Paul Tucker: Introductory remarks at the book launch for "Investing in change – the reform of Europe's financial markets"

Introductory remarks by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the Association of Financial Markets in Europe book launch, London, 1 February 2012.

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AFME's book is significant as it has reached beyond its own community – of investment and wholesale bankers. The contributions come from journalism, politics, academia, business, and central banking. Each of our communities carries some of the responsibility for the mess that engulfed the world's financial system, inflicting hardship on households and businesses around the globe. That must continue to drive us as we work to devise new "rules of the game" for a better financial system.

This evening, I want to dwell on just one of the guiding principles of the international reform programme: banks should not depend on a safety net from taxpayers.

Of course, retail deposits – up to £85,000 in this country – will continue to be insured. And we probably also need measures – possibly segregated accounts – that can protect the Temporary High Balances that arise when, for example, a person sells a house or receives a legacy. But regular creditors of banks should be at risk. Pretty much everything underway in international finance at present reflects the dynamics set in train by a progressive withdrawal of the safety net.

Two points on how that will be delivered. And three points on what it will mean.

On the "how", the first thing to say is that going forward, banks are being required to carry considerably more capital and liquidity. Second, as is now well known within the industry, the international authorities have agreed a blueprint for resolution regimes to manage the failure of so-called Systemically Important Financial Institutions in an orderly way. G20 Leaders have committed to legislate that regime into their domestic systems where necessary. All resolution regimes have the effect of distributing the losses of distressed financial firms – ie losses already or prospectively exceeding equity – across unsecured, uninsured creditors. That is the only place losses can go if taxpayers are to be spared. "Bailin" has focussed minds on this, but is in fact just one method, albeit a very important one, for ensuring that uninsured creditors take losses.

Those "how" points are very familiar. A few comments, therefore, on possible implications – all of which, looking ahead, point towards the crucial importance of our capital markets.

First, in a world of less leveraged banks, a business model of Originate and Warehouse – because that is what it became by the middle of the past decade – is unlikely to be viable. Maybe a genuine model of Originate and Distribute will emerge, with something like agency-type market making and trading.

Second, holders of bank paper – especially bonds – will be living in a different world. They will have a big incentive to monitor the riskiness of banks. This is prospectively very positive. A couple of years ago I asked around London who were the best analysts of banks. Pretty well all those named were current or past equity analysts. A measure of success of our reforms will be that some leading analysts will concentrate on debt rather than equity, on the downside risks: credit analysts. They will be needed. Maybe there are some already.

The upshot is that withdrawing the safety net from banks will require the other parts of the financial system to be sound, because they will have to stand on their own feet. It is sometimes pointed out that the insurance industry – other than AIG – did not benefit from state support. But, of course, insurance companies holding bank debt were the direct beneficiaries of state support for the banking system. Regulators of insurers – including, in this country, prospectively the Bank of England through the Prudential Regulation Authority – will need to take the changed regime for banks into account. We no more want insurance to be part of a "socialised" financial sector than banking.

Finally on the "whats", a world in which bank debt is perceived to carry risk is a world in which, as I have said before, it may be helpful for banks' management to be remunerated partly through subordinated debt rather than just equity. Management would then have a clear personal incentive to focus on and contain tail risks. I understand that the EU Code on remuneration would already be consistent with this.

What I am describing is not a scary prospect. It should, in fact, be liberating to establish a financial system based more firmly on the principles of the market.

But it is a prospective world in which our capital markets will be at least as important as they were over recent decades. That underlines the necessity of the work on, for example, standards for central counterparties, on shadow banking, and on transparent and resiliently liquid markets. This is a world in which securities regulators will play a vital role in underpinning stability. In the UK, the new Financial Conduct Authority under Martin Wheatley will be a member of the new macroprudential body, the Financial Policy Committee, for just that reason.

Thank you again to AFME for providing a forum through its book for this public policy debate to continue.