BANK OF ENGLAND

Why Britain’s banking rules aren’t restricting our economic recovery

Article by

Paul Fisher, Executive Director, Markets and Member of the Monetary Policy Committee and the Financial Policy Committee, Bank of England

Published by City AM on 14 September 2012

The Financial Policy Committee (FPC) was set up in 2011 to protect and enhance the resilience of the UK financial system. Some commentators have argued that this is part of a regulatory onslaught by the UK authorities, responsible for stifling lending growth.

So it may have come as a surprise to these critics when, earlier this year, FPC members saw the chancellor's announcement of a secondary objective for the Committee – to support the economic policies of the government, including its objectives for growth and employment - as entirely consistent with its recommendations so far.

In my view, the aims of ensuring a strong and resilient banking sector on the one hand, and supporting lending and economic growth on the other, are not conflicting. On the contrary: it is difficult to have one without the other. UK banks before the crisis were not resilient - not even close - as demonstrated by the huge amount of public sector money that was used to support them and the financial system more generally. Banks found their levels of capital were inadequate and rapidly depleted, causing a reduction in lending to the real economy. It is no coincidence that the subsequent years have been marked by a period of stagnant output.

The FPC is working hard on macroprudential policies to ensure that this does not happen again. The sceptics may need some convincing on that. First and foremost, I want to stress that the FPC is not trying to prevent banks from taking risks. If we stopped all risk taking in the financial system – including, for example, those arising from the maturity transformation inherent in taking deposits and then lending - the economy would grind to a halt. It is an essential part of what financial firms do as part of allocating funds between competing needs.

But it is crucial for stability that the risks that banks - and other financial firms - do take are known, proportionate and properly managed. That is something the FPC can promote using macroprudential policy. In 2011, the FPC made policy recommendations aimed at encouraging banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing real lending to the economy. These were implemented by the FSA, which worked with individual banks on their plans to manage down positions that created particular funding risks.

More recently, in June this year the FPC highlighted that concerns about redenomination risk and banking book exposures to the euro area were contributing to a lack of investor confidence. We therefore recommended banks to make prudent valuations of their exposures, and to assess, manage and mitigate specific risks to their balance sheets.

We want banks to take appropriate risks – every loan a bank makes carries a certain amount of credit risk. By doing so prudently, the FPC primary and secondary objectives are both met. The resilience of the banking system to unforeseen shocks is higher if banks have identified, managed and provisioned for the risks they take. And banks, by reducing uncertainty about the overall risk on their balance sheets, will be more attractive to creditors and investors, ensuring a steady flow of funding and, in turn, lending.

The FPC has also asked UK banks to raise capital. This is entirely consistent with our objectives. A strongly capitalised banking system will be better placed to absorb shocks in the future and maintain lending to the real economy. Capital can fall in value when banks make losses and help keep them solvent. By contrast, when bank lending is backed by debt then losses can very quickly lead to insolvency. Higher capital levels will generally lead to greater investor confidence and lower funding costs.

An extra pound of capital does not mean a pound less of lending. Capital is a source of funding for banks – it is not an asset on their balance sheets. It is not kept in a vault, it is used to support lending. Indeed the FPC recommended that some additional capital should be used to take risks: to support additional lending to credit-worthy firms and households. The FPC’s actions are intended to ensure that more capital and more lending go together.

We recognise that the ability to raise capital varies across UK banks, especially given the weak profit outlook. That is why we encourage them to work with the FSA to consider alternative means of raising capital, including contingent capital instruments or debt-for-equity swaps.

Banks face exceptional risks at the current time. The banking system needs to be safer, it needs buffers in case these risks were to crystallise. But that should not come at the detriment of lending or risk-taking, because these are essential parts of banks’ business models. Instead of worrying about the perceived costs of regulation, people should focus on the benefits to everyone of a safer banking system that takes measured risks through well-judged lending.