Andrew Bailey: Michael D Gill Memorial Society Lecture

Text of the Michael D Gill Memorial Society Lecture by Mr Andrew Bailey, Governor of the Bank of England, at the Commodity Futures Trading Commission (CFTC), Washington DC, 24 October 2024.

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Quite simply, I wish I was not giving this lecture today. Or, perhaps better, I wish I was giving it with Mike Gill here to participate. But, only one of those is possible due to his tragic and senseless killing. I am sure I am not alone in thinking that when these events happen to people we do not know, we find a sort of anesthetised isolation by resorting to commenting on the public policy implications in a rather dehumanised way. But when it happens to someone we knew, hugely liked and respected, who was without question a good person, then it is almost natural to be lost for words. It has taken me a long time to compose thoughts on someone to and about whom I could say so much in life.

There is an old saying that someone is a pillar of society. They are the people who support and hold society together. Well, Mike was without question a pillar of society. He was generous, kind, thoughtful and very supportive. Kristina, Sean, Brian, and Annika, as you know even better than us, he was an outstanding person.

But Mike was not a pillar of society in the sense of that term of someone who was stuck in the past, holding together a world that was lost. He was a moderniser, and that was why it was so appropriate that he served at the CFTC, which has its history but also is at one of the cutting edges of finance. Mike loved that. He talked at length about visiting farms with Chris and about the technology changing farms and agricultural markets. But he was also an enthusiast to find an appropriate treatment of cryptocurrency in derivatives markets.

The second thing about Mike and his work here at the CFTC that naturally brought us together was that he was a passionate internationalist. And he always seemed happy to visit London, and it was always good to see him there. Our international travel went further. There is a memorable, for me certainly, picture of the two of us on a boat trip in Sydney Harbour in 2019.

It wasn't just the travel. Mike was, like Chris, an internationalist through and through. I spent time with Mike after the UK's Brexit Referendum in 2016. I am strictly neutral on Brexit as a public official. I knew then that our job was to work out how to implement something that, let's be honest, had not been planned. In the area of financial services, clearing was going to be probably the hardest area for us, because – and I will come back to this point – it is inherently international in many parts, and particularly the parts we do in London. I knew immediately after the Referendum that it was critical for the UK not to become isolated and certainly not isolationist. That would be the road to a very bad outcome for the City of London. We needed friends, both in deeds and words, those who would be prepared to stand by us, and put up with uncertainty while we worked out the best course. Chris, you and Mike were those people – friends when we were in some need.

Now, it is the case that, as a internationalist, Mike arrived in the world of clearing at the right time. It is a fairly esoteric activity, always important, but also often in the background. We quite like it to be humming away safely in the background. But the Global Financial crisis had emphasised that we had undervalued its importance, that the world would have been safer if we had put It more into the centre of the financial system.

But, to do that it must be done safely and soundly. Unsafe clearing would be worse than no clearing, it would amount to concentrating the risk in one unsafe house.

And so, if we are asked to list the very big financial system changes post financial crisis, we should naturally start by saying that we have put clearing at the heart of the system. Central Counterparties (CCPs) are a key to mitigating counterparty credit risk, which has become even more relevant following the crisis and, in so doing, bring significant financial stability benefits. The experience of the collapse of Lehman Brothers demonstrated that CCPs should be able to dampen the shock of a major counterparty credit failure. One of my abiding memories of the Lehman weekend was the attempt to organise an ad-hoc trade position compression exercise, to net down the positions. It wasn't possible, and the hard lesson was that only permanent institutional structures with clearing houses at their heart can achieve the ends we desired.

But, of course, we know that CCPs, can pose significant risks to the stability of the financial system if they are not properly managed. A consequence of central clearing is that CCPs themselves become a financial network which can bring about the contagion of financial instability if they are not robustly established and operated. In line with G20 commitments following the Financial Crisis, the introduction of mandatory clearing for various classes of over-the-counter derivatives has driven an increase in the systemic importance of CCPs.

In the banking world, that tendency for banks to grow and become more globally systemic led to hostility to allowing very large banks which could be too big to fail. Clearing is different. Its not just that clearing didn't cause the crisis, though just to be clear, it didn't. Rather, its more than that. Up to some point, and that point can naturally be large, there are benefits of scale and scope in clearing. Yes, there is contagion risk if a CCP fails, and especially where it is large in its market, but there are real benefits of scope and scale.

And, this naturally leads to the international dimension that Mike so much emphasised. The global nature of many financial markets means that clearing is naturally a cross-border activity. Cross-border clearing also brings significant benefits. A single CCP operating across multiple jurisdictions and currencies can provide efficiencies and reduce risk through multilateral settling of exposures across counterparties in different jurisdictions.

This puts an obligation on us as regulators of clearing houses. We have a duty to enable the safe operation of the global financial system. Public authorities have risen to this duty, supervising standards on CCPs have been strengthened and new international standards have driven the establishment of credible CCP resolution regimes. We also have a deep sense of responsibility for the impact of our actions on other countries. And, we take this very seriously, as we must. In the UK, as the regulator we are required in any exercise of our rule-making power to consider the effects of these rules on the financial stability of any country where one of our clearing houses provides services, and we must act in a way that does not favour one jurisdiction over another.

This is of course all common sense. We all recognise that the interconnectedness of global markets means that any shocks in one part of the world can quickly reverberate and cause stress elsewhere. But common sense though it is, I can tell you that it's a lot easier to put into practice when you are working with someone like Mike Gill, who wants to get things done and is at heart an internationalist.

And, so it should be no surprise that during the period Mike was here at the CFTC, things did get done, and they continue to get done building on his legacy.

There is another feature of clearing that is distinctive. As I said earlier, by its very nature it concentrates the risks associated with the trades being cleared. That's how and why CCPs are such crucial nodes in the financial system. But it also means that if a CCP doesn't manage its risk well, the concentration magnifies the impact of the problem. Moreover, CCPs tend to be highly interconnected because the instruments they clear are likewise interconnected – think about the different ways to trade interest rate risk. A small number of CCPs provide most of the capacity in over the counter derivatives clearing. And, a small number of clearing members provide the majority of clearing services to clients at all of these big CCPs. These firms are also providing key services to the CCPs, such as settlement, custody and liquidity backstops.

We can take a few points from this. Clearing is quite complicated and technical as an activity. I'm going to stick my neck out and suggest that here in Washington, conversations in bars are not of the sort: "tell me how does margining in a clearing house work". Its notoriously a dry subject, but important, hugely so. But therein lies a risk – even at international meetings there can seem to be other things to talk about, happily so, and that can lead to problems of neglect.

Except, onto the scene came Mike Gill and Chris Giancarlo. The enthusiasts had arrived. Suddenly, it seemed a pleasure to talk about clearing. The fun kids talked about clearing. The serious point is that supervising big CCPs requires deep cooperation between authorities across multiple jurisdictions. It requires cooperation not fragmentation. We knew how to do that, but it always seemed harder to put in practice than it should have done. We don't like economic fragmentation in the world, rightly so, but somehow arguments are made that its ok to do so for clearing. No it isn't as a matter of fact, because such a view defies the logic of how financial markets work. Supervising and regulatory cooperation is a key part of the right approach.

I want to finish by looking forwards. I think that is what Mike would want, because it was very much as I remember him. There was always something new and interesting, whether it was drones overseeing crop production or crypto assets.

The importance and role of clearing continues to grow rapidly. A few facts help to illustrate the importance of clearing. I will focus on UK-US clearing facts. The notional amount of OTC derivatives cleared by UK CCPs with US counterparties continues to be greater than that cleared with any other jurisdiction. Across the three UK CCPs, 38% of margin is derived from US clearing members, and volumes have been larger this year than last, which was also up on previous years.

Overall, one thing that lies behind this growth is a rise in non-bank financial intermediation versus bank intermediation. We should not be surprised at this. But let me go back to 2008 and the Lehman weekend for a moment. The attempt to put in place an ad-hoc trade compression process – to net down exposures – reflected in the main banks having – sloppily – built up very large derivative books, and not managed them effectively. I remember several CEOs told me at the time that it just had not occurred to them that they needed to manage these books efficiently.

Indeed, it was very clear that for quite a few, there was very little awareness of the problem that was building up. It was too easy to pile trade upon trade with little regard for the need to risk manage these books throughly.

And then the music stopped, and suddenly what had been out of sight and out of mind in the good times became a problem. Outsized books had to be managed down by banks. Today that legacy is behind us. But the scale of derivative activity has nonetheless grown much further. That growth has provided important hedging benefits, and it has enabled much larger position limits to exist, concentrated more in the non-bank sector, but inevitably with links into the banking system. The so-called basis trade is a good example of this.

These developments leave us with major puzzles. Is there a scale of activity beyond which stress sets in when it has to be unwound quite suddenly? What would be the effects of that stress? And how do we model such a fluid landscape, where stress could emerge in several places at once? Better tools of diagnosis are important here.

At the Bank of England we have designed and run something we call the System Wide Exploratory Scenario, which seeks to synthesise the effects of some severe but plausible shocks passing through the financial system. Over 50 firms have participated, as have the clearing houses that support the activity. This is not a stress test in the now quite traditional individual bank by bank sense. It is a market-wide test designed to simulate shocks – it's a flow test, designed to find obstructions and concentrations of risks and correlated positions that might otherwise be opaque. It is I think an important step forward in testing behavioural reactions to stress including how risks might cascade across markets. And, it will give us a better answer in terms of the effectiveness of CCPs in managing market-wide risks. The results should be published by the end of the year. It's the sort of new thing that I think Mike would have appreciated, and been enthusiastic about.

The Bank of England and the CFTC have a longstanding relationship of cooperation on CCPs. Mike added his special qualities to that relationship. Its our duty to carry his work forward, but even more so to do it in his spirit, the one we enjoyed and miss so much.

Thank you.

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