BANK OF ENGLAND

Speech

Why we need a leverage ratio, and how bank boards might take charge

Speech given by

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It is indeed an honour to be speaking at an Oliver Wyman event. I was lucky enough to work over many years with Alex Oliver, who always seemed to me the personification of the inquiring mind, something we need more than ever in finance.

For the last 18 months I've been privileged to serve as an external member of the Financial Policy Committee, the Bank of England's recently-established macroprudential body. We are charged with ensuring financial stability in the United Kingdom; we're also required to consider the costs and consequences for the real economy of actions we may take. The structure of the banking sector and the behaviour of bankers are thus extremely important for us.

I want to talk today about aspects of both these subjects – two quite distinct matters, although there is a not-so-tenuous connection between them. One is the leverage ratio, about which the FPC published its proposals, with the Bank's usual fine sense of theatre, at sunset on Hallowe'en. The other is the contentious question of how the boards of directors of banks might most productively carry out their duties. The views I shall express on these topics are entirely personal: on the second in particular I can claim no possible authority. I speak for no one but myself.

Let's start with the leverage ratio. I intend briefly to consider four questions. Why have a leverage ratio at all, when we have a risk-weighted capital ratio already? What determines the calibration proposed by the Committee? Why are the FPC's proposals not simpler? And what kinds of capital is it appropriate to allow into the numerator of the ratio?

We need a leverage ratio – that is, a capital-to-assets ratio in which the assets are not risk-weighted – because the risk-weighted capital ratio, though admirable in theory, is not infallible in practice. It incorporates a number of conventional assumptions, some of them contentious – for example, that domestic sovereign debt is riskless. It relies on widespread use of models, which are inherently incomplete and imperfect in the way they describe the working of the system. (It's also the case that those who design them may have an incentive to understate risk, and if we know one thing for sure, it is that bankers respond to incentives).

The models may also be inherently pro-cyclical, as risk weights tend to rise as economic circumstances deteriorate. And they may not capture the extent to which very large concentrations of supposedly low-risk assets – in a mortgage portfolio, for example – may be highly correlated with each other. This means that models can give a rosy view of the world in good times, which can quickly deteriorate as times turn bad.

The denominator of the risk-weighted capital ratio starts from the gross assets of a bank's balance sheet and adjusts them for risk, less by increasing the weight of high-risk items than by reducing the weight of supposedly low-risk items. It thus produces a smaller number. Over time, and as firms – assisted no doubt by Oliver Wyman – have honed their risk weights, in particular as mortgages have taken a larger share of

the banking business for many banks, the denominator has departed very considerably from its unadjusted state. When we say, for instance, that total loss-absorbing capital needs to be some 20% of risk-weighted assets, we no longer mean anything resembling 20% of the bank's balance sheet. We mean in many cases 20% of something like 40% of the bank's balance sheet.[1] As professionals, you all know this, of course, but lots of people don't.

In other words, the denominator of the risk-weighted capital ratio is a conceptual number – a sophisticated concept, but a concept all the same. In contrast, the denominator of the gross leverage ratio represents something closer (allowing for inevitable defects of valuation) to a reality – a primitive reality, as the Building Societies Association authoritatively reminded us, but something nearer reality nonetheless. And if a bank's gross assets, however valued, fall below what is owed to debt-holders and depositors, the bank is bust.

By keeping an eye on both ratios at once we can avoid making the kind of mistake made by investment analysts who look only at corporate profits but not cash-flow (or vice versa). Of course we now also have stress tests to complete the triangulation – a very important subject on which I don't intend to say more today. We're trying to give ourselves more ways of reading the financial weather. Come to think of it, wasn't it always very strange to believe that all that is known about the risk characteristics of an immensely complex bank could be boiled down to a single ratio?

Second question: calibration. A rather arid debate, reminiscent of Swift's Big-Endians and Little-Endians – you will recall the bloody Lilliputian arguments over which end one should break open a boiled egg – has been simmering over whether the leverage ratio should be a back-stop or a front-stop; that is to say, whether it should provide a remote piece of capital insurance or be a binding constraint on financial firms. The FPC has aimed as far as possible for a position of complementary neutrality between the two ratios. Which will bind first ought then to depend on the business models individual firms pursue. Thus judgements that the committee has been "lenient", as some have said, are really beside the point.

But if the two ratios are to be genuinely complementary, and if the risk-weighted capital ratio is to vary over time as envisaged in the new international regulatory architecture, it is necessary that the leverage ratio should vary as well, or the complementarity will be lost. For this reason the FPC has rejected the perfect simplicity – glorious but spurious – of an unvarying leverage ratio, and has proposed that it should vary over time, with a countercyclical leverage ratio buffer, just as the risk-weighted capital ratio will, thanks to the countercyclical capital buffer: indeed, we expect the two ratios as a general rule to move in proportion. In addition, systemically important firms should have a higher leverage ratio: here too we are mimicking the risk-weighted capital architecture. If we don't do this, all sorts of perverse incentives will come into play as the risk-weighted capital ratio is varied. And I think it's fair to say that without this principle of time variance

[1] Major UK banks' average risk weight (aggregate peer group risk-weighted assets divided by aggregate peer group assets) was 39.9% at H1 2014 (http://www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx).

the Committee would be looking to set a much higher – less lenient, if you like – base leverage ratio. I hope that answers question three.

Finally, what capital should be allowed to count for leverage ratio purposes? Common equity tier one is clearly the gold standard. But how about Additional Tier One (AT1), as pretty much all bankers have proposed?

AT1 has become more or less a euphemism for CoCos, contingent convertible capital instruments, and CoCos are a characteristic product of modern finance – clever, profitable for the issuers, untested in adversity, and reliant on a structural asymmetry, in this case a productive disagreement between two presumably incorruptible sets of public officials. The tax authorities accept that CoCos are debt, while the bank supervisors deem them equity in that state of the world that most concerns bank supervisors. (Note that disagreement is a necessary but not sufficient condition for CoCo issuance to flourish – if the taxman called them equity and the PRA said they were debt, I don't suppose we'd be on our way to a trillion dollar global market).

We are certainly trusting CoCos will work in the next crisis, because they play a big role in the international post-2008 financial architecture. But they carry a real structural disadvantage where the leverage ratio is concerned. They only trigger – i.e. turn into equity – as a consequence of declines in the risk-weighted capital ratio, not the leverage ratio, and it is possible for these two ratios to diverge, sometimes quite sharply, if risk weights change. So we could reach a situation in which the leverage ratio is falling, and the FPC might want to take action from a financial stability point of view, but banks are still meeting their risk-weighted requirements, and CoCos are not triggered. So I worry that CoCos may not be a suitable instrument to accept into the leverage ratio calculations. The point about divergent readings is not a remote theoretical possibility: between 2004 and 2008 average risk weights in the major UK banks fell by over 20%, and risk-weighted capital ratios as a whole increased slightly. At the same time, though, gross leverage increased by more than 60% – that is, the leverage ratio fell by around 40%, much more in some firms.[2] No one now seriously believes that the system was getting less risky at that time, but that was the signal broadcast by risk-weighted asset readings.

The FPC has taken here what seems to me, given that so much AT1 has already been issued, a pragmatic view: CoCos will be accepted for up to 25% of the minimum leverage ratio (that is 75 basis points out of the 3%) provided they have a high conversion trigger – 7% or more on a risk-weighted capital ratio basis. This again mirrors the approach taken in the risk-weighted capital framework. But add-ons above the 3% need to be proper equity. I am perfectly comfortable with the soundness of the position that we have reached, and hope that it may eventually form the basis of an international standard.

[2] Calculated using data on the major UK banks from the FPC's Core Indicators set (http://www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx).

Now to the more serious of my two subjects – how can bank boards be more effective? To hear what directors have been saying recently, you'd almost think the exam question was "How can board members stay out of jail?" That seems to me too modest an objective for financial titans to set themselves, as well as being less novel than people would have you believe. There was plenty of legislation that could theoretically catch negligent management in the past; as a bank director in the mid-1990s I certainly worried about the potential consequences for me of misdemeanours by unknown colleagues. But let's start with the idea that a board has higher aims than just keeping out of trouble: let's suppose it wants to do a good job.

There is no doubt that directors of banks, more especially since the crisis, are working enormously hard. If any of them has been able to take time off – most unlikely – to visit the wonderful exhibition on the early Ming dynasty at the British Museum, she may have smiled wryly at a prominent quotation from the Emperor Yong Le, who wrote to his son at the beginning of the 15th century: "Even though the secretaries handle the documents, you must read them all yourself. Thus you may know the hardship of the official so you may one day be a leader of men." Directors, like those poor officials in Nanjing, seem to be drowning in information. But we can scarcely pretend that confidence abounds in the governance of the financial sector; indeed, it's just been dealt another blow by the ghastly revelations about the rigging of foreign exchange markets. The over-confidence that was rife before the crisis has given way to profound institutional unease.

Some difficulties are structural: they do not yield easily to mere diligence. I sense that one of the solutions we have developed to address the thorny problems of corporate governance has turned into a large, looming, silent problem itself. I refer to the over-development of board committees, and – as a consequence – the reduced space for boards as a whole to operate in. (This observation, by the way, goes well beyond the banking sector, though the phenomenon may be most acute there).

Now committees are self-evidently a good thing. Not only modern corporate norms approve of them – the great Walter Bagehot did too: he argued that a board could not run a bank (I don't disagree); instead, the bank should effectively be governed by a "real working committee", a group of experienced and more or less full-time directors whose job consisted of active supervision of the general manager, what we would now call the CEO, lest he "glide into dangerous and insecure transactions". How eloquent that "glide" is, with its prefiguring of the slippery slope.

What Bagehot described was very much the way merchant banks used to be run, or partnerships in London and on Wall Street. But our modern committee structures speak to something quite different: the technical issues of running very large corporations. It is no exaggeration to say that nearly every accident in corporate governance in the last quarter-century in the UK has spawned a new board committee.

I'm ashamed to tell you that I've been around for so long that I can remember sitting on the main board of a big industrial group before there was an Audit Committee (we didn't have computers, either, or bonuses,

come to that). We may have been less professional than boards are today, but let me tell you: we all paid attention when it came to signing off on the accounts.

These days, of course, boards have committees to cover not only audit but also remuneration, risk, nominations, social responsibility, and in some cases capital allocation and many other matters. The committees are subordinate to the main board – powers are delegated to them. They make the board more efficient in the sense that they allow it to take on a greater workload – indeed it's hard to imagine how a board today might function without a slew of committees, never mind what the governance rules require. But I believe this efficiency has been bought at a high price in reduced board cohesion. It has got harder – perhaps because some organisations are ungovernably large – for boards to see any sort of big picture. Unable to encompass the blurred outlines of a sometimes ugly reality, individuals take refuge in trivial detail.

Two powerful effects seem to be in play – entirely understandable, quite subtle, and in the end perverse. First, a director who is not on the remuneration committee or the audit committee thanks her lucky stars and removes these crucial topics from her personal list of concerns. Second, the committees themselves take on a fundamentally technical aspect, where the members, drawing heavily on consulting advice and inter-firm comparisons, tend to behave more as experts, and less as broadly responsible directors. In the end the committees usurp the power of the board – after all, they perform three quarters of the board's role – but they do not really behave like boards.

TS Eliot famously wrote of the "dissociation of sensibility" that he claimed had infected English poetry in the seventeenth century, when intellect became divorced from feeling. Few directors of banks would see themselves as the heirs to Milton, but in a strange way they experience the same distancing.

I believe there are some matters that the board of a bank absolutely has to have collective understanding of and take collective responsibility for. One is the risk framework. In particular, does the board really understand the model that determines how much capital the bank believes it requires? The entire business rests on this judgement. It is far too important to be left to the risk committee.

Does the board understand the incentives that underlie the remuneration system? The question here is not – or at least not just – how much money individual bankers are paid, but what behaviours are likely to be encouraged by the way in which they are paid. This is far too important to be left to the remuneration committee, so anxious to achieve the mathematical impossibility of paying top quartile packages to all that it ends up institutionalising rapacity.

How is capital allocated in the business? Directors with industrial training often find it difficult to catch the numerous mini-cycles in banking markets: it is often not wise to pile more capital into last year's successful area – returns, in a business where capital is so fungible, may be about to plunge there. Equally, too keen

an emphasis on micro-segments – a characteristic failing of bankers, not boards – can obscure the larger cycles than can prove so devastating.

Is the board capable of understanding all the different activities in which the organisation is engaged? If not, it should either acquire this understanding, and quickly, or reduce the breadth of its ambitions.

Every one of these considerations is too big to delegate. They are quintessentially matters for the whole board, and a board that applied itself to them all properly would not have to worry about spending its next awayday in Pentonville.

Let me sum up. The board committees, in banking and elsewhere, need to be the obedient servants of the board, not its masters. And be careful how much CoCo you consume.