

## Mark Carney: The UK at the heart of a renewed globalisation

Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at an event to celebrate the 125th anniversary of the Financial Times, London, 24 October 2013.

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### 1. Introduction

When the *Financial Times* opened for business in 1888 London was the world's preeminent financial centre. It had the most international banks, the largest capital markets, and the deepest money and gold markets. It backed projects all over the world, and most of world trade was financed by bills drawn on London. Supporting the critical mass of banks, insurers and investors was an army of solicitors, accountants and clerks.<sup>1</sup>

What London had lacked, at least until the FT's great rival *Financial News* was founded in 1884, was a ready provider of financial news. The FT famously set out to report "Without Fear and Without Favour", and declared itself to be the friend of the honest financier, the respectable broker and the legitimate speculator; and the enemy of the closed stock exchange, the unprincipled promoter and the gambling operator. Perhaps as a consequence, its initial circulation was modest.

The preoccupations of 1888 were not very different than today. Editions of the FT 125 years ago contained stories on economic development in China, the health of Spanish government finances, and the state of Irish banks.

What is clear in those early editions is the decidedly international flavour of a London investor's interests – from tramways in Buenos Aires to copper mines in Portugal. Since then, London has been a truly international financial centre. In 1913, at the twilight of the last great wave of globalisation, 71 foreign banks had London offices. A century later, there are nearly four times as many. Today, almost twice as much international banking activity is booked here as anywhere else.

London is the home of global markets as well as global banks. Almost half of all turnover in over-the-counter (OTC) derivatives takes place here. London's share of global foreign exchange turnover is almost as high and it remains a major hub for trading in gold. UK insurance companies have around 10% of the global market.<sup>2</sup> Extending the net further, the UK is home to the third largest "shadow banking system" with assets of \$9 trillion.<sup>3</sup>

The emergence of London as a financial centre in the nineteenth century owed a lot to the UK's position as the world's greatest trading nation. Britain accounted for as much as a quarter of world trade and produced around a tenth of global GDP.<sup>4</sup> Over the following

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<sup>1</sup> At around this time there were 701 accountancy firms operating in the City, and over 2000 firms of solicitors. See David Kynaston's book *City of London: The History* (Chatto & Windus, London, 2011).

<sup>2</sup> See *"Fund Management September 2013"* published by TheCityUK, available at <http://www.thecityuk.com/research/our-work/reports-list/fund-management-2013/>.

<sup>3</sup> See the Financial Stability Board's *"Global Shadow Banking Monitoring Report 2012"*, available at [www.financialstabilityboard.org/publications/r\\_121118c.pdf](http://www.financialstabilityboard.org/publications/r_121118c.pdf).

<sup>4</sup> The world trade share estimate is constructed using data from Dimsdale et al. (2010), Lewis (1981), ONS, UN, World Bank and WTO. Full references are: Dimsdale, N., Hills, S., and Thomas, R. (2010), *"The UK recession in context: what do three centuries of data tell us?"*, Bank of England Quarterly Bulletin, No. 50, December; Lewis, W. A. (1981), *"The rate of growth of world trade, 1830–1973"*, in Grassman, S. and Lundberg, E. (eds) *The World Economic Orders: Pasts and Prospects*, Palgrave Macmillan. For the output share, the source is Maddison. International comparisons of historical output are fraught with measurement issues. Data are available only for 1870 (9%) and 1900 (9.4%), and cover a relatively small sample of countries, hence the stated share for 1888 is only an approximation.

125 years the UK's shares of world trade and output have fallen to around 3%. Despite some ups and downs, London has remained a centre of global finance.

Partly as a consequence, the size of the UK's financial sector relative to its economy has increased dramatically. When the FT was in its infancy, the assets of UK banks amounted to around 40% of GDP. By the end of last year, that ratio had risen tenfold.

As we have recently been painfully reminded, a specialisation in financial services carries risks as well as rewards. And those risks will grow, unless we put global banks and markets on a sounder footing. Suppose, for example, that UK-owned banks' share of global banking activity remains the same and that financial deepening in foreign economies increases in line with historical norms. By 2050, UK banks' assets could exceed nine times GDP, and that is to say nothing of the potentially rapid growth of foreign banking and shadow banking based in London.

Some would react to this prospect with horror. They would prefer that the UK financial services industry be slimmed down if not shut down. In the aftermath of the crisis, such sentiments have gone largely unchallenged.

But, if organised properly, a vibrant financial sector brings substantial benefits. Today financial services account for a tenth of UK GDP and are the source of over 1 million jobs.<sup>5</sup> Two thirds of those are outside London, including jobs in asset management in Edinburgh, transaction processing in Bournemouth and insurance in Norwich. Being at the heart of the global financial system also broadens the investment opportunities for the institutions that look after British savings, and reinforces the ability of UK manufacturing and creative industries to compete globally. Not to mention that financial services represent one of the UK's largest exports.

More broadly, London's markets serve a vital global role. London acts as Europe's window to global capital; is a centre of emerging market finance; and can play an important role in the financial opening of China.

The UK's financial sector can be both a global good and a national asset – if it is resilient.

It is not for the Bank of England to decide how big the financial sector should be. Our job is to ensure that it is safe. The UK can host a large and expanding financial sector safely, if we implement a reform agenda that extends well beyond domestic banking.

That is not to suggest that the focus on reforming domestic banks has been misplaced. Following the crisis, it was imperative to fix first the fault lines at the core of our system, with initiatives ranging from rebuilding the capital of major UK banks and building societies, to changing the structure of compensation and the responsibilities of senior officers. In tandem, some major banks are working to change their cultures.<sup>6</sup>

But reforms of domestic banking are far from sufficient for a global hub like London. Now is the time for a greater focus on what's needed for resilient international banking and robust global markets. This will require sustained international engagement. Unlike in the early days of the FT, the UK can no longer dictate standards. Rather than ruling the waves, we must spur collective action through a demonstrated commitment to openness and the promotion of better ideas in Europe and at the G20 via the Financial Stability Board (FSB).

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<sup>5</sup> As Andy Haldane has noted, the methodology used to calculate output statistics related to financial services is likely to overstate their true contribution, especially when compensation for risk is high. See *"The contribution of the financial sector: Miracle or Mirage?"*, <http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech442.pdf>. As banks' balance sheets have shrunk since the crisis this effect is likely to have lessened.

<sup>6</sup> Martin Wheatley spoke yesterday about fairness and the importance of cultural reform, arguing that "the financial world is responding to the cultural change around it"; see <http://www.fca.org.uk/news/the-fairness-challenge>.

More fundamentally, such engagement would be timely because globalisation itself is under siege. Cross-border capital flows have fallen sharply since the crisis. Multilateral trade liberalisation has stalled, to the detriment of global prosperity.

If we are to stem this tide towards financial fragmentation we must make global finance more resilient. That serves both national and global interests.

Accordingly, I will concentrate today on three core elements of the Bank of England's new Financial Stability strategy: creating resilient global banks, building robust markets and conducting central banking for global markets. These initiatives support a fourth leg of our strategy: improving the supply of finance in the UK. You will hear more about supply-side initiatives, aimed for example at rebuilding securitisation and supporting SME lending, in coming months.

## **2. Strengthening the resilience of international banking**

Making international banks safer is fundamental to a renewed globalisation.

To this end, new global standards for capital and liquidity have been agreed. The major global banks have raised \$500 billion of new equity over the past few years and are on course as a group to meet the Basel III standards more than four years in advance of the deadline. In the UK, all major banks and building societies now have in place credible plans to achieve the Bank of England's thresholds for capital and leverage.

To finish the job, international regulators need to agree over the next year new rules for capital to be held in banks' trading books, a simple leverage ratio and a guideline which governs the stability of banks' funding.

Alongside these efforts to increase resilience, our focus is on solving the problem of banks that are too big to fail. Systemic resilience depends on being able to resolve failing banks in a way that does not threaten the entire system. Fairness demands the end of a system that privatises gains but socialises losses. And simple economics dictates that the UK state cannot stand behind a banking system that is already many times the size of the economy.

Moreover, without a credible means to resolve failing banks, regulatory Balkanisation will continue as national regulators seek to protect their own interests, threatening the efficient operation of the international financial system and accordingly London's competitiveness.

To avoid these risks, we need to make the resolution of global banks a real option.

Successful cross-border resolution requires coordination and cooperation between authorities across multiple jurisdictions. This will only work if all authorities are confident that global resolutions will deliver domestic financial stability and protect local services. Cross-border cooperative agreements will help, but fine words must also be backed up by harsh economic incentives. Operating structures of banks must be made consistent with resolvability and, above all, banks must have substantial loss-absorbing capacity that cascades through their group structures.

At the St Petersburg summit in September, G20 leaders mandated the FSB to develop these proposals. The Bank of England is now working intensively with other authorities and the financial industry. Our aim is to complete the job by the next G20 Summit in Brisbane.

By increasing the resilience of banks and tackling too big to fail we can help make London a safe global banking centre. But that is far from sufficient; we must also dramatically improve the resilience of global markets.

## **3. Creating robust markets**

To do so, we need first to consider how measures to increase the resilience of banks affect the functioning of markets. For example, the combination of higher capital held against

trading books, the new leverage ratio, and the proposed Volcker restrictions on proprietary trading have already combined to reduce dealer inventories across a range of securities.<sup>7</sup> With dealers less willing to deploy capital against large market moves, volatility has increased and liquidity fallen in the face of shocks such as the potential shift in US monetary policy earlier this year.

On the other hand, with limited proprietary positions, banks generally emerged from a summer of stress unscathed. Certainly, no one wants to return to the days when major dealers' trading books were crushed under the weight of worthless leveraged super senior debt.

To strike a balance between making banks safer and maintaining adequate market liquidity, we need to draw lessons from the financial crisis, when contagion from stressed banks spread rapidly through the global financial system via counterparty credit concerns, liquidity hoarding and mass deleveraging. In this environment, core funding and OTC derivative markets seized up and conditions were set for the panic that ensued.

By contrast, markets with greater transparency and more robust trading and settlement infrastructure, such as equity markets and exchange-traded futures and options, performed rather better. Prices were not always to participants' liking, but these markets remained open.

London should lead the way in ensuring that fixed income and derivative markets meet such standards. At the FSB, the Bank of England is helping to devise reforms that increase transparency, build more robust infrastructure and encourage better collateral management.

Since collateral management is a cornerstone of resilient markets and goes to the heart of central banking, let me take a few minutes to expand on it.<sup>8</sup> Collateral reduces credit risk between market participants and supports market-based sources of credit to the real economy. It is central to the functioning of OTC derivatives markets and the funding of the shadow banking system. Since market-based finance needs good collateral to grow sustainably, its availability directly influences the supply of finance to British households and businesses.

The use of collateral is not without risks. When collateral values rise, fixed haircuts allow banks and non-banks to borrow more, pushing up asset values further. The reverse is also true. This inherent pro-cyclicality exposes the system to sharp corrections in collateral values. In extremis, a sell-off in financial markets leads to higher haircuts, a run on repo and ultimately a market freeze.

To reduce these risks, the FSB has proposed minimum regulatory standards for collateral valuation and management as well as a schedule of numerical haircut floors to repo transactions. The FSB also now requires central clearing of "standardised" derivative transactions to limit exposures between counterparties, promote efficient netting of positions and moderate collateral cycles. New minimum capital and margining requirements for bilateral OTC derivative trades will similarly protect banks from defaults of their counterparties while reducing procyclicality in the system.

The combination of such reforms and the experience of the crisis will mean that institutions both need more collateral and need to manage it better.<sup>9</sup> Fortunately financial markets know

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<sup>7</sup> The ratio of US primary dealer fixed income holdings to bonds outstanding has fallen by between 70% and 85% since 2007. This measure includes US investment-grade and high-yield corporate bonds, non-agency MBS and commercial paper, and excludes government securities and Agency MBS.

<sup>8</sup> For a more detailed review of the issues considered here see "*The future of repo: 'too much' or 'too little'?*", a speech by Andrew Hauser, available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech665.pdf>.

<sup>9</sup> Estimates reported by the Basel Committee on the Global Financial System (CGFS) suggest that the combined impact of liquidity regulation and OTC derivatives reforms could generate additional collateral demand to the tune of \$4 trillion. Depending on the data used, that amounts to at least a third of the high quality collateral in active circulation today. But it is

how to innovate. Investor expectations for liquidity are changing and models for risk intermediation should evolve in ways that reduce balance sheet usage.

#### 4. Central banking in global markets

Central banks need to keep up. In particular, we can catalyse more efficient and effective private collateral management by backstopping private markets.

140 years ago in *Lombard Street*, Walter Bagehot expounded the duty of the Bank of England to lend freely to stem a panic and to make loans on “everything which in common times is good “banking security”.” Bagehot was particularly scathing on the Bank’s failure at that time to state a “clear and sound policy” on this general topic writing “...until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be.”<sup>10</sup>

140 years on, the Bank has a clear and sound policy. It is set out in a revised Sterling Monetary Framework (SMF), published today.<sup>11</sup> The new framework builds on the lessons learned throughout the financial crisis and draws on the recommendations made by Bill Winters in his review of our system.<sup>12</sup>

Five simple words describe our approach: we are open for business.

Our facilities are not ornamental. They are there to be used by banks to access money and high-quality collateral. We are offering money and collateral for **longer** terms. The range of assets we will accept in exchange will be **wider**, extending to raw loans and, in fact, any asset of which we are capable of assessing the risks. And using our facilities will be **cheaper**. In some cases the fees are being more than halved.

Banks can be confident that, when they want to use our facilities, they will be allowed to access them. Because we are both the supervisor and the central bank, the strong presumption is now that, if a bank meets the supervisory threshold conditions to operate and has signed up to our framework, it will be able to use our facilities.

Our Discount Window will be open every day for those firms requiring a bespoke facility with lagged disclosure. Its price will be lower. We will hold monthly repo auctions to provide predictable and regular access to high-quality collateral in exchange for a very broad range of collateral. And in times of actual or prospective stressed conditions we stand ready to provide cheap, plentiful money through more frequent auctions.

None of this means financial institutions are excused from the need to manage their balance sheets prudently. But as Bill Winters observed, more exacting liquidity requirements mean the conditions for using central bank facilities can be less stringent (and more effective). This is one example of the synergies that arise from the return of banking supervision to the central bank.

With our announcements today, we are building a liquidity framework for the markets of tomorrow. In the markets of today, initial usage of these facilities is likely to be limited. The MPC’s stock of asset purchases and the Funding for Lending Scheme currently provide all the liquidity and collateral that the sterling system needs. But as these operations are wound

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small relative to the global supply of assets capable of meeting this demand. As the CGFS has recently shown, the stock of non-cash collateral eligible for derivatives transactions is some \$50 trillion, and the supply of AAA- and AA- rated government bonds alone has risen by nearly \$11 trillion since 2007. See the CGFS report, “*Asset encumbrance, financial reform and the demand for collateral assets*” available at <http://www.bis.org/publ/cgfs49.pdf>.

<sup>10</sup> Bagehot, W. (1873) “*Lombard Street*”, particularly pages 205–207.

<sup>11</sup> See “*Liquidity insurance at the Bank of England: developments in the Sterling Monetary Framework*”, available at [www.bankofengland.co.uk/markets/Documents/money/publications/liquidityinsurance.pdf](http://www.bankofengland.co.uk/markets/Documents/money/publications/liquidityinsurance.pdf).

<sup>12</sup> The Winters Review is available on the Bank’s website at <http://www.bankofengland.co.uk/publications/Documents/news/2012/cr2winters.pdf>.

down over time, we expect to see banks making increasing use of our new permanent facilities.

While today's announcement is significant, it does not mark the end of history for the Bank of England's market operations. We will continue to evolve our approach as the financial sector changes. In particular, we need to respond to two big questions.

First, should the Bank of England allow non-banks to have access to our regular facilities? After all, our responsibilities for financial stability run much wider than the banking sector. Institutions that play a central role in markets, like broker-dealers, are obvious first candidates. We will also consider the case for opening them to other participants including financial market infrastructures. If the scope of access to central bank facilities increases, the scope of regulation can be expected to expand in a proportionate manner.<sup>13</sup> Backstopping the collateral management of a range of institutions should reduce the need for the Bank to act as a Market Maker of Last Resort.<sup>14</sup>

Second, given that we host an international banking system and global markets, to what extent should the Bank of England provide liquidity in currencies other than sterling? As markets evolve, banks and markets here may need backstops in other currencies in our time zone before business opens for the Federal Reserve and after it has closed for the Bank of Japan.

Although the Bank of England can supply limitless quantities of sterling, we rely on other central banks for access to their currencies. In response to the crisis, a network of swap agreements between advanced economy central banks was established giving us the ability to provide a range of currencies to UK-based institutions.

This network of swap lines should not necessarily be limited to the G7 economies. In June, the Bank of England signed such an agreement with the People's Bank of China, reflecting the growing international role of the Renminbi. That dovetails with the possibility of establishing a Renminbi clearing bank in London and our decision to include branches of Chinese banks in our broader policy of openness to hosting foreign wholesale banking activities.

Helping the internationalisation of the Renminbi is a global good, consistent with London's historic role. But rest assured that the Bank will act in a manner consistent with our domestic responsibilities. As my colleague Andrew Bailey said last week, our risk appetite for foreign branches will largely be determined by whether their activities in the UK are covered by credible recovery and resolution plans.<sup>15</sup> As always, renewing globalisation and building resilience go hand in hand.

## 5. Conclusion

After perhaps the worst financial crisis in the FT's long lifetime, it is reasonable to expect financial services will again grow in importance.

The process of financial deepening in emerging markets is only beginning. In Europe, there is a strong case for greater reliance on robust financial markets relative to weakened banks.

The UK stands to benefit because of London's place at the heart of the global financial system. Properly structured, this creates investment opportunities for British savers, reinforces trading ties for UK firms and improves access to credit for the real economy

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<sup>13</sup> See the FSB's "Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities", [http://www.financialstabilityboard.org/publications/r\\_130829c.htm](http://www.financialstabilityboard.org/publications/r_130829c.htm).

<sup>14</sup> Nevertheless, there can sometimes be a case for such action, and the Bank will be considering what it should stand ready to do and in what circumstances. Clearly the Bank should not support any market that would otherwise be unviable. But we have, for example, intervened in the corporate bond market, buying and selling bonds to maintain the market during the crisis until it again became self-sustaining.

<sup>15</sup> See <http://www.bankofengland.co.uk/publications/Pages/speeches/2013/687.aspx>.

across this country. London's international markets in turn provide a valuable service to the global economy. These benefits, on both sides, will be greatest as part of an open, integrated global financial system.

The Bank of England's task is to ensure that the UK can host a large and expanding financial sector in a way that promotes financial stability. Only then can it be both a global good and a national asset.

To those ends, we are working to complete the jobs of making banks more resilient and tackling too big to fail. We are making markets more robust in order to turn the shadow banking system from a source of risk to a pillar of resilience. And we are changing how we backstop private firms' liquidity management. These efforts will help set the stage to improve further the supply of credit within the UK.

Let me put my point more succinctly, in the style of the FT 125 years ago. The Bank of England today is the friend of resilient banks, continuous markets, and good collateral; and we are the enemy of taxpayer bailouts, fragile markets and financial instability.

Our circle of friends – like the FT's readership in its infancy – is expanding. As it does, the UK is helping to renew globalisation to the benefit of all.