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25 October 2010

Banking: From Bagehot to Basel, and back again - speech by Mervyn King

In a speech in New York today, the Governor of the Bank of England, Mervyn King, outlines the challenges of managing the financial system and suggests a framework for assessing proposals designed to reduce the riskiness inherent in banking and solve the "Too Important to Fail" problem.

Giving the second Bagehot Lecture at the Buttonwood Gathering, Mervyn King explains how the size, concentration and riskiness of banks have grown markedly, as has the size of the shadow banking system. This has increased the degree to which the system is interconnected and given rise to greater uncertainty about where losses will fall in a crisis.

The Governor explains that banks are inherently fragile since they use short-term debt to fund long term, illiquid investments. But he goes on to say: "Yet many treat loans to banks as if they were riskless. In isolation, this would be akin to a belief in alchemy – risk-free deposits can never be supported by long-term risky investments in isolation. To work, financial alchemy requires the implicit support of the tax payer."

Mervyn King goes on to explain that this support incentivises banks to take on yet more risk: "Greater risk begets greater size, most probably greater importance to the functioning of the economy, higher implicit public subsidies, and hence yet larger incentives to take risk ..."

He then considers a number of proposals designed to offer a solution to this incentive problem. He explains that "The guiding principle of any change should be to ensure that the costs of maturity transformation – the costs of periodic financial crises – fall on those who enjoy the benefits of maturity transformation – the reduced cost of financial intermediation. All proposals should be evaluated by this simple criterion."

The first proposal considered by the Governor is the imposition of a permanent tax, such as the UK bank levy, on the activity of maturity transformation to "internalise the externalities". But, given that crises occur only infrequently, it is almost impossible to calibrate the appropriate size of any levy. "So although there is a sound case for a levy directed at the size of short-term borrowing, it would be foolish to regard that as the main tool to align costs and benefits of risky balance sheet activity."

Second, " ... limits on leverage have much to commend them". This solution is embodied within the capital standards set by the Basel framework. But, the Governor adds: "Lauded as a new standard, Basel III is seen by some as the answer to the failure of regulation to prevent the financial crisis. It is certainly a step in the right direction ... and we should all welcome it. But if it is a giant leap for the regulators of the world, it is only a small step for mankind. Basel III on its own will not prevent another crisis ... "

Mervyn King goes on to outline why, adding, "As with a bank levy, it is no criticism of Basel III to say that it is not a "silver bullet". The difficulty of identifying and calibrating the difference between the private and social costs of maturity transformation means that there is merit in having a basket of different measures to rein in excessive risk-taking. In the area of financial stability, it makes sense to have both belt and braces."

The Governor considers what else that basket of measures may contain. In relation to large, cross-border institutions, it could include "an addition to the Basel III capital requirement of an extra layer of either equity or other loss-absorbing capital, a special resolution regime for large institutions that would allow losses to be shared among creditors as well as equity holders, and tentative steps towards international harmonisation of resolution procedures ...".

Other, more radical reforms, could include moving to capital requirements several orders of magnitude higher, or ensuring large amounts of contingent capital in a bank's liability structure, introducing "limited purpose banking" or having some form of functional separation. A key challenge with these more fundamental proposals is to ensure that maturity transformation does not simply migrate outside of the regulated perimeter and end up benefiting from an implicit public subsidy.

Mervyn King stresses that he is not offering a blueprint for reform. Rather, in the UK, that is for the Independent Commission on Banking which was set up earlier this year.

The Governor concludes: "Change is, I believe, inevitable. The question is only whether we can think our way through to a better outcome before the next generation is damaged by a future and bigger crisis. This crisis has already left a legacy of debt to the next generation. We must not leave them the legacy of a fragile banking system too."

Key Resources

"Banking: From Bagehot to Basel, and back again" – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech455.pdf
Table 3 has been revised since the original speech was given