

Jon Cunliffe: Is the world financial system safer now?

Speech by Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England, at the Chatham House City Series conference on Global Financial Markets: new rules on market structure, trading and funding, London, 17 March 2014.

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I. Introduction

On 17 November 2008, for the first time ever, the leaders of the G20 came together to try to find a way through the worst economic and financial crisis since the 1930s.

As I sat there, in Washington, in the National Building Museum, Benjamin Franklin's famous warning came to mind:

"If we do not hang together, most assuredly we will hang separately".

That Washington summit, and the ones in London and Pittsburgh that followed in quick succession, were extraordinary in many ways. Most striking, there was no rancour, no finger pointing between the leaders of the G20. Rather, the dominant mood was that we were indeed "all in it together", or in Franklin's words, would hang separately if we did not hang together.

And, in contrast to the familiar run of Summits and Councils and international meetings, from the outset, there was a powerful bias to action: "what can we do to counter this crisis?"

And, also from the outset, "how do we make sure it cannot happen again?"

History has already started arguing about whose idea that first G20 summit was. In truth, there had been growing pressure throughout that autumn for a leaders' meeting as the sheer scale of the financial crisis became clear and catastrophe followed catastrophe – Fanny and Freddie, Lehman, RBS – throughout the autumn of 2008.

When George Bush announced the summit in October 2008, the focus was on the financial sector. Had the huge injections of public capital into insolvent firms and the public guarantees of liquidity for illiquid ones, stabilised the crisis especially in New York and London?

But by the time the leaders met in mid-November, it was clear that not only was the financial sector on its knees but also that the world economy was in imminent danger of falling off the cliff.

Leaders were facing not just a financial crisis but the possibility of a global economic depression of 1930s proportions.

And it was, I think, that very frightening illustration of our economic interdependence that gave the Washington Summit and the summits that followed it the political energy not only to lay out a programme of reform of international financial regulation but also to commit to a time-bound action plan to meet it.

I should note here, that – to paraphrase Harold Wilson – in politics one commits to an action or a date but never both. The G20 Summits of 2008 and 2009 committed to both actions and dates.

So, five or so years on from the Washington summit, with the advanced economies just beginning to show signs of healing from the crisis, how well have we done?

Have we created a safer international financial system? Were we able to sustain that commitment to act together? Or have we lost sight of Benjamin Franklin's warning?

II. The reform programme

The G20 launched perhaps the most ambitious international regulatory reform programme in modern times. It also established a new body – the Financial Stability Board – to bring together the G20 members and the cats’ cradle of international standard setting bodies and to mobilise them behind the common reform programme endorsed by the G20 leaders.

That programme was grouped around **four** main themes:

First, prudential standards. Ensuring the system has the right reserves of capital and liquidity for the risks being carried. And to ensure that the leverage in the system does not run out of control.

History teaches us that banking crises are in the end always crises of liquidity and of leverage.

Second, addressing the risks that lie in the interconnections in the system. Most important here is perhaps the role in the crisis played by derivative instruments like credit default swaps traded “over the counter” between institutions.

These were intended to protect against risk but when asset values dropped they transmitted the shock from the weakest institutions to the system as a whole.

Third, getting a handle on – and where necessary – regulating, the risks in the so called “shadow banking” system: the ecosystem of non-bank financial firms that perform a similar role in credit intermediation to that played by the banking sector.

And fourth, and perhaps most important, making sure that no institution, no matter how large, how complex, how international in its activities or to put it simply, no matter how systemic, is “too big to be allowed to fail”.

Because if financial institutions can make themselves too big to fail, if they can ensure that if and when they get into trouble the taxpayer will have no option but to bail them out if, as the economists put it, they can ensure that their profits and their pay are private but if it all goes wrong the losses are “socialised” then history teaches us that this is exactly what they will do.

III. What has been achieved?

So, in these four key areas, what has been achieved?

The **inputs** have certainly been impressive.

From a standing start in 2009 the Financial Stability Board has driven the regulatory reform programme. Under the FSB, around 25 groups have been set up to run around 15 major workstreams.

Adding in the related work of the international standard setters – the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the International Association of Insurance Supervisors, we are talking about literally hundreds of meetings over the past five years, attended by hundreds of experts across a wide range of fields.

But only bureaucrats – and possibly international airlines and hotels – are interested in inputs like the number of international meetings...

What about the **outputs**?

The outputs have been impressive.

Most so, is the international agreement on a new capital and liquidity framework for banks. The so called Basel III capital standard for banks was finalised in 2011. Banks have already begun the transition to the higher standards that will be fully in force by 2019.

And the FSB has begun to take steps towards establishing a global capital standard for systemically important insurers.

Alongside capital, the first ever international liquidity standard for banks was agreed at the beginning of this year. It is part of a new liquidity framework that will be finalised by the end of the year.

We now also have an agreed definition for an international standard covering bank leverage – the so-called “leverage ratio” – the final standard is due to be set in 2017 after trial running.

To critics, the speed of progress on liquidity and capital – key areas of weakness in the crisis – may seem painstakingly slow. But I would make three points in response:

First, I would contrast the time taken to agree Basel III and much of the rest of the framework – around 3 years between the start and finish of negotiations – with the best part of 10 years it took to agree its badly flawed predecessor, Basel II.

Second, in the light of the transition to the new standards banks in many jurisdictions have already strengthened their capital positions – often it has to be said with some prodding from the supervisors.

In the UK, banks are holding £150bn more capital than prior to the crisis. Globally, there is around \$500bn more capital in the world’s largest banks. Holdings of liquid assets for the major UK banks have trebled and leverage has almost halved.

Third, the lengthy transition is designed to ensure that the new standard does not have a procyclical effect, driving banks to deleverage further, to shrink their balance sheets to help meet the new, tougher standards.

I should make clear here that I do not buy the argument that if we require banks to hold more capital and liquidity then, inevitably, they will lend less. Indeed, the opposite can be true.

As we saw in Japan and see elsewhere, weak banks desperate to do what they can to improve their capital positions – but unwilling to bite the bullet and issue fresh equity – can become zombies of little use to the real economy.

To lend, to play their necessary role in enabling economic growth banks need to be healthy. So while it is right that we give banks time to transition to the end point of the new standards, that does not mean that we put off strengthening of capital and liquidity until the end of the process.

We have needed in the UK to take action intended to restore banks’ capital positions to health. So that now they can move up to higher Basel III standards.

On interconnectedness, we have agreed standards for the \$700 trillion of derivatives, including CDS, previously sold “over the counter”.

This includes the requirements for trading to clear through “central counterparties”. So the risks in these contracts are transparent. So the risks are managed by ensuring that the parties to the contract back up their obligations to each other with collateral as the value of the contract changes.

The US has implemented the new standards in law and is now implementing them in practice. In the EU, standards are expected to come into force in the next year or so. Between them, the US and EU account for 80% of this market.

To be clear:

Progress in this area has not been without setbacks. Although there has been now agreement on an international standard, implementation in the US and EU has differed in a number of key respects. At times these differences have threatened to balkanise what is now a global market.

I am pleased to say that both the US and the EU appear now to be inching toward recognition of each other's implementation of the standards. The threat of fragmentation of the market seems to be receding, even if success is not yet assured.

But it is an example of the differences that can arise in implementation even when there is international agreement on standards – a theme to which I will return.

On shadow banking, the FSB has identified activities outside the banking sector that can give rise to some of the same risks as banking. And this is beginning to generate proposals for regulatory reform.

The US and EU have, for example, developed proposals on regulation of money market funds. And there should be an important first agreement this year on how to manage systemic risks that can arise from securities financing transactions such as in the huge global repo market.

Finally, ending “too big to fail”. This may well be the litmus by which the public judges the success of the entire reform programme. Nothing has so incensed public opinion and damaged societal support for the financial sector than the apparent “heads I win, tails you lose” experience of private profits and pay when things went well and public losses when they did not.

We will not fully restore public confidence until we can show that we can resolve failing banks – no matter how large – without public support. Have we made major progress towards that?

Yes. First, the UK, the EU, the US and many other jurisdictions now have or will soon have the legal powers to break up and wind up failing banks with far less threat to the economy as a whole.

These powers include the ability to “bail in” a bank's creditors, making them not the taxpayer responsible for a failed bank's losses once a bank's equity has been exhausted.

I should say here that it is crucial that the European Parliament now gives its final approval to the proposed resolution directive. And that the directive and the new “bail in” rules form the bedrock of the new Single Resolution Mechanism for the Banking Union in the Euro Area.

Second, in the UK and US legislation – Vickers and Dodd Frank has been passed, structurally separating the activities that systemic banks are allowed to carry out. The aim is to ensure that riskier activities are not cross subsidised by, and do not jeopardise, the essential activities these banks carry out in the domestic economy.

The EU is also considering how to address this issue following the Liikanen report.

Third, and for the major international banks, with operations in many countries, we are moving towards international agreement on how these giants can be safely resolved.

This means standards to ensure banks fund themselves with debt that is in a form that can be safely bailed-in should the bank fail.

It means measures to reduce disruption to financial markets if a bank is wound up.

And crucially it means agreement between the authorities in the countries in which these global banks operate on how they should be resolved if they fail.

We have made a lot of progress on too big to fail. But we are not yet there. I do not think we can say with confidence now that we could resolve a failing global giant.

Getting agreement on international standards to end Too Big to Fail is perhaps the most important regulatory priority for the G20 Summit in Brisbane in November this year.

When you stand back and look at the progress of this unprecedented programme of international financial reform, on the capital and liquidity framework, on inter-connectedness, on shadow banking and on too big to fail, a huge amount has been achieved.

If we can get the progress that G20 leaders committed to this year by the Brisbane G20 summit in November we will have “completed the job” of agreeing most of the key international standards and rules. And, in many areas, we will have gone a substantial way to implementing them.

And I am very pleased to say that the Bank of England has played a key role – and in many areas a leadership role – in moving this programme forward.

And I hope we can continue to do this as, increasingly, we move into the implementation phase.

IV. Have we succeeded?

So have the inputs, the thousands of air-miles and hours spent in meeting rooms and the outputs, the new global standards and rules, secured the outcome – a safer global financial system?

This is the final question I will turn to. The inputs and the output have achieved more internationally than ever before. They are necessary conditions for success. But they are not in and of themselves sufficient.

To achieve success, to make the international financial sector truly safe, this programme of reform needs to meet two further conditions. The first, and, wild difficult, the easier of the two, is the condition of coherence. The second, and harder, is the condition of mutual trust.

I am often reminded by financial sector firms of the need for “coherence”.

“How do all these reforms fit together?”

“Given the interconnectedness of all things in the financial sector what about unintended consequences?”

And, most pointedly, “when will this regulatory tsunami end?”

I have sympathy for these concerns. Financial firms need to be able to plan. They do not have unlimited resources. They need to know as soon as possible the regulatory end point they are working towards.

And it is true that some of the regulatory reforms overlap. Some address the same issue from different angles. We cannot be sure how they will work together in practice.

But remember, neither was the crisis “coherent”. It threw up multiple and complex failures and problems that then sparked multiple regulatory responses. And, unfortunately, the financial sector continues to throw up fresh regulatory issues. In this respect, one of the major challenges we now face arises from the welter of conduct issues that have surfaced in recent years.

For banks we are now at or very close to the end of the design stage for all of the major reforms. The end points are increasingly clear. In many areas we are well into the implementation stage. For non-banks we are further behind. But the direction is clear.

And the international regulatory community needs to keep its eye on how the key moving parts work together. We must be alive to the risks of unintended consequences.

Indeed, given the breadth of the reforms and the complexity of the financial system, I would be surprised if everything worked exactly as we intended it to.

There may well be cases in which we need to adapt standards and rules in the light of experience.

There may be others in which there are indeed impacts that had not been foreseen but the reforms remain justified in terms of financial stability.

So we will need to be very alive to “coherence” as implementation progresses. Given the need to agree standards between a large number of countries with very different financial institutions, we are unlikely to achieve perfection.

But if we can achieve good, robust and consistently implemented and applied international standards, we will have made the system much much safer.

This need for “consistent application” brings me on to the much harder condition for success – the “condition of mutual trust”.

We have a globally integrated financial sector. But we have national – and I should note in Europe’s case, regional – regulation and supervision that answers to national parliaments and, when it goes wrong, drags in national taxpayers.

Internationally we can only agree standards. We cannot implement them in international law, in international regulations. That can only be done by national legislators in national law.

Nor, when we have implemented the rules, do we have international supervisors to apply them to international firms. We have only national supervisors, answerable to national parliaments.

Without mutual trust between national authorities, without a willingness to recognise each other’s implementation of internationally agreed standards, we put at risk the success we have achieved so far in developing the “governance” of the international financial sector.

The risk comes from two directions.

From one side, there will be pressure for a race to the bottom.

If there is inconsistent application and lack of trust regulators and supervisors in each jurisdiction will come under pressure from the firms they regulate to ease up.

Firms will argue that other jurisdictions are not implementing properly and that their competitors in those jurisdictions are getting a favourable ride.

The pressure will be to weaken implementation everywhere ending with a race to the bottom.

This is not theory. It is one of the most important lessons of the pre-crisis period.

And if it happens again we will again risk destabilising international financial crises.

From the other side, in the absence of mutual trust, there will be increasing pressure to break up the global capital market.

Regulators and supervisors who cannot trust the implementation of standards in other jurisdictions will defend stability in their own jurisdictions by raising barriers.

Ring-fencing of capital and liquidity, non-recognition of foreign firms, restrictions on activities and extra territorial rules are just some examples of what can happen.

Such action minimises the risk of international crises. But the cost is the rolling back of financial globalisation with less effective and efficient intermediation of global savings.

So without mutual trust, the danger is either slipping back into weak regulation and supervision and regulatory arbitrage risking further crises or fragmentation of the international financial sector – a rolling back of financial globalisation that will damage global growth.

Mutual trust will not be easily achieved. It will require more than hope and faith in our fellow man.

Perhaps one day it can be founded on international law and treaty. Until then, however, it has to be built on the institutions and machinery established by those initial G20 meetings in Washington, London and Pittsburgh in 2008 and 2009. And in particular, on the work by the Financial Stability Board and the IMF.

The Financial Stability Board has already established peer review mechanisms to assess implementation in its members. These, and a willingness to put the spotlight on those that do not comply, are a cornerstone of the mutual trust we require.

The FSB has also already begun to play a role in helping jurisdictions that have implemented standards in different ways come to a shared view on mutual recognition.

The key is agreeing to focus on the outcomes achieved in different jurisdictions rather than a line by line comparison of respective rulebooks. The FSB will need to be increasingly active in this area as the implementation of the international reform programme progresses.

The IMF has a key role to play through its Financial Stability Action Programmes for individual countries and its Spillover Reports on how, within the global financial system, actions and developments in one jurisdiction can affect others.

And for the thorniest issue of all – resolving global systemically important banks and ensuring they are international in death as well as life, mutual trust has to be built on common standards and rules to ensure banks have debt that can be safely bailed-in in the right amount and location.

To return to where I started:

If we don't hang together most assuredly, one way or another, we will hang separately.

Since that first G20 leaders' summit in November 2008 we have made much greater progress than ever before on agreeing and implementing international financial regulatory reforms.

We can break the back of that work at the G20 in Brisbane this November.

But unless we can maintain and foster mutual trust as we implement the reforms, we will not succeed in, on the one hand, maintaining an integrated global financial sector and, on the other, ensuring it is proof to frequent destabilising crises.

The Washington G20 at the end of 2008 was of course followed by the Spring 2009 London G20 Summit in which I was privileged to play a part. At that deepest part of the global recession great contrast was made between the success of the G20 in 2009 and the failed London Economic Conference in 1933 in the depths of the great depression.

It will be for the historians to judge, but I hope they will find that the world has done a great deal better this time around in managing a very deep and searing economic and financial crisis.

The international regulatory reform effort is a hugely important part of that. It has already made the system safer.

And I hope if I am invited back in five years' time, at the end of my term at the Bank of England, I will be able to demonstrate that we have fully secured the objectives set at that first meeting of G20 global leaders in Washington.