are ***not*** restricted to banking. The reinsurance markets, and the mechanisms for sharing risks in Lloyd's of London, are other examples. As are the ***inter-dealer*** markets in derivatives, which have traditionally employed different protocols (notably collateralisation, under Credit-Support Annexes) than get used in transactions with end users. Away from banks, these Over the Counter derivative markets have been the principal focus of policy. They are being rethought, under a mandate from the G20 Leaders[7].

The third category of markets is those that matter directly in their own right to ***end users***. Notably the primary markets in equity and debt. These markets and the associated secondary markets often rely on "market makers" for liquidity, but they are not the marginal source of financing or risk management for banks and dealers. In the past, they have often

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4 Drysdale, Lombard Wall, and so on.

5 See Tucker P M W (2010), "Shadow Banking, Financing Markets and Financial Stability", January 2010.

6 See Gary Gorton "Securitized Banking and the Run on Repo".

7 In September 2009, G-20 Leaders agreed in Pittsburgh that: "*All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse*."

been distant from the attention of the financial stability authorities, but their integrity has long been a focus for securities regulators. They are especially important in economies where a significant proportion of the intermediation of savings/investment occurs via capital markets rather than via bank balance sheets. If those core capital markets are not resilient to shocks and, crucially, if substitutes are not readily available, disruptions could materially impair the supply of credit and risk-capital to the economy, with macroeconomic and other welfare costs. Equity and high-grade corporate bond markets probably pass that test in a number of developed economies. In the USA at least, some securitisation markets were probably significant too. When the securitisation markets closed, they had become so big in the USA that it was not realistic for that part of the credit system to be reintermediated by the US banking system in short order. Even ***if*** the banks had been strong, they would have needed to raise a ***lot*** more capital to expand their balance sheets.

It is, of course, natural that policy has focused on those markets – securitisation and some OTC derivatives – that featured prominently in the crisis. But we do need to develop a framework for identifying more generally which markets really matter to stability. That means being attentive to ***exchange-traded*** derivatives and to ***cash*** markets, whether on or off-exchange, and perhaps especially to the short-term financing markets.

Where firms are concerned, we have learned to focus on maturity transformation and leverage. For markets, it is, perhaps, not quite so straightforward. In the case of ***intra-financial system markets***, we are interested in whether they produce chains of ***cumulative*** maturity transformation and leverage, and how transparent that is. With ***end-user markets***, we are also interested in whether they are driven by strongly procyclical forces; whether they are especially liable to generate assets whose risks are mispriced or obscure; whether demand is dominated by leveraged investors and traders. We are interested in whether they can crater – becoming illiquid or even closing – under stress. And in whether there are ready substitutes. If not, intermediation can become impeded and end-users deprived of valuable services. Across all of these concerns, the underlying factors may be either structural or cyclical. And they go wider than the traditional focus of securities regulators on the integrity of transactions in ***public*** "end user" markets.

In practice, the components of individual markets give us a list of things to focus on. A list that goes well beyond firms: products and their ***distribution*** in primary markets; the rules of the game and infrastructure for ***trading***, including the role of market makers; the infrastructure for ***post-trade*** clearing and settlement; and ***asset management*** practices.

Especially for "end-user markets", these are subjects typically associated with securities market regulation not with mainstream ***micro***prudential supervision. I want to bring out that they are, nevertheless, integral to financial stability authorities. Under each of those headings, I shall raise a few points that have not featured prominently in recent debates. To be clear, I shall not attempt to cover all important markets. And I shall not address important questions about the role of securities regulators in crisis management, circuit-breakers, or counter-cyclical policies such as varying minimum margin requirements as conditions change. Moreover, I must stress that I speak only for myself.

The issuance and distribution of securities

Toxic ABS and CDOs – cash as well as "synthetic" or derivative versions – were at the centre of the crisis. They were not toxic for the financial ***system*** because they were risky or, indeed, because many underlying household and business borrowers became overindebted. Markets can price (and ration) risk they comprehend (if appropriate requiring yields that inhibit issuance). They were toxic because they were mispriced; and they were mispriced in part because they were misunderstood. Through the consequent enticements to leverage, that misunderstanding engulfed banks, asset managers, credit insurers and, eventually, the authorities. Both dealer-financing markets and end-user markets closed.

Listing authorities and securities regulation

And yet all of those securities were issued and/or distributed under the securities laws and policies of developed countries or financial centres with elaborate securities market regulation. Prospectuses or other documentation had to meet regulatory or listing requirements. Those requirements were meant to be exacting if the securities were issued onto the public markets. In Europe, it seems most issuers of ABS and CDOs chose to list them in Ireland or Luxembourg. In many jurisdictions, including the USA, the requirements were deliberately less exacting if the securities were distributed solely via the "private markets" to wholesale or sophisticated investors.

This prompts two thoughts.

First, with hindsight, could Listing Authorities and securities regulators[8] do more in the future to ensure that the disclosure around complex securities are comprehensible, coherent and, crucially, simple and short enough to be capable of being absorbed? And should Listing Authorities be more willing to step in and require changes to the structure of complex securities where they conclude that the disclosure is inadequate and just ***cannot*** realistically be made adequate? Have "risk factors" become so numerous, wordy and wide-ranging that they lose their impact? In their understandable desire to avoid validating products and securities, have securities regulators retreated too far towards simply checking that the required boxes have been ticked? Perhaps I am imagining it, but I recollect a period in which Listing Authorities were guardians of the integrity of primary markets. That over time came to rely upon disclosure. And that ended up meaning accepting documents that were comprehensive rather than comprehensible. Where something is incomprehensible, and has reached a scale where it could even jeopardise stability, the relevant authority should say so. Where it can be made comprehensible via a succinct piece of analysis in the introduction of a Prospectus, the Authority could require that.

What I am suggesting would entail Listing Authorities and securities regulators more generally thinking about themselves somewhat differently and, if I may say so, being somewhat less bound by the traditions of public equity markets. This seems unavoidable given the growth in private offerings of complex securities and the involvement of banks in securities-market intermediation. It might require legislation in some jurisdictions to entitle securities regulators to take into account financial stability[9]. Prior to the crisis, that had hardly been debated anywhere, but IOSCO's principles of securities regulation have recently been revised to identify reducing systemic risk as one of the three objectives of securities regulation.[10] That innovation is big, but it needs to be incorporated into national regimes and practices.

Second, is it always right to make a clear distinction between laws and rules governing "public" issues and private placements? Viewed against the historical objectives of securities regulation – fairness, transparency, and investor protection – the public market v. private-transaction distinction ***does*** indeed seem valid. But we need to debate whether the separation is so neat when the public policy objective of financial stability is taken into account. That is because the creation and private placement of very large amounts of particular types of security can affect the amount of risk being borne by the system as a

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8 Confusingly, the language and structures vary considerably across countries. In some jurisdictions, such as the UK, the securities regulator is the listing authority. In others, such as the US, listing documentation is approved by exchanges, with minimum disclosure requirements set by the securities regulator. This is tied up with whether regimes retain an element of Self-Regulatory Organisations.

9 In the UK, although the FSA was given a "financial stability" objective in 2010, it did not apply to its functions as UK Listing Authority. The proposed objectives of the planned new securities and conduct regulator, the FCA, are intended to apply to the UKLA.

10 IOSCO Objectives and Principles of Securities Regulation (2010).

whole in ways that are opaque to everyone. For example, in the USA, as the SEC has commented, a lot of structured-finance products, including pretty well all CDOs and Asset-Backed CP, were issued privately and so were exempt from a panoply of disclosure requirements that apply to "registered" offerings.[11] Reducing that opacity, and ensuring the integrity of these market mechanisms, could well be in the interests of investors in private placements themselves.

This issue is not easy. On the one hand, it is reasonable for the regulatory regime to make allowance for private transactions amongst "consenting adults". And the issuance of small amounts of any type of security cannot possibly jeopardise stability. On the other hand, it is reasonable for public policy regimes to address the externalities – in this case, the potential systemic effects – of thousands of large private transactions that take place away from public markets. My concern is not that sophisticated investors cannot fend for themselves. And I do not want to deny that private transactions can aid stability, as indeed has been the case with much recent private-market debt issuance by banks. But nobody can assess the risks they are incurring in some transactions without much more information about the ***totality*** of risks out there and the network of exposures within the financial system. At the least, good aggregate information is needed about patterns of issuance in private markets.[12]

Product gatekeepers: securities regulators

These questions of how securities regulators should respond to the possible effects of innovations on the stability of the system are not limited to their listing-authority function. The rules for collective-investment schemes matter too.

A good example, highlighted recently by the G20 Financial Stability Board, is the development of the Exchange-Traded Fund markets to include synthetic structures, leveraged funds, less liquid underlyings, and all three combined.[13] Remind you of how securitisations ended up in CDO^2 and CPDOs? In the EU, ETFs are subject to the UCITs rules for what are in effect mutual funds available to retail investors.

Securities regulators need to think about how to avoid mechanically applying a regime for vanilla investment schemes to the structuring and distribution of much more complex and sophisticated products.

In the same spirit, recent ETFs innovations underline the need for securities regulators to work closely with bank supervisors and macroprudential authorities on shadow banking and what I earlier called "financing markets". For both physical and synthetic funds, the underlying collateral pools are being swapped to provide financing for dealers and banks. It is not clear whether bank supervisors have caught up with this, or whether the risk of the collateral swaps being called is treated appropriately in regulatory maturity-mismatch ladders. Who would have guessed that vanilla collective investment schemes, could be turned to this purpose? The truth is that any pool of assets can be.

While the FSB has already called for authorities to act to keep the evolution of ETFs on a sustainable path, the broader lesson is that securities regulators need to be alive to the need

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[11] Securities and Exchange Commission, Release No. 33-9117, Asset-Backed Securities (April 7, 2010).

[12] The FSB took a small step towards addressing this issue in its March 2011 publication, "Thematic Review on Risk Disclosures Practices: Peer Review Report". This did not get much traction at the time, but the FSB's Vulnerabilities Group, chaired by Jaime Caruana and on which I sit, plans to draw on that Review in its own work programme. In the US, as noted, the SEC has begun to grapple with this set of issues. Its April 2010 notice proposed enhanced disclosures requirements for asset-backed securities sold privately as well as via the public (registered) transactions.

[13] "Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)", published by the Financial Stability Board, 12 April 2011. The Bank of England covered similar issues in its June 2010 *Financial Stability Report*, pages 40–41.

to keep up with innovations and, like bank supervisors, they need to be ready to accept an occasional steer from macroprudential authorities.

Product "gatekeepers": Credit Rating Agencies

It would be hard to talk about the issue and distribution of securities without mentioning Credit Rating Agencies. It is important to reduce the significance of CRA ratings in our capital markets. Pervasive ***mechanistic*** reliance on ratings is by no means mainly the fault of the Rating Agencies themselves or of financial firms, although many of the latter have acted – and probably continue to act – foolishly. The extent to which ratings have been bolted into regulatory regimes – by securities regulators ***and*** prudential supervisors – has plainly been a great mistake. And it is one of those mistakes whose effects have become so woven into the fabric of "modern" finance that it is going to take an extraordinary act of will (and patience) to undo it. Yes, we do have asset managers (and banks) who might not be able to evaluate some securities on their own if they were not permitted, by official regimes, to ***rely*** on CRA ratings. But what on earth are we doing not only tolerating but effectively encouraging a financial system in which asset managers and banks can't always understand their portfolios?

It is therefore vital that, together with the Basel Supervisors Committee, securities regulators around the world actively implement the FSB's Principles for reducing ***mechanistic*** reliance on CRA ratings.[14] In the US, the SEC is embarked on that. But I worry that others, including prudential supervisors, might not grapple with this admittedly difficult exercise in a determined way. The enhanced (meaning better not longer) disclosure by issuers I discussed earlier could make the standard-setters' task somewhat less difficult.

Infrastructure

One of the wonderful things about capitalism is innovation. It helps to drive technical progress and higher-living standards. Open economies allow those innovations to spread across the world. Freely flowing capital is essential for this to work in my view. But innovations can take a nasty turn in financial markets when they outgrow their supporting infrastructure.

This is an area where the authorities can do good, because there is often a collective action problem. For example, the recent crisis would have been much worse if the authorities, led by the New York Fed, had not "asked" the dealer and fund community to clean up the problem of assignments in credit-default-swap markets in the early years of the last decade. But we need to ***remember*** to be ready to step in. The OTC derivative markets are an example where the authorities have had to chase after events. The cash ABS markets are another, with central banks now taking a lead by introducing standards for transparency and the structure of the securities we are prepared to take as collateral.

Trading platforms and exchanges

Currently, a key area of reform is the infrastructure for the main ***over-the-counter*** derivative markets.

In the trading area, there is a debate about how far to unravel the predominantly bilateral mechanics of OTC derivatives markets and how far to move towards exchanges. Perhaps to

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[14] I should disclose that I chaired the FSB working group that drew up the Principles. But they belong to the FSB, endorsed by its Plenary, rather than to the working group. "Principles for Reducing Reliance on CRA Ratings", Financial Stability Board, 27 October 2010.
Available at http://www.financialstabilityboard.org/publications/r_101027.pdf

different degrees in the US and the EU, there is an unresolved issue about whether all standardized derivative products should be traded via Multi-Dealer Platforms, which are a bit like exchanges, or whether to allow Single-Dealer Platforms through which a broker-dealer sets up its own quasi-exchange. A preliminary study by IOSCO did not reach a clear conclusion given the dispersion of views.[15]

I want to inject one thought from a financial stability perspective into this debate. So far as we can see, the debate has been cast pretty much entirely in terms of market integrity (honesty and fairness), transparency and the efficiency of price discovery – the core concerns of a securities regulator. The missing word is "liquidity". And the question is whether or not liquidity would be more ***resilient under stress*** depending on whether an asset class was traded on MDPs or SDPs.

The question of resilient liquidity matters enormously. As the crisis in 2007 reminded everyone, the liquidity of markets can evaporate, causing liquidity premia to soar, undermining the net worth of those intermediaries and investors who mark to market, feeding back into market dynamics in a vicious circle. As well as controlling leverage, prudential standard setters can help here by ensuring that bank and dealer intermediaries carry capital to cover the risk of swings in liquidity premia and against the pervasive basis risk warehoused by "market makers" in illiquid or non-standard products. The Basel Supervisors Committee ***is*** working on that in its Fundamental Review of Trading Book Capital Requirements.

But, surely, the design of the market microstructure also matters. In that sphere, might the choice between MDPs and SDPs also make a difference? It is hard to know. There is some evidence from the fx markets that, during the crisis, volumes shifted to single-dealer platforms. One possible explanation for that would be the incentive of individual firms to make clear to their customers that they provided a liquidity service during thick and thin, expecting to be rewarded with more business as normality returns. But I must stress that I do not have a position on this. Rather, my point is that this very important issue has been debated without the liquidity dimension being explicitly considered. Following discussion at FSB, that gap in the analysis is now being addressed by the IOSCO leadership.

Post-trade infrastructure: CCPs as risk managers

The other big area of reform is, of course, around central counterparties. Clearing more OTC products; being more resilient; revisiting criteria for access to CCPs, and so on. You don't need me to rehearse all of that for you.

But I would note that this is not just about derivatives markets. LCH's move to clear repos in Spanish government bonds helped that market stay open during some dark days.

And I do want to make one very important general point about the role of CCPs and their management.

CCPs simplify the complex web of counterparty exposures through multilateral netting – precisely what the US authorities contemplated trying to achieve ad hoc towards the end of a weekend when Lehman was unravelling. They act as a central market authority for valuing positions and setting minimum margin levels. Having centralised risk upon themselves, they redistribute it to their clearing members through a clear waterfall. They are, in effect, ***systemic risk managers***. They absolutely must think of themselves as that. Their job is not just to deliver ever greater operational and capital efficiency for their clearing members. Too many senior executives at CCPs I have met over the past decade or so have seemed to fall into that trap – a trap encouraged by some being for-profit organisations. I fear that what I am

[15] Report of the Technical Committee of IOSCO on Trading of OTC Derivatives (2011).

saying will seem novel. In fact, this emphasis on their role as systemic risk managers was a clear lesson from the very few instances of clearing houses failing over past decades.[16] If I may quote from the post-87 crash Report of the Hong Kong Securities Review Committee:

> "When everything else is stripped away, the most pressing issue is the management of risk. The focus of this is ......increasingly, the central clearing houses – indeed [their] prudent operation is perhaps the single most important objective for the market authorities and regulators.[17]"

What does this mean in practice? My personal view is that, amongst other things, it means that CCPs should not outsource their core risk management functions; they should monitor the robustness of their clearing members; and they should monitor risks from the business that their clearing members are bringing to them as an indication of incipient fragility. Amongst other things, that means collecting and analysing information from clearing members on large positions taken by their customers. In 1987, it was the long positions of a trader that bankrupted the Hong Kong clearing house.

Some elements of the clearing house regime are clearly for the authorities to determine. One important one, which is implicitly being debated in some jurisdictions but not in a way noticed by anyone other than specialists, is whether clearing houses should adopt what is called Gross Margining rather than Net Margining. What this means is that a clearing member – ie a dealer – could not net off positions of their various customers and their own house position when the amount of margin they have to hold with the clearing house is determined. That would affect the incentives of clearing members to collect minimum margin amounts from their customers. And, more generally, it would probably reduce the amount of leverage in the system and simplify the chain of credit. Again, my point is not at all to advocate a position on this one way or another. It is to note that this is about more than investor protection through the segregation of client moneys, and so needs to be debated against the goal of preserving stability without impairing efficiency.

Post-trade infrastructures: trade repositories

Moving on from CCPs, a quick appeal – in fact, two if I may – to the securities regulator community on Trade Repositories.

They are one of the most interesting innovations brought forth by the crisis. They are expected to house information, on a trade-by-trade basis, on the type of contract, notional value, currency, maturity, counterparties of derivative transactions. This needs somehow to extend to valuation(s) and collateral terms.

My appeal to the US, EU and Asian authorities is twofold. First, should we not have a Trade Repository covering securities lending – a cash market – including the way collateral is employed? We surely need to do something to lift the veil on this vital financing market and, probably, on the collateral swap market more generally.

Second, we need to think carefully about the purposes for which the information in TRs is collected, and thus how it is stored. As well as helping to identify market abuse, which of course is a core mission of securities regulators, we need to use the information to track more generally what is going on in markets to help us spot incipient, often slow-moving threats to stability. And even though ***individual*** Trade Repositories are being set up to handle ***specific*** markets (credit-default swaps, interest-rate swaps etc), it needs to be possible to see the pattern of risk and flows ***across*** markets and products. Recognising that,

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16 Paris in 1974, Kuala Lumpur in 1983 and, most dramatically, the Hong Kong futures clearing house in 1987.

17 Paragraph 3.21, Report of the Hong Kong Securities Review Committee, 1988. I should disclose that I was an Advisor to the SRC and drafted much of the text submitted to the committee.

the FSB has called for the relevant authorities, liaising with the BIS Committee of the Global Financial System, to set requirements for reporting of transactions to trade repositories that meet the needs of financial stability analysis.[18] This work needs a higher profile.

Firms

Markets are places where end-users and intermediaries meet. Securities regulation affects financial firms – traders and asset managers – as both intermediaries and as users. It is important this gives proper weight to financial stability. Three broad thoughts on that.

Regulated banks: provisions and disclosure

Everybody in this room and outside knows, or should know, that for much of the past quarter of a century there was a stand off between bank supervisors and securities regulators over provisioning policy. On the one hand, until they gave up in exhaustion, many bank supervisors wanted banks to set aside (general) provisions against losses that were implicit in portfolios but not yet manifest in arrears or other concrete measures of impairment. Today we would call this forward-looking or expected-loss or dynamic provisioning. On the other hand, securities regulators typically opposed this because they feared, no doubt with some reason, that it could be used to smooth profits in a misleading way. There were some famous stand offs. I do not doubt the sincerity of the securities regulators' concerns. And no-one could ignore the constraints that, as the years passed, were codified into accounting policy. But the stand off across the supervisor/market regulator divide was a problem. Progress is now being made by the IASB and FASB on developing more forward-looking impairment standards. The key to progress was the joint recognition by market regulators and supervisors that earlier identification of credit losses is consistent both with financial statement users' needs for transparency regarding changes in credit trends and with the prudential objective of safety and soundness.[19]

In the other direction, bank supervisors have typically insisted on the vital confidentiality of the information they receive, while securities regulators emphasise transparency. One could argue that, in many countries, the bank supervisors have done too well in this debate. That was brought home to me some years ago when, in a previous existence at the Bank of England, my then team realised that we could analyse large and complex firms most easily using disclosures made under SEC rules. As announced last week in the joint Bank of England/FSA document on how the future Prudential Regulation Authority will approach banking supervision, we plan in the future to publish prudential returns to the extent possible.

Shadow banking and the prudential perimeter

My second point about firms concerns shadow banking, defined to mean non-bank firms or structures that replicate the monetary and/or credit services of banks in some way, involving maturity transformation and/or leverage[20].

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[18] See Recommendation 19, FSB Report on Implementing OTC Derivatives Reforms (2010); and the recommendations of the FSB's Data Gaps and Systemic Linkages Group. The Basel Committee on Payment and Settlement Systems has published revised draft Principles for market infrastructures, including (Principle 24) that "A Trade Repository should provide timely and accurate data to relevant authorities and the public in line with their respective needs".

[19] See recommendations on bank provisioning in Chapter IV of FSB (2009), "Report of the FSB on Addressing Procyclicality in the Financial System". Available at http://www.financialstabilityboard.org/publications/r_0904a.pdf

[20] See Tucker P M W (2010), "Shadow Banking, Financing Markets and Financial Stability", January 2010.

In a world in which regulatory arbitrage is endemic, it is a fact of life that the re-regulation of banks will set up incentives to build banking-like functions in other forms.

The import of this for my remarks today is that securities market regulators (and insurance regulators) need either to be relaxed about the supervision of shadow banks being transferred to banking supervisors or, alternatively, vigilant about maintaining regimes that do not permit systemic risk to accumulate beyond the perimeter of the banking system. In the UK's planned new regulatory framework, the Financial Policy Committee will be responsible for recommending to the Treasury when prudential supervision of a type of firm should shift from the securities regulator to the prudential regulator (and vice versa); and it will be able to advise the FCA on when it needs to revise its rulebook in the interests of stability. Different jurisdictions will come up with different arrangements to address this issue, but I would say that every jurisdiction ***is*** going to need its own solution. And, perhaps for the first time, that has highlighted the need for some international co-ordination of policies on shadow banks. The FSB is just starting to explore this virgin territory.[21]

Asset managers and incentives

The vast majority of the asset management world is not engaged in shadow banking and, more important, does not of itself jeopardise the stability of the system ***directly*** if it gets into trouble. The taking and absorption of risk by ***unlevered*** funds is a fundamentally healthy part of the system.

But financial stability authorities cannot be indifferent to this industry. By investing in the debt and equity of banks, it is a vital part of market discipline. We do not want – and cannot have – a system where the first line of defence after the management of banks themselves is the cadre of official sector supervisors. For the system to be healthy, we need boards, auditors, equity investors and debt holders to play a big part, and for investment decisions to be subject to constructive incentives. Yet, there is relatively little debate about whether the incentives of asset managers made the system more prone to crisis.

Although not a subject for today, an important part of this is the drive to develop resolution regimes that entail debt holders taking losses on their exposures to distressed banks and dealers. That will create an incentive to price risk.

We also need to be alive to artificial but potent incentives to ***take*** too much risk. What I have in mind here, for example, are the regimes or practices under which long-term asset managers (life companies and pension funds) end up targeting or even guaranteeing high ***nominal*** returns or, a separable issue, investing as herds.

For example, it is said that public sector pension funds in the USA aim to achieve returns of around 8%.[22] This kind of thing, which I would guess has global effects, distorts the appetite for risk in our capital markets, especially when current and expected policy rates are low. We need to get to the bottom of whether this materially fuels the Search for Yield, which is being talked about again by market participants in ways that remind me of 2003/04, when the markets reignited astonishingly quickly after the dotcom and telco debt blood bath.

Separately, we need to have a richer understanding of the effects of relative-return performance measures on the dynamics of crucial debt and equity markets.

These seem like badly neglected issues, of little interest to microregulators of fund managers or securities markets but, possibly of profound system-wide significance. My objective today is no more than to call for research on this.

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[21] See FSB (2011) "Shadow Banking: Scoping the Issues. A Background Note of the Financial Stability Board."

[22] The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Systems', Pew Centre of The States, April 2011.

Summary and conclusions

The international reform agenda to make firms more resilient, and especially to address the Too Big To Fail problem, is absolutely essential, the number one priority. But we should take care not to neglect the importance of the rules of the game for capital markets.

Once upon a time banks extended and held illiquid loans, overseen by banking supervisors. And in a largely separate universe, securities regulators policed the integrity of individual transactions and offerings on public exchanges served by specialist intermediaries. The growth of private markets, over the counter markets, derivatives, securitization, and banks as intermediaries in capital markets has changed all that, as the crisis cruelly exposed. Banking supervisors are having to recover their historic mission for systemic stability, but this time round that calls for greater attention to markets and, in particular, not simply assuming that what's in a bank's trading portfolio and warehouse must be liquid. Securities regulators are having to look well beyond their roots, accepting that their rules and policies influence the resilience of the system. And financial stability authorities, including central banks, have to become as comfortable debating the (hard and soft) infrastructure of core capital markets as they are with, say, the intricacies of the capital structure of banks. All of that is essential if we are to make progress with comprehending the network characteristics of the financial system. Securities regulators and financial stability authorities will have to meet half way.

In that spirit, today I have posed questions about the perspective and responsibilities of Listing Authorities; whether the distinction between public and private market transactions is as relevant for financial stability as it is for some other public policy objectives; how securities regulators need to be alert to innovations outstripping their regimes; how to factor the importance of resilient liquidity into the debate about trading platforms; the importance of CCPs as ***system risk managers***, collecting large-position data, and whether they should apply gross margining; the case for a Trade Repository for securities lending and collateral swaps; the need for securities regulators and accounting standard setters to relax about forward-looking provisions, and for banking supervisors to relax about publishing some regulatory returns; the need for reform of the regulatory regime for some types of shadow banking; and the need for a review of the regulatory and other incentives prompting long-term asset managers to target minimum ***nominal*** returns.

If that is a longish list, it is because there has still been little public debate in this area.

My review of the overlap of interest between securities regulators and financial stability authorities enters familiar territory when it gets to CCPs, shadow banking and banks' own disclosure practices. But I hope I have persuaded you that the regimes for the issuance and distribution of securities, for trading platforms, and for asset management can also matter to the resilience of the financial system. I hope that there may be some agreement that, from a financial stability perspective, policies might sometimes more appropriately be cast in terms of inter-dealer (or "intra-financial system") markets and "end user markets" rather than in terms of public markets and private transactions. And I hope that there can be a consensus that central banks can play a useful role in monitoring and fostering robust practices and infrastructure in the short-term financing markets.

The co-incidence of interests between macroprudential authorities and securities regulators ***is*** beginning to be recognised. At a global level, IOSCO is represented on the FSB and, perhaps encouraged by that experience, earlier this year, it published its report on "Mitigating Systemic Risk"[23]. In Europe, the European Securities Markets Authority is on the Systemic Risk Board. In the USA, CFTC and SEC are on the Financial Stability Oversight Council.

[23] IOSCO (2011), Mitigating Systemic Risk: A Role for Securities Regulators. IOSCO has added to its Core Principles two new principles on how securities regulators should seek to contribute to containing systemic risk.

What I have been discussing is especially important for the UK. London's capital markets are so international that threats to stability from any corner of the globe ricochet through our system. We cannot afford to ignore capital markets if we are to restore and preserve stability in the UK. The UK's new macroprudential regime recognises this. The CEO of the planned new market regulator, the Financial Conduct Authority, will sit on the Financial Policy Committee once it is placed on a statutory footing. And the government proposes that the FPC be given power by Parliament to give Recommendations and Directions to FCA where it could develop its policies and rules in the interests of stability.

Domestically, internationally, financial stability is a shared endeavour. I am therefore especially grateful for being invited to join you, the securities market community, today in what can only sensibly be the beginning of a collective process.