A great vantage point

According to Paul Tucker, treasurers are at the fulcrum between the real economy and the financial economy. He says: "Treasurers live in two worlds: the world of corporations producing goods and services and the world of wholesale financial markets. Therefore they have a tremendous vantage point on what is going on in both the real economy and the financial economy."

It is positive description of treasurers from a man who should know about great perspectives and fulcrums. It was what brought him to The Treasurers' Conference in May, where he described the Bank of England's new system for implementing monetary policy and risks in financial markets.

From his position within the Bank Tucker has a pretty good view of the state of the economy and global financial markets. He says that central banks generally live in three worlds: government, markets and academic economics. But while central bankers have to cope with a trinity of worlds, Tucker shows no confusion about the Bank's responsibilities: "Our mission is very clear: to preserve monetary stability – low inflation in the economy – and to contribute to preserving stability across the UK financial system."

Executive summary

- Global current account imbalances will ultimately resolve themselves, but how – and the effect on the credit market – remains uncertain.
- The modern fall in the price of risk is related to central banks' successfully stabilising inflation rates and innovations in credit risk management by the financial services industry, although there are hazards associated with the latter.

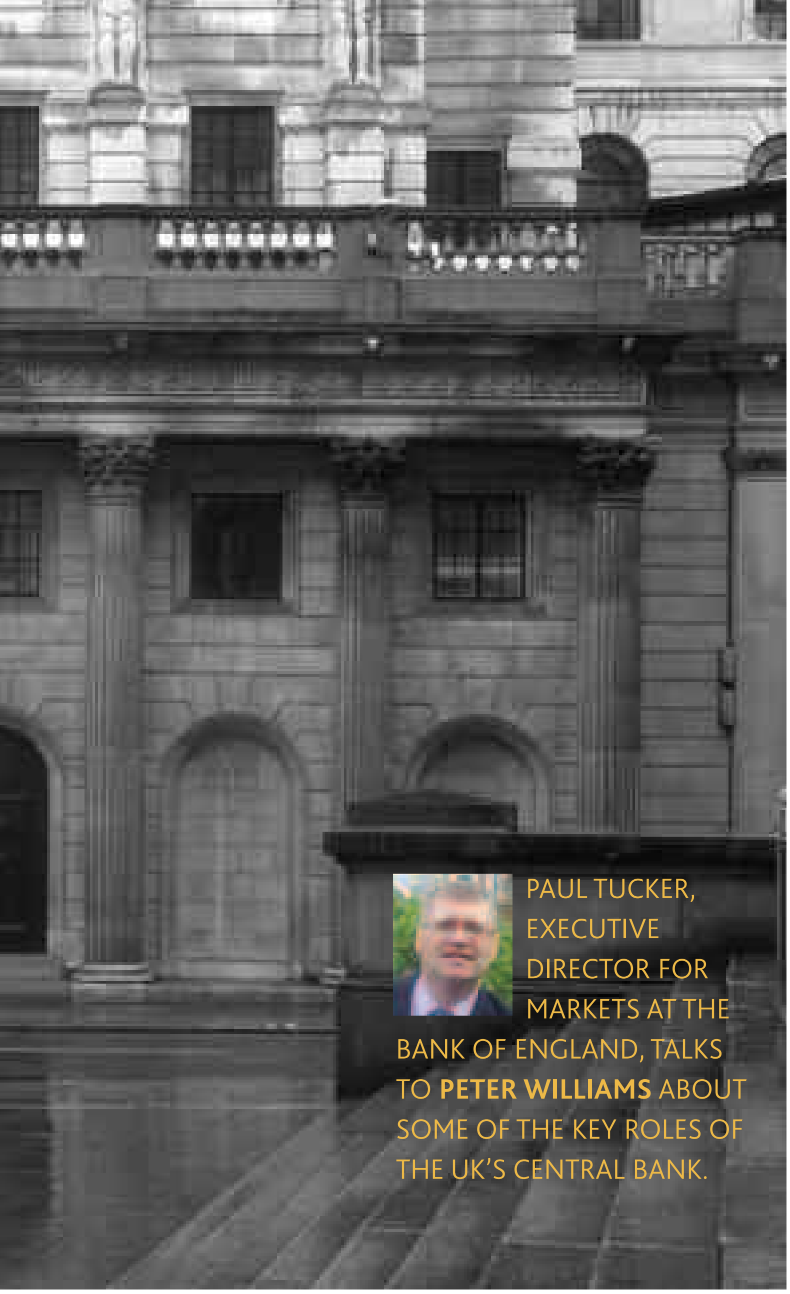
UNCERTAIN ENVIRONMENT Such a mission represents a formidable challenge. For some time the official sectors – not just central banks but others such as ministries of finance and the International Monetary Fund – have been highlighting the uncertainties in the global environment. These centre around the price of risk and global imbalances; some countries have large account surpluses and others large account deficits.

Tucker says that the global current account imbalances will eventually resolve themselves. "However, there is a great question of whether that will be a smooth or abrupt adjustment. Related to that is the question of whether or not credit markets will be entirely smooth over the next few years or will be jolted at some point. These are real uncertainties to which no one knows the answer."

While the official sector worries about an uncertain global environment, the degree of uncertainty apparent in financial market prices has been low in recent times. Tucker says: "We have gone through a period in which the price of risk – by which I mean, for example, the future volatilities of asset prices implied by option markets, and credit spreads on pretty well all kinds of instrument – has gradually come in over a number of years. Maybe risk is underpriced in markets. Maybe markets are projecting forward the stability that we have had now for a number of years. Or maybe the world has truly become a safer place. Market participants can't avoid forming a view on that, sooner or later."

If the financial world is a safer place, then it is down in part to central bankers like Tucker. He says: "I would say this but I would like to think that central banks, not just here but around the world, have become better at doing their job: better at maintaining low and stable inflation, perhaps better at avoiding boom and bust. That is one change for the better. Another is that innovation in the financial services industry has made it possible for the banks and others to manage their risk more effectively than in the past."

Part of this improved risk management is associated with the development of credit derivatives, which enable some credit risk to be dispersed beyond the banking sector to insurance companies,



PAUL TUCKER, EXECUTIVE DIRECTOR FOR MARKETS AT THE BANK OF ENGLAND, TALKS TO **PETER WILLIAMS** ABOUT SOME OF THE KEY ROLES OF THE UK'S CENTRAL BANK.

pension funds and other long-term investors. And while overall such innovation is good for the markets, and for stability over the medium term, it can create hazards. Tucker says such hazards aren't purely theoretical; there have been some strains over the last year or so. As an example, he points to the big backlog in confirmations and settlements that crept up in the credit derivatives world. The backlog didn't reflect well on the large firms that lead the market, but the problem was spotted and now appears to be broadly under control, thanks to co-ordination by the New York Fed and the FSA.

THE PRICE OF RISK Another indication of how the financial world is perceived as a safer place is the fall in the price of risk as seen in the narrowing spread between corporate bond yields and government bond yields. This has happened for both investment-grade and sub-investment grade borrowers in both the developed world and in emerging markets.

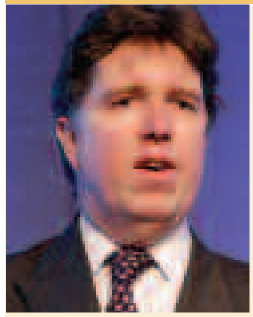
Tucker says: "Is that because the world has become a less risky place or because not many corporates have defaulted for a while and people have forgotten that credit risk is a real risk? Unfortunately, we probably won't know for sure the effects of the new structured credit markets until we reach a phase of the global economic cycle when defaults rise in the corporate sector."

OPEN QUESTIONS For the Bank of England it is essential to monitor developments in the system and follow the trends. One overwhelming trend in the past couple of years has been the rise of private equity. Against a backdrop of low credit spreads and increased competition in the lending and credit risk business, there has been a large pool of debt finance available to the leveraged buy-out market during a period in which private equity firms have posted pretty strong returns.

Tucker says: "There has been a lot of money chasing takeovers via the leveraged buy-out world and we have seen multiples of debt to underlying cashflow – essentially EBITDA – rising year after year for several years. Essentially, this is taking a bet on the overall environment remaining benign. It might, and obviously we hope it will, but there a lot of uncertainties in the global environment at the moment."

The interest for the Bank is from both a monetary policy and a financial stability perspective. Tucker says: "It has become essential to follow what is going on in private equity land in order to understand what is going on in some parts of the credit markets. In some respects there aren't two parts of global finance further apart

BOX 1. Paul Tucker's role at the Bank of England



Tucker: MPC member.

Appointed to his current position of Executive Director, Markets, in 2002, Paul Tucker is a member of the Bank of England's Monetary Policy Committee and has executive responsibility for:

(i) The Bank's implementation of monetary policy; the Bank's foreign exchange market operations, including management of the government's foreign currency reserves; related risk management; contributing to any crisis management operations; and

(ii) Providing market intelligence and analysis supporting the Bank's monetary and financial stability core purposes.

Tucker is a member of the Governor's Executive Team and the Bank's Financial Stability Board, and chairs the Bank's Asset and Liability Committee. He also chairs London's Money Markets Liaison Group and the Cross-Market Business Continuity Group, which operates under the umbrella of the HMT-FSA-Bank of England Tripartite Committee on Financial Stability. And he is a member of the Financial Markets Law Committee.

"THERE HAS BEEN A LOT OF MONEY CHASING TAKEOVERS VIA THE LEVERAGED BUY-OUT WORLD AND WE HAVE SEEN MULTIPLES OF DEBT TO UNDERLYING CASHFLOW – ESSENTIALLY EBITDA – RISING YEAR AFTER YEAR FOR SEVERAL YEARS. ESSENTIALLY, THIS IS TAKING A BET ON THE OVERALL ENVIRONMENT REMAINING BENIGN."

BOX 2. The lessons of the past

Central bankers throughout the industrialised world have tried to learn from the mistakes of the past. They have tried to understand better how economies work, but the most important development has been a greater transparency in their thinking and their objectives. As a result, central banks now work in a much more disciplined environment than in the past.

In the UK the big steps forward were taken in the early 1990s, when the UK moved to targeting inflation, and in 1997 when the current government made the Bank of England operationally independent and so took politics out of month-to-month interest rate decisions.

Paul Tucker says: "I don't want to claim that we will never make mistakes but we will always be trying to do the right thing. We are not running for election and we are focused on the technical job of trying to keep the economy as a whole in broad balance and, paramount, inflation in line with our target of 2%. Having a very clear target set by the government and for which we are accountable is a hell of a discipline and a very positive one."

Most of the big mistakes of the 1970s and the 1980s can be attributed to the inclination of central banks and governments to let economies grow too rapidly. Everyone likes rapid growth: unemployment goes down, people feel prosperous and there is a feelgood factor. Although that is tremendously welcome, it ends in tears if an economy grow beyond its capacity to produce the goods and services that its citizens and others want to purchase.

Tucker says: "We are much better focused at keeping aggregate demand in the economy broadly in line with the supply capacity of the economy than we were in the past. Less wishful thinking goes on. We're not clairvoyant about what will happen in the economy but I do believe that we are less likely to make big mistakes than in the past."

BOX 3. New framework for implementing monetary policy

At The Treasurers' Conference in May, Paul Tucker announced details of the Bank's new framework for implementing monetary policy. From mid-May, for the first time in its history, the Bank started to pay interest on sterling reserve balances held by banks and building societies, which now target average balances with the Bank over the periods between the MPC's monthly interest rate decisions rather than having to square up every day.

Three months on and Tucker says the new system has so far worked well, with the rate of interest on overnight money much more stable than was previously the case.

Tucker says: "It is too early to declare victory. We'll give it a few months because people are still adapting. It is quite a different world for the banks to operate in than the one they were used to."

The new system gives the banks much more flexibility, and the number of counterparties that the Bank is dealing with has increased from the 12 biggest banks in the sterling market to nearly 60, encompassing medium-sized banks and building societies, giving the Bank more operational reach than before.

Tucker says: "There is an advantage in terms of stabilising interest rates because if the market is volatile people can do their business across our balance sheet rather than in the market. And that in itself helps to stabilise the market. The incentive to try to drive rates higher or lower in the market has been significantly reduced."

than central banking and the market for corporate control [M&A]. We're not interested in the market for corporate control in itself, but it has become a big influence on wholesale credit markets and we are interested in credit conditions because they have macro effects."

Perhaps of even more interest to central bankers than private equity are hedge funds. To understand what is going on in financial markets it is essential to track the hedge fund industry. The impact of hedge funds on financial stability and how much risk they bring to the financial markets are questions which have been widely discussed (including in the Bank's *Financial Stability Report*). Undoubtedly important, hedge funds have lost their exotic tag and become a fact of life. They range from big institutions to small and boutiques, covering every asset class conceivable.

Tucker says: "In many respects hedge funds may well have helped to reduce risk because they probably make financial markets more efficient and they are one home for risk that banks shed – credit risk or exotic types of interest rate risk or foreign exchange risk. Some of the risk that banks would have held onto in the past they will now sell on to hedge funds in some circumstances."

From the central banker's perspective there is one key risk question. Hedge funds are leveraged in that they borrow money either in its traditional form or are synthetically financed by the banking industry through total return swaps, via the so-called prime brokerage services that banks and securities dealers provide. Echoing points he made at The Treasurers' Conference in May, Tucker says: "The big challenge for banks and dealers is to control those financing risks and to be clear about the circumstances in which risk would flow back from the hedge funds to the banks. Are there really bad circumstances in which the banks would end up picking up the tab after all?"

The Bank of England believes those risks are, in general, understood by the banking industry. However, Tucker says: "It remains an open question for the moment whether the stress tests at the banks are as thoroughgoing in that particular area as perhaps they need to be. That is because we are talking about bad scenarios which are very improbable. The question is how much weight should banks' risk managers give to highly improbable but damaging events. And how can they take into account crowded trades among funds or among the banks themselves?"

COMPLEX WORLD Tucker stresses that the Bank of England doesn't sit in isolation in its splendid Threadneedle Street offices. It has wide-ranging operational relationships with the market – for instance, with more than 50 sterling-based banks that participate in its monetary operations. The Markets directorate is also responsible for managing the UK's foreign exchange reserves (as agent for the government) and other parts of the Bank's balance sheet, thus giving it an operational presence in a number of markets and giving it contacts in London, elsewhere in the UK, Wall Street and further afield.

Tucker says: "We then use those contacts to pursue a dialogue about what is going on in the core markets of concern to us for monetary policy, but also about the more exotic markets, and that serves our financial stability mission. In today's world it is essential that we should understand how global capital markets work and broadly who's who in capital markets.

"We have a special vantage point as the central bank in London. And I place a great deal of weight on our team coming across as knowing what they are doing and not being naive or innocent about global capital markets. I would like to think that we earn the respect of market participants, so that in consequence they have a worthwhile professional dialogue with us. And that is part and parcel

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of our collaboration on financial stability with the FSA in the UK, and with overseas central banks."

And while the Bank of England, unlike the Financial Services Authority, does not have a formal role in professional training for the City, Tucker is convinced of the need for continuing education and development for those working in the markets. He says: "No doubt people need technical training in things that they did not need in the past. It is no good being involved in finance and not having a basic knowledge of issues such as options, asset-backed securities, credit derivatives and the structured credit market. One doesn't have to be involved in these things directly to have a need to know about them. The City has become much more technically proficient in my lifetime and that is all to the good."

And that need for technical proficiency will continue. Paul Tucker is convinced that the pace of innovation, if not quite as frenetic as over the last 10 years, will remain high. Such innovations will provide intermediaries with a challenge in terms of ensuring controls, back-office systems and supporting infrastructure. But innovation also provides a terrific opportunity for the intermediaries and, most important, for the end-users of financial markets.

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