



BANK OF ENGLAND

Speech

What a Difference a Decade Makes

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Remarks at the Institute of International Finance's Washington Policy Summit, the Reagan Centre, Washington DC

20 April 2017

I am grateful to Alice Carr, Wayne Chapman, Carsten Jung and Iain de Weymarn for their assistance in preparing these remarks.

Introduction

It's a pleasure to be back at the IIF's Washington Policy Summit.

Last time I spoke here (in 2011) it was still early in the international financial reform process.¹ From the IIF's perspective at the time, there were three major concerns:

- The consistency of implementation across the G20;
- The possibility of significant regulatory arbitrage in shadow banking; and
- Whether the FSB/G20's ambitious agenda would impair the recovery.

Today, those debates have largely been settled.

First, the new international minimum standards are being, by and large, consistently and promptly implemented in G20 jurisdictions. This progress is regularly assessed and transparently reported by the FSB and the IMF.² And in general, when countries have deviated from international standards, it's because they have chosen to go further.

Second, activities which give rise to similar risks are being treated consistently regardless of where they originate. A series of measures have addressed the major regulatory arbitrage opportunities that encouraged shadow banking. Contingent exposures of banks have been brought on balance sheet and appropriately capitalised. More generally, shadow banking is being replaced with market-based finance that adds diversification, competition and resilience to the system.

As for the macroeconomic impacts, it has been apparent for some time that having well-capitalised, liquid banks is a pre-requisite—rather than an impediment—to growth. In those economies where reform has moved the quickest, the recoveries have been the most robust.³

Indeed, the broader benefits of reforms are now being realised as the global financial system moves from fragility to resilience. Credit is now growing in all major economies. The cost of financing has remained low. Sources of finance are increasingly diversified between banks and markets. And the system is demonstrating an ability to dampen shocks rather than amplify them.

The biggest question now is how to best take advantage of these years of hard work. In my remarks today, I will suggest three priorities.

¹ "Some current issues in financial reform", remarks by Mark Carney, Governor of the Bank of Canada, to the IIF, Washington DC, 25 September 2011. See: www.bis.org/review/r110927a.pdf.

² The FSB conducts thematic and country-specific peer reviews (see http://www.fsb.org/what-we-do/implementation-monitoring/peer_reviews/) and the IMF conducts Article IV consultations and the Financial Sector Assessment Programme (FSAP) (see <https://www.imf.org/external/about/econsurv.htm> and <https://www.imf.org/external/np/fsap/fssa.aspx>).

³ Countries like Canada and Australia, with well capitalised and generally well-managed banks that did not require any bail-outs, saw their economies substantially outperform their peers in the wake of the crisis. Of the countries at its epicentre, those that moved most decisively, like the US, have experienced the fastest recoveries. And now that Europe is making significant progress, growth there has begun to pick up and broaden.

First, reform implementation must not only be effective but also dynamic. That means adjusting measures if there are unnecessary duplications, inconsistencies or material unintended consequences. The objective isn't just resilience, but efficient resilience.

Second, we must resist steps that would fragment the global financial system.

Instead, we should take full advantage of the progress made by building a system of deference to each other's approaches when they achieve comparable outcomes.

What a Difference a Decade Makes

A decade ago, regulatory frameworks in advanced economies had become light touch and ineffective. Looming risks in the financial system were ignored. Markets were fragile and unfair, plagued by numerous instances of misconduct and insufficient market discipline on large firms. And few participants were exposed to the full consequences of their actions as governance and compensation arrangements focused on the short term.

In Washington in 2008 in the aftermath of the Lehman debacle, G20 Leaders committed to radical reform of the financial system, and they charged the FSB with fixing the fault lines that caused the financial crisis.

The comprehensive reform programme had four main components:

- Creating resilient banks
- Ending too big to fail
- Transforming shadow banking into market-based finance; and
- Making derivative markets safer.

A decade on, this programme has largely been achieved. The financial system is safer, simpler, and fairer.

The financial system is safer

A central achievement has been the transformation of banking.

A decade ago, banks were woefully undercapitalised (some were levered over 50 times), with complex business models that relied on the goodwill of markets and, ultimately, taxpayers.

Large global banks are now considerably stronger. They can stand on their own.

With capital requirements for the largest that are ten times higher, banks have raised more than \$1.5 trillion of capital. And they are disciplined by a new leverage ratio that guards against risks that seem low but prove not.

Banks are also more robust because they have changed their funding models, not least due to new global liquidity standards.

The financial system is simpler

The system is simpler in part because, a decade on, banks are less complex and more focused. They lend more to households and businesses, and less to each other.

Business strategies that relied on high leverage, risky trading activities and wholesale funding are disappearing, as intended. Trading assets have been cut in half, and interbank lending is down by two-thirds.

In parallel, the system is simpler because a series of measures are eliminating the fragile forms of shadow banking while reinforcing the best of resilient market-based finance.

A decade ago, off-balance-sheet vehicles masked enormous leverage. Monoline insurers supported unsustainable debts, and banks became overly reliant on fragile short-term funding from money markets.⁴ As the complex chains in shadow banking unravelled, a spiral of asset fire sales and liquidity strikes followed, threatening the stability of the entire system and withdrawing access to credit from millions of households and businesses.

In response, the FSB set out a comprehensive framework – the Shadow Banking Road Map – to strengthen oversight and regulation of shadow banking.

A decade on from the ABCP crisis, the toxic forms of shadow banking at the heart of the crisis – with their large funding mismatches, high leverage and opaque, off-balance-sheet arrangements – no longer represent a global stability risk.⁵

And other, more constructive, forms of shadow banking, including money market funds and repo markets, are now subject to policy measures that reduce their risks and reinforce their benefits.

In tandem, global assets under management have grown rapidly from around \$50 trillion a decade ago to \$77 trillion in 2015, equivalent to 40% of total financial system assets.⁶

This growth creates new sources of funding and investment, promotes international capital flows, reduces reliance on bank funding, and brings welcome diversity to the financial system.

⁴ Broker dealers were involved in market intermediation with short-term funding, opacity in securitisation gave rise to imperfect credit risk transfer, and money market funds were major purchasers of risky bank certificates of deposit and of asset backed commercial paper.

⁵ These risks have been addressed through reforms to money market funds in the US, broker dealer regulation and securitisation reforms.

⁶ See FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

At the same time, however, asset management's importance reinforces the need to minimise the risk of sudden stops in times of stress. The FSB estimates that in 2015, more than \$20 trillion of assets were held in funds susceptible to such risks.⁷

In January 2017, responding to the direction of G20 Leaders in Hangzhou, the FSB finalised its recommendations to address structural vulnerabilities and reduce liquidity mismatches associated with asset management. These recommendations are now being operationalised by IOSCO.⁸

The financial system is also simpler because more durable market infrastructure is untangling the previously complex – and dangerous – web of exposures in derivatives markets.

A decade ago, OTC derivative trades were largely unregulated, unreported and bilaterally cleared. Uncertainty about such exposures contributed to the panic.

In Pittsburgh in 2009, the G20 announced a series of reforms designed to make these markets safer and more transparent, including by requiring trade reporting and by encouraging central clearing of OTC trades.

CCPs reduce contagion risks in banking, and they make the massive derivatives markets more robust. The extent to which they reduce overall systemic risks, however, depends on their resilience and resolvability.

To those ends, CPMI-IOSCO and the FSB will deliver further, detailed guidance for CCP resilience, recovery and resolvability to the Hamburg Summit. By the 2018 G20 Summit in Argentina, the FSB will report whether any additional financial resources are required to resolve safely CCPs.

The financial system is fairer

The system is fairer because of reforms that are ending the era of “too big to fail” banks and addressing the root causes of a torrent of misconduct.

A decade ago, large complex banks operated in a “heads I win tails you lose” bubble. They privatised profits in the run-up to the crisis before socialising the losses when the music stopped.

The loss of confidence in private finance that crystallised in the autumn of 2008 could only be arrested by public support over the following year that totalled \$15 trillion in bail-outs, government guarantees of bank liabilities and special central bank liquidity schemes.⁹

To bring back the discipline of the market and end reliance on public funds, FSB members have agreed standards to ensure that major banks can fail safely in future.

⁷ Such collective investment vehicles with run risk now account for almost two-thirds of identified shadow banking up from about 40% prior to the crisis.

⁸ Work on liquidity mismatches in open-ended funds is scheduled to be completed by end-2017 and development of consistent leverage measures by the end-2018. The FSB has now completed its work under the Shadow Banking Roadmap. It has not identified new shadow banking risks that require additional regulatory action at global level. Of course, since new forms of shadow banking activities are certain to develop in the future, FSB members will continue to monitor for emerging risks, and share data and analysis in order to support any future regulatory response.

⁹ The data refer to the UK, the US and the Euro Area, as of June 2009 (see Bank of England Financial Stability Report, June 2009).

These include reforms to secure the tools and powers authorities need to deal decisively with failing banks. At the same time, major banks are required to make themselves easier to resolve, including by writing 'living wills'.

Most importantly, global standards now require that banks hold sufficient debt in life such that, in the event one fails, its successor can be recapitalised to support the continued operation of its most important activities.

The combination of these initiatives and the determination of authorities to complete the job explains why the too-big-to-fail public subsidy for private systemic banks has fallen by 90% in the UK.

Put simply, a decade on, market discipline is coming back.

The system is also fairer because we are addressing the root causes of misconduct.

In the wake of the crisis, a series of scandals ranging from mis-selling to manipulation undermined trust in banking, the financial system and to a degree markets themselves.

The economic consequences have been enormous. Global banks' misconduct costs have now reached over \$320 billion – capital that could otherwise have been used to support up to \$5 trillion of lending to households and businesses.

The FSB's misconduct action plan addresses these issues through:

- (i) improvements to financial institutions' governance and compensation structures to align better risk and reward;
- (ii) new global standards of conduct in fixed income, commodities and currency markets; and
- (iii) reforms to major financial benchmark arrangements to reduce the risks of their manipulation.

Authorities cannot and should not try to legislate for every circumstance, watch every transaction, or anticipate every market innovation. So while fines and sanctions have roles in deterring misconduct, they will not, on their own, bring about the cultural change we need.

In the view of UK authorities, we must move from an excessive reliance on punitive, *ex post* fines of firms to greater emphasis on more compelling *ex ante* incentives for individuals, and ultimately a more solid grounding in improved firm culture.

In the UK a significant proportion of variable compensation for senior employees now must be deferred for a period of seven years. This ensures that it can be clawed back over the time scale it generally takes for conduct issues to come to light.

To address the “rolling bad apples” problem, mechanisms are now in place in the UK to ensure that when individuals move on their history will be known to those who consider hiring them. The FSB is now considering whether to adopt such an approach more broadly.

UK authorities have used their convening powers to encourage market participants to establish standards of market practice that are well understood, widely followed and, crucially, that keep pace with market developments.

That’s why the global FICC Market Standards Board is establishing readily understood standards for their markets. And it’s why global FX Committees will launch in May the first consistent code of conduct for FX markets. The best in the markets are codifying the best of markets.

But codes are of little use if nobody reads, follows, or enforces them. This is where the UK’s Senior Managers Regime (SMR) for senior decision-makers of banks, building societies and major investment firms comes in.

The SMR addresses the common refrain of senior management that they weren’t aware that misconduct was taking place in their firms.

The SMR re-establishes the link between seniority and accountability. Senior Managers now must take reasonable steps (including training or proper oversight) to prevent or stop regulatory breaches in their areas of responsibility.

Adoption is spreading. Some international firms are voluntarily adopting elements of the SMR’s certification requirements to strengthen their global operations. And the FSB is now reviewing the merits of such “responsibility mapping”.

A decade on, individual responsibility is returning.

Three Priorities to Move Forward in the Decade Ahead

There are three priorities to maximise the benefit of the progress made over the past decade.

Dynamic Implementation

Full, timely and consistent implementation of G20 reforms remains essential to deliver a financial system that supports growth in the short, medium and long term. We must finish the job to build the level of resilience our citizens deserve.

But we should do so as efficiently as possible.

Implementation must not only be effective; it must also be dynamic. That is, authorities must learn by doing and make adjustments, as necessary, to optimise our efforts, without compromising on the level of resilience the reforms are intended to achieve.

The FSB is increasingly focused on assessing whether the reforms are achieving their intended outcomes. To embed a dynamic approach, the FSB is now developing a structured framework to evaluate reforms. The framework, which will be delivered to the G20 Summit in Hamburg, will support more comprehensive impact analysis and will help inform future decisions about any possible adjustments to the reforms.

Specifically, it will assess whether G20 reforms are achieving their intended outcomes, identify any regulatory gaps or emerging risks, and flag any potential material unintended consequences.¹⁰

As we assess the effectiveness of reforms at a global level, many national authorities are conducting similar exercises with respect to their domestic efforts. These are to be welcomed, provided the overall level of resilience is maintained.

Resisting Fragmentation

There are, however, other nascent risks that, if left unchecked, could threaten the progress made, and, ultimately undermine the G20's objective for strong, sustainable and balanced growth.

These risks include the impact of reform fatigue on implementation momentum, the outcome of Brexit negotiations, the need to complete Basel III, and the importance of finishing the job of ending too big to fail.

In many respects, the global financial system is at a fork in the road.

On one path, trust and cooperation diminishes, fragmentation hardens, capital flows are disrupted, and trade and innovation are curtailed. If authorities do not have sufficient confidence that their efforts to promote financial stability are being reciprocated elsewhere, then concerns about the risks of openness could intensify.

If that happens, domestic authorities could impose local requirements on domestic entities of foreign firms. In a world where many banks and FMI's are highly interconnected that would generate significant inefficiencies, frustrating the benefits that flow from open trade and investment.

Taking this low road would be sub-optimal for all, with fewer jobs, lower growth and higher domestic risks.

¹⁰ One example is a report by the Committee on the Global Financial System on the resilience of global repo markets that is being delivered to the G20 this week.

But there is another path: the high road. This builds on the foundations of a new responsible global financial system that are being put in place. The combination of robust international standards and greater trust as a consequence of transparent implementation and intensive supervisory cooperation can create a system of enhanced equivalence and mutual deference.

Such an approach would allow capital to move more freely, efficiently and sustainably between jurisdictions. With robust standards consistently applied, wholesale financial services could be brought more fully into trade agreements, keeping the global financial system open and resilient, and supporting greater trade, investment and innovation.

This high road leads to more jobs, higher sustainable growth, and better risk management across the G20.

Working Together to Take Full Advantage

The high road can be followed if my third priority – taking full advantage of the progress made – is pursued.

In this regard, it is important not just to recognise progress made but *how* it has been made.

The FSB has succeeded by emphasising collaboration, consensus and openness. Its strength lies in its members who bring authority, expertise and shared objectives.

The FSB is not a treaty-based organisation, so its standards do not have direct force in any member jurisdiction. Decisions are ultimately matters for national authorities who – acting out of enlightened self-interest and in recognition of the benefits of a resilient and open global financial system – guide and discipline the reform process.

As such, FSB reforms would amount to little if they did not represent the best collective judgement of our members on how to deliver efficient resilience.

But because they are the product of the authority, expertise and shared objectives of its members, the FSB reforms create the foundations for an open, global financial system.

We now have agreed common minimum standards that are being consistently and transparently implemented. The playing field for cross border activities is being levelled. Opportunities for regulatory arbitrage are being reduced.

In short, a platform is being created for deference to each other's approaches when they achieve similar outcomes.

To seize this opportunity and to build responsible financial globalisation, authorities also need to share relevant information and work together to manage cross border challenges to financial stability.

The FSB and Basel Committee have developed a number of information sharing guidelines to help foster trust and cooperation between international regulators. These include supervisory colleges and crisis management groups.

One of the most critical elements of supervisory cooperation is understanding how each other will behave when things go wrong. In this regard, operationalising new “gone concern” regimes is critical. Best practice is captured by the FSB’s Key Attributes and involves resolvability assessments and regular crisis management group meetings for systemic firms.¹¹

In the decade ahead, members of the G20 will be increasingly well-positioned to defer to each other’s comparable regulatory outcomes, supported by commitments to common minimum standards and open supervisory co-operation. These commitments could be reinforced by reliance on independent peer reviews and a new, independent dispute resolution mechanism.

Brexit will be a litmus test of the future of international cooperation. The UK and the rest of the EU have exactly the same rules and the most highly developed frameworks of supervisory cooperation. Their capital and banking markets are already highly integrated. They have the potential to create the template for trade in financial services.

Conclusion

A decade on from the start of the crisis, the G20 is building an efficient and resilient financial system which serves our domestic economies and supports sustainable cross-border investment and economic activity.

As the global recovery strengthens and broadens, now is the time to take full advantage of these hard won gains.

That means completing the journey from fragility to resilience by ensuring that:

- shadow banking is fully transformed into resilient market-based finance,
- durable market infrastructure is in place,
- we complete the job of ending too big to fail, and
- emerging vulnerabilities are addressed in a timely and consistent manner.

That means adjusting the reform measures dynamically to maximise efficient resilience and avoid unintended consequences.

¹¹ The UK was an early adopter. We host crisis management groups for the UK’s globally systemic banks, insurers, and systemic CCPs and attend all such meetings internationally for firms with significant operations in the UK. And we conduct exercises with other major jurisdictions to test preparedness.

That means recognising that because risks to financial stability are constantly evolving we must continue to work together to identify emerging vulnerabilities in a timely and consistent manner.¹²

And that means not merely resisting the forces of fragmentation but actively building an open global financial system that places increasing reliance on, and deference to, each other's national regimes when they achieve similar outcomes.

A decade on from the start of the crisis, now is the time to take the high road to the benefit of all.

¹² Just as the FSB is doing in its work to assess the financial stability implications – both opportunities and risks – of FinTech.