FINANCE WATCH CONFERENCE

BRUSSELS, 1 JUNE 2016

REFORM AS A PRECONDITION FOR COMPETITION AND INNOVATION

[Check Against Delivery]

PAUL TUCKER, CHAIR SYSTEMIC RISK COUNCIL, AND FELLOW HARVARD KENNEDY SCHOOL

Thank you to Finance Watch for inviting me to speak at this conference wearing my hat as Chair of the Systemic Risk Council, a position I took up late last year in succession to Sheila Bair, former chair of the US's Federal Deposit Insurance Corporation. Since we have been increasing our focus on EU regulatory policy, I will open with a few words about the SRC before going on to discuss how the regulatory reform programme, and in particular the resolution regime, is necessary for sustainable competition and innovation to thrive in financial services. I want, therefore, to draw out connections between the two themes of your conference.

The Systemic Risk Council: a voice for stability

The SRC was established by the CFA Institute in 2011, with its founding members an extraordinary assembly of former US policy makers including Sheila, former Federal Reserve Chairman Paul Volcker, former SEC Chair Bill Donaldson, former CFTC Chair Brooksley Born, along with former US Treasury Secretary Paul O'Neill, former Senator Bill Bradley and a group of distinguished academics and a small minority of former industry leaders. As you will grasp immediately from those names, this is a group of people utterly --- indeed, famously --- dedicated to stability, as an absolutely essential precondition for an efficient market economy and, more broadly, a healthy society. Of course, as with low and stable inflation, maintaining financial stability is not sufficient for prosperity and the other good things of life, but it is absolutely necessary, as the Western world has been painfully and tragically reminded over the past decade.

The group that set up the SRC had dedicated much of their professional lives to that cause, and so knew as well as anyone can that broad support for effective and robust policies and regimes can wither away as memories of crisis fade. The benefits of a stable system are highly dispersed but the private costs of reregulation are concentrated, so it is only natural that the industry is a potent lobby against initiatives that bring benefits to hundreds of millions of people.

In this respect, the public debates around stability are quite different from those around policies on our physical environment. Environmental campaigners engage not just at a general level but in microscopic detail on pollution issues. They have become a social force; even a form of identity politics. This does not mean that they are always right, and perhaps they are often wrong. But it means that policy initiatives are analysed and debated from pretty much all points of view. If an environmental agency proposes a policy that is unwarrantedly tough, that will be called out by industry. If an agency puts out a policy that claims to be tougher than it is, the softness buried in the detail will be called out by the other side. Nothing is going to remain uncontested, which has it costs, but just as important nothing is going to get slipped through.

In the financial arena, there are fewer voices for a resilient system. The SRC is one such voice. We hope that Finance Watch is another. That is why we are glad to be here in Brussels today.

The SRC's goal was always to engage with the EU as well as with US and global policies. To that end, a couple of years ago a terrific group of former European policy makers joined the Council, including Nout Wellink, former chair of the Basel Supervisors Committee; Adair Turner, former chair of the G20 Financial Stability Board's standing committee on supervision and regulation; John McFall, former chair of the Westminster Parliament's Treasury Select Committee, which framed the post-Northern Rock reforms in the UK; and Sharon Bowles, former chair of the

ECON Committee of the European Parliament. So far we have one Europe-based academic: Jan Pieter Krahnen. And recently, to my enormous pleasure, Jean-Claude Trichet came on board as a Senior Advisor, alongside Paul Volcker. So I hope you will see that we are now truly transatlantic, as we must be since, in a world of international capital flows and risk transfer, no jurisdiction, however big, can make its financial system resilient through its own efforts alone.

The SRC is funded by the CFA Institute, as its members benefit from stability. It respects the complete independence of the SRC. We are, in short, a consistent independent voice for stability. That means supporting the authorities against industry lobbying where needed, but also, conversely, giving the authorities backbone when, as is inevitable, their resolve falters.

An example of the former would be our Comment Letter at the beginning of this year supporting the SEC in its proposed rules on liquidity management and risks in open-ended funds, which we also saw as a very welcome sign of securities regulators taking up their part of the burden of providing a framework for a financial system that serves people, whether as investors, savers or borrowers, through thick and thin[1].

But my subject today touches on the need, sometimes, to help to reaffirm the direction of policy, as Europe enters the phase of finalizing its regime for resolving important complex financial intermediaries in an orderly way.

A third of the way back to normal

As this conference meets, it is almost eight years since the crisis began, with the suspension, during the summer of 2007, of credit-fund redemptions in Europe and the failure of a couple of Wall St hedge funds. Even while those and other effects of the deflating US sub-prime mortgage-market bubble accumulated, few

---

[1] Letter to the SEC commenting on a proposed rule on Open-End Fund Liquidity Risk Management Programs (13 Jan. 2016), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2016/01/SRC-Letter-to-SEC-re-Open-End-Fund-Liquidity-Risk-Mgmt-01-13-16.pdf.

appreciated during that summer and autumn of systemic liquidity shortages that many of the underlying problems were rooted in the fragile solvency of the banking system or that the collapse of the system would expose fault lines in the construction of Europe's monetary union and the resilience of its own financial system. But so it was.

I would say that we are a third of the way through the period of adjustment. In other words, I think it will take the best part of a quarter century to find our way back to a sustainable steady state. This suggestion can cause a degree of bewilderment, even anger, but I don't think it should be so surprising. The new regimes for banking, shadow banking and capital markets are not yet fully articulated; once they are, it will take years for intermediaries to tailor their business models, including their cost structures, to the new 'rules of the game'; and no one will be able to judge the adequacy of the regime until they can observe its effects in a world of restored macroeconomic equilibrium.

Especially here in Europe, we are no way near close to even beginning the path back to 'normal', and we can't remotely know whether, when one day we get there, it will look rather like or completely different from the old 'normal'.

The need for an ambitious Capital Markets Union project

That is the environment in which the technological revolution is playing out; in which the forces of regulatory arbitrage and evasion will, as ever, work their way through the system; and in which policy makers are finalizing the regime for a more resilient system and, here in Europe, mapping a Capital Markets Union (CMU) that could transform finance in this continent in ways that underpin the monetary union.

The CMU reforms should surely be ambitious, enabling much greater risk transfers across the regions of Europe through the private equity markets. As Vítor Constâncio has eloquently set out, much greater private risk transfers are necessary to help the single-currency area absorb regional economic shocks and, I would add, to take the pressure off the opaque official sector risk transfers that work through the TARGET payments system. I hope that those of you here engaged in debates on the future of the financial system will be pushing for reforms in bankruptcy laws and variations in national securities laws that impede savers in, say, the Netherlands investing in, say, Puglia in the way that cross-continental investment in the US helps to cushion their economy from disaster.

But the benefits of an appropriately ambitious CMU would take time to come through. Meanwhile economic conditions remain fragile.

Given all those uncertainties, and many more, these are times in which our ignorance about the short-run and longer-run effects of stability policy on economic growth must be a burden and worry for policy makers and their political overseers.

My own conviction, borne out in the US and slightly more slowly in the UK, is that strong banks lend but weak banks do not. Or, more accurately, weak banks do not lend once their weakness has been spotted by the markets, and grasped by management and the board. Research increasingly, but not surprisingly, backs up this view.

That is, of course, the basis for the core of the reform programme: making the financial system more resilient. The most familiar measures are requirements for a stronger equity base, more liquidity, and fewer complex interlinkages that propagate distress. It is less appreciated that resilience policy does not rely wholly on reducing the *probability* of distress amongst intermediaries. That, foolishly, was almost the sole foundation of the pre-crisis conception of regulatory policy.

Today there is an equal emphasis on the effective resolution of firms in distress so that core services can be maintained *without* taxpayer solvency support. But it is just here that conviction might be faltering.

Challenges to resolution policy

The centrepiece of resolution policy for complex intermediaries is bail-in of bondholders: *bail-in rather than bailout*. Europe played a vital part in getting that policy agreed globally and, under Michel Barnier and my now SRC colleague Sharon Bowles, the EU gave member states many of the necessary powers through the Bank Recovery and Resolution Directive.

I am slightly concerned, in the light of events in Portugal and Italy at the turn of the year, that the grounds for and core of this policy regime are at risk of getting lost, which I believe would be immensely damaging to Europe: its recovery, harmony, and standing in the world.

I was recently reminded that, while in office, I had commented:

> *One of the greatest paradoxes of crisis management is that the political will is only there when it is absolutely necessary, but by which time it is not enough.*

Perhaps with hindsight, describing this as a 'paradox' might have been overly delicate. In fact it is not short of the Red Alert for the design of stability regimes.

Politicians inevitably delay until almost the last possible moment before bailing out firms because it is deeply deeply unpopular; its unpopularity outlives the relief at the world being saved; and it is unpopular for good reasons. It is unfair; and it makes the world riskier because financiers can expect to get rich during the good times without sharing the disciplines of the market during the bad times. A *de facto* regime of bailout makes high finance a peculiarly semi-socialised industry: socialized when the bankers have stepped over the cliff, but the epitome of market forces ('we must pay market rates') when all seems to be going well.

But if it is entirely understandable that our elected representatives delay and delay saving the world until the last possible moment, that very delay weakens the force of their actions. It should not be forgotten that for a while it looked as if the G7's concerted underpinning of banking in the autumn of 2008 had not completely worked. It was only in the spring of 2009, with the US stress tests, that things began to stabilize. And by then the blow to confidence had been so devastating that the most extraordinary macroeconomic stimulus in modern (perhaps all) history has taken years and years to bear fruit, even in the US.

We should hold to those memories, and the political currents they have generated, as resolution policy is finalized and implemented in Europe.

There are, quite simply, three components to a decent resolution regime:

- The authorities having the necessary powers
- The banks, dealers and others having a capital structure that makes it realistic that the authorities will use those powers, and
- A willingness to use the powers as soon as an intermediary is clearly doomed.

Since I have suggested that the EU passed a pretty good directive, I will elaborate on only the second and third points.

The challenge in resolving complex intermediaries is that they cannot easily be broken up into a 'good bank' and a 'bad bank' over a weekend, the strategy that the FDIC has demonstrated beyond peradventure for small vanilla commercial banks. (The strategy, by the way, that would very likely have worked for Nothern Rock had the UK only had those powers back in 2007.)

The essence of resolution strategy for large or complex firms is, instead, to reconstruct an intermediary's capital structure, putting onto bondholders the losses that remain to be absorbed after equity is extinguished[2].

But for that to work in a way that materially reduces the wider disruption and, therefore, for the authorities to be willing to do it when it matters:

- Bonds can't rank equally with other senior creditors, such as trade creditors and uninsured depositors
- Bonds should be held by professional investors

[2] My post-office account of the framework was set out in Tucker, "The Resolution of Financial Institutions without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations", European Summer Symposium in Economic Theory, Gerzensee, Switzerland, 3 July 2014.

- Retail investors must know the risk of investing in bonds that would be first in line to take losses after equity.
- There must be a large enough quantity of such bonds outstanding to recapitalize the firm.

This is the basis of the principle that the bonds taking losses immediately after equity should be very clearly subordinated to all other creditors, and that the authorities should prescribe minimum requirements for the amount of such bonds outstanding.

I worry, therefore, when I hear rumours that Europe will, in the event, not require subordination or that it might dilute the internationally agreed policy on minimum requirements.

To abandon subordination would be to abandon resolution policy, which is to say that they we would be back to bailout[3]. But today that would be even worse than in the past, since not a few countries' public finances would be inadequate to the task. This, therefore, would be a state of affairs where confidence elsewhere in the world in European finance would be damaged, with investment in the economy further deferred and a risk premium charged to governments in the bond market. Of course, that would increase the headwinds impeding economic recovery, and would lead to more pressure for central banks to intervene to offset the effects for the time being, and thus mask what at root would be a flawed banking policy.

On this side of the Atlantic, we should bear in mind that the Federal Reserve is consulting on a policy that is a degree or so tougher than the international

[3] Technically, the law might allow the authorities to cherry pick amongst creditors ranked equally under bankruptcy law, subject to a test that resolution leaves no creditor worse off than they would have been under liquidation. But if pretty much all creditors rank equally, this may well lead to law suits and appeals for injunctive relief given the uncertainties surrounding the liquidation value of complex firms in bad states of the world. Reforms to the capital structure can address those risks.

minimum standard. The SRC has supported this (while posing some questions about its application to cross-border resolutions)[4].

All this really matters when the world economy remains precariously placed. Yes, one's central expectation would be for the American economy to continue to recover this year, and for the Chinese authorities to navigate the needed rebalancing of their economy without crisis given the surplus savings at their disposal. But the world is riddled with risks, and will be for some time. Sooner or later, some of those risks will crystallize, and it cannot be guaranteed that that happens only after a degree of normalization has allowed the armoury of macroeconomic policymakers to be replenished.

That is true more or less across the world. Here in Europe, there is the extra ingredient of the incompleteness of the Economic and Monetary Union. Since that makes the economy as a whole less resilient, it points towards banks in the euro area needing *more* loss-absorbing resources than otherwise identical firms elsewhere in order to achieve the *same* degree of financial-system resilience. That entails a prudent resolution policy as well as a robust approach to minimum equity requirements.

It means sticking to subordination, requiring enough deeply subordinated bonds to recapitalize a distressed firm, and empowering the Banking Union's resolution authority to respond in a timely way to distress. Not too early, but not too late. The legislated regime is the way out of the politicians' 'paradox', as they grasped when they passed it.

Stability and the environment for competition and innovation

If the authorities succeed in tying themselves to the mast of these policies, setting aside complaints that the supply of credit and other services will be harmed, the benefits will be widely felt through society. Obviously, the public will benefit since they will no longer underwrite without control: risk will get priced through the

---

[4] Letter to Hon. Janet L. Yellen, Chair, commenting on the Federal Reserve's proposed rule on total loss-absorbing capacity (TLAC) (14 April 2016), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2016/04/SRC-TLAC-comment-on-FRB-proposed-rule.pdf.

bond markets and change the terms of trade for undercapitalized banks. But, and this is sometimes overlooked, much of the industry will benefit too. Looking ahead, a world in which distress and failure are not social catastrophes is a world in which barriers to entry and to innovation could gradually be relaxed.

That is where, to conclude, despite their superficial remoteness, resolution policy and technological innovation come together. It is by making finance a full part of a market economy --- rather than a peculiar form of asymmetrically socialized capitalism --- it is by making failure as well as success possible that technological innovation can become the basis of true technical progress in the economy, helping to overcome the productivity growth slump, with rewards for the winners, losses for the losers, and choice for the users.