BANK OF ENGLAND

Capital and lending

Article by

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Crises often lead to big changes in public policy. Britain's decision in the 1990s to embrace the objective of sustained low inflation and an independent central bank had its roots in the horribly high inflation of the 1970s.

Now we have a big change in financial regulation rooted in a more recent crisis, the credit crunch of six years ago. Since the start of April, the financial policy committee (FPC) of the Bank of England has had a statutory duty to protect and enhance the stability of the financial system.

Alongside it at the Bank is the new Prudential Regulation Authority (PRA). Its job is to promote the safety and soundness of banks, insurers and large investment firms by focusing on the problems they cause for financial stability. This is a new direction for financial regulation.

The crises that lead to such big changes often follow long upswings in economic and financial conditions that are allowed to go to excess. Light touch regulation in the run-up to the start of the financial crisis in 2007 supported expansionary growth in the balance sheets of banks — too much borrowing — which was literally too good to be true.

Our new approach is designed to counter the risk that policy is too accommodating in upswings and too harsh in downturns. Two important principles stand out for me: first, that we must carry out financial regulation with an eye on conditions in the real economy, which means promoting stable and sustainable credit creation and growth; and second, we should always be prepared to look to the risks ahead, and exercise sensible judgment.

The financial crisis has taught us in the most painful way of the dangers of waiting too long to take action and then being unable to prevent the worst consequences of delay.

The FPC has recommended that British banks make sure their capital level is high enough to withstand future threats. Some banks will need to increase their equity capital for a given level of risk in their balance sheets.

Concerns have been expressed that this change will harm lending to the UK economy. I do not agree with these concerns. Equity capital is not money that has to be stashed away for a rainy day and thus put to no good use. It is the shareholders' stake in the company. In non-financial companies, shareholder capital or equity is used to finance the acquisition of assets.

The same is true for banks. Equity finances the provision of loans to households and companies, and those loans are the banks' assets. In that sense, capital supports lending by banks and does not substitute for it. Higher capital requirements ensure that enough of the finance raised by banks is in a form that can absorb losses without the banks failing.

Higher levels of capital enable banks to attract other non-capital funding, in turn making it easier for them to lend to households and businesses. At present it is the better capitalised banks that are expanding lending.

How well are the banks doing in building resilience? There is good news here, as the banks have strengthened their capital positions since the darkest days of the crisis. But there is further to go. These capital positions are most often measured by the ratio of capital to risk-weighted assets.

Risk is difficult to measure, but I think that we must continue to do this, albeit accepting the uncertainty in the process by using a healthy dose of scepticism, and aiming to keep the method of measurement as simple as we reasonably can. But it is helpful to back up the risk-based measure with a leverage ratio that simply measures capital as a proportion of assets.

In the lead-up to the crisis, banks around the world chronically underestimated the risks to which they were exposed. The consequences were dramatic and highly damaging, and we are still living with them today.

The crisis has been fundamentally a product of banks that grew rapidly and failed to back that growth with sufficient capital to bear the losses. The FPC has recommended that banks should ensure that they take the necessary steps to put our system in a place where it can support the economy without compromising its stability.

The Bank of England has taken steps to extend the Funding for Lending Scheme, and within that has acted to provide a clear incentive to stimulate lending by banks to small firms.

But banks that are short of capital cannot increase lending. That is why in March the FPC made a series of recommendations to ensure that UK banks are well capitalised, and that banks meet that requirement in a way that does not hinder lending to the economy.

You may be assured that we are determined that the newly formed PRA follows through on those recommendations.