Navigating risk & regulation in support of the real economy

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Ladies and Gentlemen

It is a great pleasure to have the opportunity to make a few remarks in the early stages of one of the most interesting and definitely challenging years of recent times, with many of the issues that absorbed our attention last year still very much alive in 2012 and whetting our appetite as to what is to come.

I have always understood risk to be defined with reference to a range of possible outcomes and risk management as steps taken to reduce or eliminate the adverse and tail outcomes so far as possible. The unhedgeable risk is the most dangerous risk and often derives from being unable to quantify the full range of outcomes because of uncertainty. There is no question that the world has become a much more uncertain place to do business. On top of the aftermath of major events such as the geopolitical and natural disaster upheavals of the last year and the numerous elections and leadership transitions which we'll see this year, the financial world is undergoing a once in a lifetime transformation.

For corporate treasurers this new risk environment makes fundamental questions of how to hedge against business and economic risks, when and how to raise funds, and what cash to hold and where to hold it, significantly more complex.

Adding to the complexity is the reform of the monetary and financial system, its regulation and supervision – and for corporate treasurers, as customers of the regulated sector, your interests stand to be hugely affected by this debate and should be paramount in the minds of policymakers.

Our focus throughout the ongoing programme of regulatory change is to assess the impact on our customers; the people who use and rely on the financial system – and particularly those in the wealth creating parts of the economy. Any good outcome has to strike the right balance between preventing further crises and supporting the real economy. Without a clear eye on what role we want the financial system to perform in aggregate, unintended consequences will emerge, and end-users will be the ones who pay the price.

So I want to cover three themes today:

1. The shape of regulatory debate in the financial sector and why it matters to all of us
2. How these reforms impact on the real economy
3. How we can best avoid unintended consequences for the corporate sector

Background

- I don't apologise for spending most of my allotted time on the regulatory scene – it's where I spend my time and the consequences of the decisions made are perhaps the greatest influence on the shape of the financial industry and its ability to support the real economy.
- The economic challenges being faced today are immense, the solutions are neither obvious nor without risk.
- Without doubt decisions taken by this generation of economic, financial and political leaders will have consequences for many years to come.
- Perhaps we should sympathise with those who have the responsibility to make judgments today on how to move on from the worst financial and economic downturn since the 1930s – this time in a demographically ageing world – and one which is exhibiting lower than expected growth rates.
- On top of this, with interest rates in the developed world at record lows and with fiscal flexibility as commonly understood all but exhausted the armoury to address the challenges is limited.

The major anxieties are evident; the ability and timetable in which to confront them less so – the European sovereign debt crisis and its impact on the Euro; the constrained fiscal positions and recurring budget deficits in many developed countries; the ticking healthcare and pensions time-bombs as populations age; the balance between austerity and stimulus; the challenge of addressing growing inequalities within and between generations – all require decisive action – leadership – to re-establish confidence in the future.

That word – confidence – is important, as it is worth observing in passing that there is no model, no proven recipe to recover or improve confidence – which is essential to economic recovery – and without confidence in the future there is no investment, no one willing to borrow, and you will have your own views whether our leaders today – whether political, financial or business – inspire confidence about the future through their words and actions.

And inevitably many of the necessary actions to establish confidence about the future are unpopular. Austerity programmes have – understandably – limited popular support so it takes political courage and leadership to get them through.

And we have to recognise that political support is dependent inter alia on a belief that lessons have been learned from recent crisis and that the financial system is aligned with the real economy it serves.

Hence there is an implicit focus to concentrate the benefits of regulatory reform on domestic operations – in reality a form of protectionism – for example:

- higher capital ratios lead to home bias in branch based organisations –the risk to treasurers is that funding availability from foreign branches will likely be at risk if the domestic operations are troubled or capital requirements are raised;
- cross border flows get constrained by regulatory attention, e.g. US mutual funds' short term funding of EU banks was severely cut back once regulators started asking for regular reports of exposure – and this impacted capacity to fund EU importers and exporters – understanding how your banks fund themselves is something you will need to spend more time on in the future.
- structural reforms that prefer certain sectors over others – e.g. ring fencing – will this require you to have more counterparties, enter into fresh CSAs, re-assess counterparty strengths?

The political/regulatory interaction seems currently to have got into a world of 'line of least regret' – in large part because there is no way of gauging our proximity to the next crisis. Hindsight allows self deception on both sides – we convince ourselves we really knew what caused the problem so that we can justify actions to avoid repetition or justify no actions because lessons have been learned. We fuel that self deception by selectively pointing to events that fit easily to our view of the world. We justify our respective positions by exaggerating the downside –'ok we may have gone too far but far better to overestimate the risk than underestimate it' and on the other hand 'the actions proposed will seriously damage the real economy'

Two possible futures that neither side can contemplate:

- Why did you do nothing to prevent another crisis?
- Why did you turn the system upside down at huge cost to address an event that did not occur or was less damaging than predicted?

For example:

- Y2K
- Repeat of 9/11
- Climate change/global warming
- Nuclear proliferation
- The next financial crisis

All this having been said, we welcome the steps being taken by the official sector to improve the financial stability and resilience of the industry. They are necessary. But we must focus on what we want the wider financial system and the banks in particular to do – while recognising that the rehabilitation of the industry in terms of public trust and confidence can only be earned by demonstrating both that lessons have been learned and that social contribution trumps self interest.

So how well have we done?

Balancing the competing priorities of all the various constituencies to deliver a workable solution – without unintended consequences – has been one of the greatest challenges the industry and its regulators have faced and one where strains are now beginning to show as policy design moves towards practical implementation. Creating a robust, resilient and sustainable platform across which you – our clients – can manage your funding and your risks is essential to economic prosperity.

So what has been achieved?

- We have done a great deal to better calibrate risk, build loss absorption and liquidity and thereby improve the capacity of individual institutions to handle risk.

- We have made progress in defining how systemic risk might be better identified and how through macro-prudential tools that identification could cause the supervisory framework to recalibrate credit supply – but it is very early days in terms of putting this into practice.

- We have done a great deal to discourage that which we don't want to recur – but have done less to define what we want the system to look like once we are finished with reform.

- We are better able to calibrate the consequences of systemic collapse but no more able than before to predict when and for what reason the next crisis will occur.

- Partly as a consequence of being unable to predict the next crisis, we have identified the critical importance of effective cross border resolution – but have made little progress in getting the political buy-in to reforming and conforming national insolvency regimes to facilitate such resolution.

- We are in continuous debate around what is regarded as 'prudent precaution' on one side of the table versus 'unintended consequences' on the other, with both sides prone to exaggerate the risks to the downside – 'better to be safe than sorry'.

But if this sounds a bit grudging it is true to say that a lot was delivered in 2011 – building a framework for the industry in the future which will bring enormous benefits if successful - namely – greater financial stability, alignment of the financial system with economic growth objectives, more sustainable allocation of credit to the real economy, better alignment of investor and market participant rewards, market infrastructure improvements, enhanced competition, greater transparency, more effective supervision and greater linkages between micro and macro-prudential supervision – to name but some.

So as we move into 2012, the epicentre of the debate has changed – no longer a debate about whether something should be done – but now about managing transition, timescales for implementation and avoiding unintended consequences.

But just like in so many areas of life today there is a real need for leadership to call the point at which we have to stop adding to the reform agenda and observe whether the aggregate of all that has been done has been sufficient to change behaviour so that the system in aggregate is fit for a purpose that is universally understood and accepted.

I make this point because as one stands back and looks at the enormity of what has already been done and what is still being attempted – a number of issues stand out.

- Are there gaps in coverage? Shadow banking?
- Is the aggregate of all the measures both complete and in train duplicative or reinforcing?
- Is there coherence between banking, insurance, pension fund and asset management regulation?
- Does the understandable focus of national fiscal authorities towards limiting their contingent risk to domestic deposit bases risk

unwinding many of the elements of globalisation of economic activity?

- If a consequence is to unwind globalisation to some degree and establish a 'home market' bias - does this impact the availability and cost of financial services delivered to multinational groups? Does this change the competitive landscape between companies domiciled in Europe versus the US versus Asia? Does this matter?
- Does the public policy concern over SIFIs create a greater probability of stability because of higher capital requirements and supervision or does it further concentrate activity into these institutions because of their elevated status; we argued the latter and evidence so far suggests we are right.
- Is there too much focus on products, platforms, infrastructure, capital and liquidity because they can be defined and measured as opposed to focussing on behaviour which is much more difficult to pin down objectively.

Given that the hard wired rules are simply means to an end of getting the system to look and behave as we want it to, the current debate often hinges on hard to prove assertions around what would happen if we took a different policy course or exactly how we want people in the system to behave or indeed what the system should look like if it is to be optimally structured.

This understandably reflects how difficult it is for the official sector to really get to grips with management intentions, character and behaviour. To the hawks, banks are simply self serving whereas we bankers believe we are misunderstood.

But what is certain is that if we perpetuate a feeling of distrust and hostility we will exaggerate the downside risks to justify our respective positions and by preparing for the worst we may well ensure it occurs; and from your perspective we will increase costs unnecessarily.

And yet the challenge to deliver reform that meets all the expectations now built up will bring enormous benefits if successful.

But we have to be careful not to promise too much:

- One of the main contributors to the situation we now face was promising more than could be delivered – whether it was economic growth without productivity, credit growth beyond our ability to identify misallocation, a step on the housing ladder without any down-payment, higher returns without higher risk or growing social benefit, retirement and healthcare programs without commensurate and sustainable fiscal support.
- Secondly – there are clear inconsistencies in the multiple policy objectives now mandated:
    1. we want stability as well as growth, we promote economic growth as well as fiscal austerity;
    2. we want banks to lend more and also grow capital both in absolute and ratio terms;
    3. we want the banking system to raise more capital privately while restricting its activities and restraining dividends;
    4. we want to see more competition in financial services but we don't want to see the higher returns that would attract external private capital;
    5. We want to add more capital, insert more buffers, mandate changes in collateral requirements, change settlement architecture and organisational design but we haven't got an impact study that informs how such changes will change demand or pricing;
    6. we want to see fewer interdependencies without losing the benefits of scale;
    7. we continue to incent the banking system to lend ever more to governments and then seek to stress test what happens if the same governments don't/can't pay;
    8. we want the system to respect market signals but then we don't like what ratings agencies say;
    9. we want to use more market based pricing in OTC derivatives but we don't really understand if credit default swaps are fit for this purpose
    10. we want greater transparency but fret about how immediately markets respond to events not yet understood at a policy level; and finally;

- Thirdly, what is good and rational for the few may be disastrous for the many – deleveraging an over-extended institution or country works when there are those able to take up the slack but doesn't if everyone does it at once, risk-off is fine if it is to bring an outlier back to normality or to adjust risk preference in a single portfolio but is hugely pro-cyclical and destructive if everyone does it at the same time.

It is also worth reflecting on some of the things we learned last year and some of the unintended consequences we now recognise:

- We learned there is no such thing as a risk free asset
- We learned that models failed us in the last crisis but we still believe we can build better models
- We learned that economies where investors hold most of the domestic assets are more resilient
- We wanted greater competition in financial services – that led to multiple trading platforms and greater use of technology so that markets have become ever more correlated – which has led to greater buffers as natural diversification is lower
- We admired interconnectedness when it facilitated the risk sharing that reduced the probability of a systemic crisis; we loathed the interconnectedness that spread the crisis when it did occur beyond our ability to contain it
- We learned that market signals can equally reflect competitive advantage, or mispriced risk, or information asymmetry or maybe all three and given we won't know till afterwards we should exercise caution on relying on such signals
- We learned about co-dependencies – stable banking systems depend on strong sovereigns and strong sovereigns depend on strong banks – and in times of stress financial systems will force 'home bias' to protect domestic depositors and national fiscs
- We promoted growth in trade, we delighted in the disinflationary benefits from accessing lower cost goods but couldn't get to grips with the growing and persistent current account imbalances
- We wanted greater transparency – that, leveraged by technology, has facilitated the high speed trading that accounts for 75% plus of trading across markets today – accentuating trends ahead of possible policy responses
- We encouraged people to reduce their indebtedness but not stop spending
- We saw why it was necessary to warn people of the dire consequences of not taking hard decisions in order to build political support for these actions but that made it difficult at the same time to encourage businesses to invest for the future
- We can see that we have to plan for a less connected world in the future in financial terms – less cross border funding, less foreign currency funding

And as we plan for the future the list of outstanding issues remains significant. The most relevant to you include:

- the capacity of the G20 / FSB to deliver a level playing field for banks and the scope within that for national solutions; this will clearly have an impact on how and where activities are performed and their cost
- addressing cross border resolution protocols – how will this impact established creditor hierarchies and established rights of set-off?
- the governance and operation of central counterparties – who have to post collateral – are there competitive challenges if some are exempt?
- the prospective role of clearing systems and exchanges – again will we see fragmentation or concentration of exposures and settlement accounts
- the calibration of the proposed new liquidity framework – clearly will have an impact on credit pricing and the liquidity of securities held for cash management
- what liabilities within banks – i.e. your deposits - are potentially subject to bail-in will no doubt influence where you place your cash balances
- the harmonisation and peer review of the calculation of the risk weights that drive capital requirements – again level playing field issues
- a re-assessment of the risk free treatment of sovereign debt – will this reprice the risk curve?

- Oh and on top of this – for all of us - the accounting rules on impairment measurement, hedging, securities valuation as well as further international harmonisation are all under review.

And on top of this the FPC is beginning to articulate how it wishes to exercise its statutory powers to direct and recommend:

- Direction to encompass the countercyclical capital buffer, sectoral capital requirements and the leverage ratio;
- And possibly also a time varying liquidity tool, the terms of margin and collateral requirements, disclosure requirements and Loan-to-Value and Loan-to–Income constraints.

I see this as a significant new risk for you all to get to understand as a change in sectoral capital requirements or commentary around emerging risks could easily materially impact access to credit and its pricing – think about the recent impact of the US authorities seeking information on US money market funds' exposure to Eurozone borrowers.

So the landscape remains massively uncertain both as to when the period of reform will come to a close and what the landscape for the capitalisation, shape and returns of the banking industry might be.

The potential implications for corporate treasurers are many. For example:

- The ability to obtain foreign currency and interest rate pricing through the use of over-the-counter derivatives has become a cornerstone of modern financial management.
- Under the EU's draft proposals to implement Basel 3, OTC derivatives would attract high and potentially volatile capital charges, mainly through the so-called credit valuation adjustment charge. One of our principal areas of intervention is to seek to have this removed for corporate customers.
- Derivatives which are centrally cleared are likely to cost more after the necessary margin and collateral have been provided.
- Moreover, it is currently uncertain whether corporates in Europe will be treated on the same basis as against their competitors in Asia and America.
- Even if the regulations are the same, market pricing convention may well confer advantages to certain participants. For example, in industries which tend to require long-term investment of capital such as power generation, transportation and aircraft manufacture, many of the end products such as ships, oil service platforms, aircraft engines and power turbines are typically bought and sold in US dollars.
- US corporates therefore have – by definition - less need for derivatives to manage the currency and interest rates risks of operating in these industries – while corporates based in Europe will be among the heaviest users of such derivatives.
- Based on preliminary proposals, corporates could find that the costs of risk management increases by up to 300% as a result of the imposition of the CVA capital charge; hence our focus on removing this charge for corporates.
- As a matter of public policy we also are advising that such higher and more volatile costs of hedging could well impact on the ability or willingness of corporates in Europe to risk manage their businesses as they have done before – potentially creating an unlevel playing field in the global market.
- This touches on broader issues of global consistency and whether the regulatory agenda is favouring a transactional model over a relationship banking model.

The outcomes will be significant – and so the regulatory debate must sharpen its focus:

- on global consistency
- on the cumulative effect of regulations, and
- on the resultant ability of the sector to serve and support the real economy.

And operating in this context of increased uncertainty, corporates – and corporate treasurers in particular – need to consider:

- How the cost of managing risk in their business could change and become more volatile;
- Whether they understand fully how credit capacity and pricing could change as CDS pricing becomes more important in the regulatory framework going forward;
- Whether the finance function set up appropriately to address these evolving challenges;

A final thought – if we are to make the most of this reform period we really do need to focus more on what we want the financial system to do in aggregate and less on where there is a need for detailed reform. Candidly representations made by you – our customers – carry significantly more weight than input from our industry which is seen as self serving by too many.

Thank you for listening.