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The high road to a responsible, open financial system

Mark Carney looks at London's importance as a global financial centre, and how, against the background of the Brexit negotiations, the Bank will work to support global prosperity through an open global economy

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Introduction

The United Kingdom has been at the heart of the global economy for centuries. Throughout that period, the City has channelled the life blood of the world economy, finance.

London emerged as the world's leading financial centre at the end of the 18th century, overtaking Amsterdam, as Britain became the dominant economy[1]. Whereas other major financial centres lost their importance as economic power shifted elsewhere, London has retained its pre-eminence even as the UK's relative economic weight has declined[2].

This staying power reflects London's inherent strengths: its people, law, language and time zone. And it testifies to the City's enduring commitments to markets, openness and innovation.

Long experience teaches that an open global economy is not predestined. A responsible international financial system requires:

- a shared commitment to markets;
- common minimum standards;
- high degrees of cooperation amongst regulators; and
- resilient institutions and markets at the core.

Authorities who oversee the largest global financial hubs, like the Bank of England, bear special responsibilities. The Bank's primary one is, of course, to ensure that the UK financial system serves UK households and businesses. This

includes protecting the UK real economy from being sideswiped by global developments. As much as possible, we must do so in a manner that keeps cross-border markets open.

When these responsibilities come into conflict, we have to work with others to build resilience at home and abroad in the most efficient and cooperative way possible.

The pillars of responsible financial globalisation eroded prior to the global financial crisis. Regulation became light touch and ineffective. Looming risks in the financial system were ignored. Markets were fragile and unfair, plagued by numerous instances of misconduct and limited 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.

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How the Brexit negotiations conclude will be a litmus test for responsible financial globalisation

The resulting cost to our citizens has been tremendous. Over the past decade, UK average real earnings have fallen for the first time since the middle of the 19th century. Trust in the financial system has plummeted[3].

Over the past decade, the UK and its key G20 partners have been fixing these fault lines and creating a system that is safer, simpler and fairer.

The system is safer because banks are now much more resilient, with capital requirements for the largest global banks that are ten times higher than before the crisis and a new leverage ratio that guards against risks that may seem low but prove not.

The financial system is simpler. As banks have become less complex and more focused, they are lending more to households and businesses and less to each other. A series of measures are eliminating toxic and fragile forms of shadow banking while reinforcing the best of resilient market-based finance. And more durable market infrastructure is simplifying the previously complex – and dangerous – web of exposures in derivative markets.

The financial 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.

The benefits of these painstaking efforts are beginning to be realised. The global financial system is moving from fragility to resilience. The too-big-to-fail public subsidy enjoyed by private systemic banks has fallen by 90% in the UK. Credit is now growing in all major economies. Sources of finance are increasingly diversified between banks and markets, helping to keep the cost of finance low. And the system is demonstrating an ability to dampen shocks rather than amplify them.

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Despite this transformation, there are nascent risks that, if left unchecked, could reverse the progress made and ultimately undermine the G20's objective of strong, stable and balanced growth.

Indeed, the global financial system is at a fork in the road. On one path, we can build a more effective, resilient system on the new pillars of responsible financial globalisation. On the other, countries could turn inwards and reduce reliance on each other's financial systems. That would, in turn, fragment pools of funding and liquidity, reduce competition and impede cross-border investment. The net result would be less reliable and more expensive financing for households and businesses, and very likely lower growth and higher risks in all our economies.

The outcome of the Brexit negotiations could prove highly influential in determining which path the global financial system takes.

In that context, and fully consistent with the priorities of Her Majesty's government, the Bank of England will work to build a responsible financial globalisation that first protects and serves the UK real economy, and then secures the UK's traditional role of supporting global prosperity through an open global economy.

The UK financial system is a national asset and a global public good

Having a large financial sector brings substantial benefits to the UK[4].

Financial services accounts for 7% of output and is a source of over 1 million jobs, two thirds of which are outside London. It contributes around £70 billion, or 11%, of annual tax revenues[5].

Financial services are the UK's most important exports, running a trade surplus of around £60 billion or 3% of GDP. The rest of the economy runs a deficit almost twice as large.

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Being at the heart of the global financial system reinforces the ability of the rest of the UK economy, from manufacturing to the creative industries, to compete globally. And it broadens the investment opportunities for UK savers, giving them the potential to earn better risk-adjusted returns.

But the UK's financial system is more than a national asset. It is also a global public good[6].

The UK is the leading internationally active financial centre. It has the largest global share of cross-border bank lending and foreign exchange trading, the second largest asset management industry, and the fourth largest insurance industry in the world. More foreign banks operate in the UK than in any other EU country, and around half of the world's largest financial firms have their European headquarters in the UK.

London is Europe's investment banker, with UK-based firms involved in over half of debt and equity issuance by EU27 borrowers. Over three-quarters of foreign exchange and OTC interest rate derivatives trading in the EU takes place here. This concentration of activity increases efficiencies and lowers fees for European end users, while reducing the risks associated with complex finance to European real economies.

The City has long been a leader in financial innovation from the development of the eurobond market in the 1960s through to becoming the Western hub for renminbi and rupee businesses, and Europe's premier centres for Islamic and green finance. London also has the most vibrant FinTech centre with revenues of £6.5 billion and employment of over 61,000, both of which are growing rapidly[7].

Alongside these benefits for the UK, Europe, and the world, there are risks – risks that first and foremost are borne by the UK.

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The UK financial system is almost ten times GDP, and is arguably the most sophisticated and complex in the world. Large complex financial institutions and major wholesale financial markets are inherently risky. Left unattended, these risks can easily spill over and damage the domestic real economy.

Openness and interconnectedness mean shocks from abroad quickly reach our shores. This is particularly true for risks from the euro area given the tightness of our trade and financial linkages. Equally, these tight linkages mean that others rely on us to maintain high standards of resilience and to share relevant information openly and cooperatively.

In short, hosting the leading international financial sector brings immense responsibilities alongside great prosperity. The Bank of England's primary responsibility is to protect our domestic real economy, and to ensure that finance serves it rather than the other way around. And second, we must ensure our institutions and markets are sources of strength for the global system.

Fulfilling these dual responsibilities requires the highest standards of supervision and regulation, and a commitment to the most effective cooperation with other regulators.

Let me take those in turn.

The UK targets a level of resilience beyond global minimum standards

As the FPC has repeatedly made clear, the UK financial system will require a post-Brexit level of resilience at least as great as that currently planned, which itself generally exceeds that required by international baseline standards. This imperative reflects the scale, complexity and importance of the UK financial system.

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This does not mean we are pursuing the stability of the graveyard. Rather, we are building the necessary resilience for our system as efficiently as possible by simultaneously implementing major structural reforms. Such 'efficient resilience' allows the UK financial system to fulfil both its domestic imperatives and its international responsibilities.

Efficient resilience is why our capital standards are simultaneously well above Basel minimum requirements and substantially below the levels that would be necessary if those banks could not be safely resolved if they got into trouble[8].

Efficient resilience is why we are ring-fencing the domestic banking services on which UK households and companies depend. Requiring higher prudential requirements for a ring-fenced bank and structurally separating it from wholesale and investment banking activities helps ensure that retail lending can be sustained despite external shocks. At the same time, this approach preserves the free flow of capital provided by wholesale banking activities across borders.

Efficient resilience is why we are building robust markets supported by the necessary hard and soft infrastructure. This is how we reinforce the City's genius which is based on its fundamental belief in the power of markets.

We have comprehensively reformed how we provide liquidity. Our new approach can be described in four words: we're open for business. The Bank now provides liquidity against a wider range of collateral, to a wider range of counterparties, for longer terms, at lower fees than ever before[9]. Collateral totalling over £400 billion is prepositioned, ready for use if needed including in times of actual or prospective stress – as was the case around the Referendum last year. Moreover, we stand ready to provide liquidity in a wide range of foreign currencies if required.

Efficient resilience is why we are committed to world class supervision of UK-based globally systemic financial market infrastructure. The UK has been at the forefront of implementing recovery and resolution regimes for CCPs,

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well ahead of final international guidance. The Bank pioneered global colleges for CCPs. And we have introduced 'pre-funding' into our systemically important retail payments schemes, Bacs and FPS, to eliminate settlement risk. Such initiatives have prompted the IMF to conclude that *"the Bank is one of the leaders worldwide in shaping reforms in this area"*.

Finally, efficient resilience is why the Bank of England, working with the Financial Conduct Authority, has been at the forefront of efforts to increase individual accountability in financial services. While the UK's action plan to improve conduct includes stronger deterrents and reduced opportunities for bad behaviour, we recognise that ex post penalties are only part of the solution.

To put greater emphasis on individual accountability, the UK has introduced new compensation rules that go much further than other jurisdictions in aligning risk and reward. And we have put greater stress on the importance of better governance and firm culture. At the heart of these efforts are new codes of conduct developed by the market for the market, including those of the UK-based FICC Market Standards Board and the new global code for FX markets[10].

Since codes are of little use if no one reads, follows or enforces them, the UK has instituted a unique Senior Managers Regime to embed cultures of risk awareness, openness and ethical behaviour. Based on its early successes, international authorities are now considering following the UK's lead.

Effective supervisory cooperation and coordination is essential

Better regulation is not enough. To build responsible financial globalisation, international authorities must also share relevant information and work together to manage cross border challenges to financial stability. There are three critical elements to international regulatory cooperation.

First, we need common minimum standards and consistent implementation. While regulations need not be exactly the same, they should deliver similar outcomes. This is now possible given progress at the FSB, where a series of agreed reforms are levelling the playing field and reducing opportunities for regulatory arbitrage.

The UK is implementing its rules consistently, fairly and transparently. For example, the PRA's regulatory standards are the same for domestic and international banks. We allow third country branching, under certain conditions outlined in our 2014 *Supervisory Statement*[11]. The key factors which have determined the PRA's stance towards non-EEA branches are the equivalence of the supervisory regime of the home state, and arrangements for resolution.

Second, information sharing is fundamental. Even if two countries have exactly the same set of rules, if they cannot share information on the financial positions of different entities within a global financial group, they cannot clearly gauge and manage the risks that the firm may be running on a consolidated basis. We have seen a few examples of the value of such cooperation in recent years.

The FSB and Basel Committee have developed a number of guidelines on information sharing, which have helped foster trust, cooperation and enhanced dialogue between international regulators. These include supervisory and crisis management colleges and supervisory assessments. The EU has further enshrined these practices through legislative requirements in the CRR and BRRD for supervisors and resolution authorities respectively.

The Bank is a staunch supporter of these mechanisms. As the home country regulator for four G-SIBs and the host for all 30 G-SIBs we see them as essential elements of delivering global financial stability. We participate actively in supervisory colleges, sharing the supervisory expertise we have developed from managing the multitude of complex risks that are traded in London. And we expect the same from those whose firms operate and take on large risks here. Symmetry is fundamental to an effective global system.

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Third, the most critical element of supervisory cooperation is confidence in how each other will behave when things go wrong. In this regard, operationalising new 'gone concern' regimes are critical. These set out what happens when a firm fails.

In our view, best practice is captured by the FSB's Key Attributes and involves resolvability assessments and regular crisis management group meetings for systemic firms. The UK was an early adopter. We host Crisis Management Groups for the UK G-SIBs, G-SIIs 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.

The road ahead

We are at a fork in the road.

One path builds on the foundations of a new responsible global financial system that are being put in place. The combination of robust international standards and trust built through 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 bilateral 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. But there is another path – the low road – where trust and cooperation diminish, fragmentation hardens, capital flows are disrupted, and trade and innovation are curtailed. If authorities do not have sufficient confidence that their efforts to

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promote financial stability are being reciprocated elsewhere, then concerns about the risks of openness to domestic financial stability could intensify. If they do, domestic authorities will act to safeguard their primary responsibilities.

Without cooperation, host authorities may become more inclined to impose local requirements on domestic entities, to insulate domestic stability in cases where there is no support from the group or coordination amongst authorities in responding to distress. In a world where many banks and FMIs are highly interconnected both financially and operationally that would generate significant inefficiencies, frustrating the benefits that flow from open international trade and investment.

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

The path taken by Brexit

How the Brexit negotiations conclude will be a litmus test for responsible financial globalisation.

We start from a position where the high road is both readily attainable and highly desirable for all involved. The UK and the rest of the EU have exactly the same rules governing our systems. And we have the most highly developed frameworks for intensive supervisory cooperation. Capital flows seamlessly across our borders. The current EU legal regime allows firms to passport throughout the Union, supervised by the home supervisor.

The EU and UK are therefore ideally positioned to create an effective system of deference 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.

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Such an outcome would be entirely consistent with the UK Government's stated aim of a new, comprehensive, bold and ambitious free trade relationship with the EU that embraces goods, services and network industries.

And such an approach could be applied more broadly to the immense benefit of the global economy. The UK and EU have the potential to create the template for trade in financial services – one that leverages the tremendous progress that has been made in recent years building resilience and cooperation.

But financial services are only part of a much broader negotiation. Given our responsibilities to promote financial stability, the Bank – like its counterparts on the continent – must plan, purely as a precaution, for all eventualities. As the Vice Chair of the Supervisory Board of the Single Supervisory Mechanism recently stressed, for example, *"both banks and supervisors must prepare for any potential scenario"*[12].

Under one scenario, negotiations could result in a new statutory and regulatory regime with a large number of firms – currently either physically based in the UK or providing services within the single market via passporting arrangements – coming directly under PRA authorisation and supervision. In that case, we would need to form our own judgments, rather than relying exclusively on those of others.

As our continental colleagues have observed in the analogous case of UK firms operating in Europe, these judgements could affect whether the firm operates as a branch or a subsidiary, as well as the range of services it can supply.

Consistent with our current approach, and the PRA's stance towards non-EEA branches, any judgements would reflect:

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- the cooperative and information sharing arrangements in place;
- our confidence in the standards to which others are adhering; and
- any assurances we have on arrangements to address circumstances when things go wrong.

Ideally all of these issues would be addressed in a cooperative and symmetrical way, as part of the overall agreement the UK will strike with the EU-27.

Whatever is agreed, there are risks to financial stability both in the transition to the new relationship and in the new steady state. These risks include disruption of services, a further weakening of investment banking profitability and the potential for greater complexity in firms' legal structures. Increased complexity would place greater demands on firms' risk management and on supervisory oversight, and pose challenges for effective resolution. We expect firms to plan accordingly.

Sam Woods, the CEO of the PRA, is writing to all firms with cross-border activities between the UK and the rest of the EU asking them to inform us of their own planning in response to the UK's decision to leave the EU. These include, for example, subsidiaries of US investment banks based in London doing business throughout the EU under passporting arrangements, as well as UK banks doing likewise, and branches of institutions from other EU states operating here in London. The main purpose of this letter is to ensure that all firms are making, and stand ready to execute in good time should the need arise, contingency plans for the full range of possible scenarios. The FPC will oversee this process of contingency planning to mitigate risks to financial stability[13].

Asking firms to plan thoroughly is the hallmark of the prepared and professional approach we take to promote financial stability.

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Conclusion

The UK has been at the forefront of efforts to make the global financial system safer, simpler and fairer. Recognising our role as guardians of the leading international financial centre, we have gone further than these minimum global standards.

These efforts ensure that the world's largest international financial centre both protects and serves the UK economy. And they mean that others can rely on us as a pillar of strength for the international monetary and financial system.

As the FPC has made clear, we won't turn our backs on these hard won gains. There should be no bonfire of financial regulation. But we will be dynamic – learning by doing and making adjustments, as necessary, to optimise our efforts without compromising on the level of resilience the world's leading international financial centre demands.

We will ring fence our banks to protect the core retail financial services they provide to households and companies.

We won't allow under-capitalised, opaque financial institutions to operate freely within our borders. But, while we won't hesitate to do what's necessary to protect the UK real economy, we will also work tirelessly for a responsible and open financial system that benefits all.

A decade of hard fought financial reform creates enormous opportunities.

It is all too easy to give into protectionism, but the road less taken is often the most rewarding. All the conditions are in place for following the high road of mutual recognition and cooperation both with Europe and across the G20.

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The UK has the expertise, the temperament and the will to take this path, one that will make all the difference to all our citizens. ■

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Endnotes

1. For example, Britain accounted for nearly 20% of the world's manufacturing by the mid-19th century.

2. At the end of the 19th Century, the UK accounted for as much as a quarter of world trade and produced around a tenth of global GDP. Today, those shares have both fallen under 5%. For details on how the historical estimates are calculated, see 'The UK at the heart of a renewed globalisation', speech given by Mark Carney, 24 October 2013, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf

3. The British Social Attitudes Survey (2013) reported that only 20% of UK citizens now think banks are well-run, down from 90% in the late 1980s.

4. More broadly, for centuries, the UK has bet on openness, and it has paid off handsomely. A more open economy, if properly managed, can grow faster without generating inflationary pressures or risks to financial stability. Those benefits accrue through a variety of channels. Openness increases dynamism by spreading knowledge and new technologies across borders; by enabling firms to specialise and take advantage of economies of scale; and by better matching of savers and

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borrowers, lowering financing costs and boosting investment. Openness increases choice for consumers. And it enables more effective risk-sharing, both across borders and generations.

5. See 'Total tax contribution of UK financial services, Ninth edition', City of London Corporation Research Report in association with PwC, available at
https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research%202016/total-tax-report-2016.pdf

6. See 'The UK at the heart of a renewed globalisation', speech given by Mark Carney, 24 October 2013, available at
http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf

7. See 'The Promise of FinTech – Something New Under the Sun?', speech by Mark Carney, 25 January 2017, available at
http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech956.pdf

8. The FPC judges the appropriate Tier 1 capital requirement for the UK banking system, in aggregate, to be 13.5% of risk-weighted assets (RWAs), as currently measured. This compares with around 10.5% including capital conservation and SIFI surcharge buffers based on international standards. The Bank has also introduced a leverage ratio requirement in advance of international requirements that currently amounts to, in aggregate, 3.3%. If resolution arrangements were not in place, the FPC is likely to have judged that the appropriate baseline Tier 1 capital requirement for the UK banking system would be closer to 20% of RWAs than the current 13.5%.

9. Membership of the SMF has risen from 70 in 2008 to 190 today. Our Discount Window is open daily for those firms requiring a bespoke facility with lagged disclosure. We hold monthly repo auctions to provide predictable and regular access to reserves in exchange for a very broad range of collateral, including raw loans.

10. A global code for the foreign exchange market, put together with support from central banks, will be launched in May as the first globally consistent code of conduct for these markets.

11. 'Supervising international banks: the Prudential Regulation Authority's approach to branch supervision', SS10/14, available at
http://www.bankofengland.co.uk/pra/Documents/publications/ss/2014/ss1014.pdf

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12. 'Introductory statement to the press conference on the ECB Annual Report on supervisory activities 2016', remarks by Sabine Lautenschläger, Vice Chair of the Supervisory Board of the Single Supervisory Mechanism, 27 March 2017.
13. The statement is available at
http://www.bankofengland.co.uk/publications/Documents/news/2017/008.pdf

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