BANK OF ENGLAND

News release

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Capital discipline - remarks by Andrew Haldane

On a visit to Denver earlier this year, Andrew Haldane - Executive Director for Financial Stability - discussed the success, or otherwise, of international capital standards in forestalling banking distress and set out one possible framework that might address some of the observed short-comings.

Andrew Haldane begins by defining three principles required, in his view, for regulatory capital standards to best insure the financial system against crisis: simplicity; robustness; and timeliness. Taking simplicity first, he says that under Basel I calculating regulatory capital ratios ".involved little more than half a dozen calculations.", but the quest to introduce greater risk-sensitivity in Basel II increased the required number of calculations to many millions. On robustness he notes that banks' attempts to model risk suffer from many sources of uncertainty such that ".error-based confidence intervals around reported capital ratios might run to several percentage points." He says: "For a bank, that is the difference between life and death." And turning to timeliness, he presents evidence that reported capital ratios as currently calculated ".are essentially uninformative about future bank stress". In summary, Andrew Haldane says: "A critic might argue that regulatory capital ratios have become too complex to verify, too error-prone to be reliably robust and too leaden-footed to enable prompt corrective action".

That leads Andrew Haldane to consider how market-based metrics of bank solvency measure-up against his three principles as alternatives to reliance on banks' risk models. He argues such measures ".offer the advantage of simplicity and transparency.", they are ".largely model-free." and offer ".far timelier signals of impending stress". As a result, he suggests building into the capital structure for banks, alongside equity, contingent convertible instruments - so-called 'CoCos' - with three characteristics: triggers based on market-based measures of solvency; graduated triggers; and claims that convert from debt into equity. Andrew Haldane says that with such additions, ".banks' insurance contract would be fundamentally different than at present. Instead of equity being provided at haste under stress, the safety net would extend automatically in advance. And instead of being provided by the state ex-post, insurance would come from private creditors ex-ante." He also believes that this structure could reintroduce market discipline by altering the incentives of investors, management and regulators, and be in the banks' own best interests.

With the apparent advantages, Andrew Haldane asks why such a structure does not exist already. He says that concerns have been raised about the potential for speculative attacks by short-sellers and the seniority of debt-holders in the event of loss, but believes these challenges could be managed by careful design of the instruments. And he notes that uncertain investor demand could naturally be addressed through a requirement for discretionary distributions to staff and shareholders to be made in CoCos, which ".better aligns risk for shareholders and staff with the risks for society at large."

In conclusion, Andrew Haldane says the role of regulation is ".to set the overarching rules of the game. In tackling banking stress, that means the framework for banks' capital structure. As far as possible, that framework should aim to leave the pricing of risk ex-ante, and the consequences of risk ex-post, to the market. The framework outlined here could be one simple, robust and timely way to help achieve that. It is different. But it is far from radical. Nothing could be less radical than returning banks, and banking risk, to the market."

Key Resources

Capital discipline – Full speech