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News release

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Competition, the pressure for returns, and stability - speech by Paul Tucker

Speaking in London today, Paul Tucker – the Bank's Deputy Governor for Financial Stability and a member of both the Financial Policy Committee (FPC) and the Monetary Policy Committee (MPC) – considers the factors driving excessive risk-taking in the financial system leading up the crisis, and outlines some of the key aspects of the reform of banking. He says "the changes are profound". But in "overhauling the 'rules of the game' for global finance", he emphasises that the goal of the international authorities is not to abolish risk or risk-taking. "We need to find broadly the right balance between, on the one hand, safety and, on the other hand, the contribution that sound and honest finance can make to economic prosperity".

Paul Tucker notes the way increasing leverage fed upon itself in the run-up to the current crisis, and says it poses "deep but pressing questions about the efficiency and effectiveness of capital markets in monitoring and pricing risk". And while 'Too Big To Fail' is "the biggest problem we have to crack", he says moral hazard isn't a complete explanation. Rather, it was compounded by agency problems, myopia, complexity obscuring the risks in the system as a whole, and accommodative global monetary conditions. Together, these factors combined, he says, to create "a heady mix ... which the prevailing regulatory regime was singularly ill equipped to address, and in some respects had done much to create through inadequate capital requirements and an absence of liquidity requirements. In fact, a toxic mix."

Paul Tucker highlights six key aspects of the domestic and international reform programme pertinent to the banking industry. "First and foremost, we need holders of bank debt to be exposed to losses when banks fail." He states the imperative of having deposit-takers that can be resolved in an orderly way, and the significance of the UK government's ring-fencing plans in this context. But in addition, he says, the capital markets need sound intermediaries which, if they become distressed, can expire safely or whose viable parts can be resurrected. Bail-in, set to become part of UK law over the next few years, is, he says, one way of doing this. "The prospect of taking losses via resolution gives debt holders a strong incentive to monitor banks' risk taking. That will be a first order change for the financial system."

Second, Paul Tucker says the authorities need to consider whether to require management to be paid to a significant extent in subordinated debt, an idea recently endorsed by the Liikanen Committee. "Having managers exposed to instruments whose value depends on the survival of their firm would give them a healthy incentive to maintain a safe and sound bank". In addition, he says, there should be a review of the structure of remuneration for desk-level bankers – tying pay to the medium-term success of the firm. "Putting it bluntly, that would make it less easy to get rich quick irrespective of the quality of business transacted or the compliance culture in their part of the firm". This, he says, points to revisiting the terms and scope of the existing codes on remuneration of the G20 Financial Stability Board, the European Union and, in the United Kingdom, the Financial Services Authority.

Third, Paul Tucker highlights measures to address industry structure and system resilience. These include the UK's ring-fencing plans, which will he says make it somewhat easier to see what is going on, and help establish different cultures in different lines of business. "Within domestic commercial banking, we need somehow to unwind some of what I think of as the industrialisation of retail and business banking that occurred during the years of plenty. Branch and regional banking came too close to being seen as an exercise in sales and marketing ... Banking is about credit judgments. Boards need to think about how to re-inject that into the role of banks' front line managers." And, he says, competition policy may matter too: with more domestic competitors around, the wider effects of an individual bank failure would in all likelihood be smaller. In this vein, he notes the Bank's wish to reduce barriers to entry to the banking system somewhat by removing barriers to exit, and the role of the UK's Special Resolution Regime in this context.

Fourth, Paul Tucker notes changes in prudential regulation, in particular higher risk-based capital requirements and a cap on leverage. As well as providing a bigger buffer against loss, higher capital requirements will, he says, also affect behaviour, depressing the headline return on equity and likely prompting shareholders to "demand a larger share of the cake". He notes the need for robustly-determined risk-weights, and advocates a debate on introducing mandated floors on risk weights in Basel as a means of containing the risks from complexity. But he warns that it would not be sensible to rely entirely on a simple regulatory constraint: "history teaches us that they do not work on their own". The new Basel package is, he says, an attempt to use simple measures to put bounds on the consequences of flaws in more complex measures, which were themselves designed to avoid the perverse incentives to hold only very risky assets created by the previous generation of simple measures. But "more will need to be done in the years ahead to simplify and underpin the Basel regime".

Fifth, Paul Tucker discusses the role of microprudential supervision under the UK's new Twin Peaks structure. The advent of the Financial Conduct Authority will, he says, "finally give London a dedicated securities regulator a quarter century after the Big Bang that made it so necessary". Meanwhile, the future Prudential Regulation Authority will work to "transform the climate of prudential regulation ... We want this to be as collaborative, open and honest as possible – a different relationship between banks and their supervisors. One that revolves around penetrating and forensic analysis of the business and, where necessary, frank discussions with senior management and the board. Not a negotiation. And a regime where the Bank's Prudential Regulation Authority has the powers to underpin pursuit of material concerns about safety and soundness, based largely on whether firms meet the broad statutory criteria - the Threshold Conditions - for being authorised."

Finally, Paul Tucker highlights the significance of macroprudential policy: keeping the rules of the game up to date and leaning against exuberance. This, he notes, is precisely the remit of the FPC. And although most of the Interim FPC's deliberations to date have concerned bank capital adequacy, he says he expects the FPC's longer-term focus to be as much on the capital markets and, thus, the policies of the FCA. But, he says, taking away the punchbowl will be unpopular. "That is why the current debates in the UK Parliament about the Bank of England's new Financial Policy Committee are so very important: in a word, legitimacy."

In conclusion, Paul Tucker states that "work by the international central banking and regulatory community to make the system safe and sound has made real progress in recent years, but it is not complete and absolutely must continue with energy … We may not be able to abolish the occasional waves of optimism that grip humanity and the tendency to excess they set off. But we can and must dampen their effects on the financial system and economy … Markets will, in time, forget about the risks, but the system will be safer if we succeed in building official institutions that do not forget. Parliament can underpin that by holding us to account in this endeavour, as it does on monetary policy – incentives matter in the official sector too. That will make for a safer and sounder financial system that can meet the abiding needs of the economy as a whole. And, to those of you here today, I would say that the Bank believes what it always believed: that sound and honest finance is not only essential for the economy, it will be good for the City too."
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