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News release

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Chatham House conference – Regulatory reform and returns in banking - Speech by Sir Jon Cunliffe, Deputy Governor, Financial Stability

In a speech on Monday to a Chatham House conference on "the new shape of banking", Jon Cunliffe provides an overview of three major developments in the regulatory landscape since the financial crisis and considers the commercial implications of these changes for the banking industry.

The most important development has been the adoption of macro-prudential "machinery", such as the Financial Policy Committee, to monitor and address risks to the financial system as a whole. For macro prudential policymakers, systemic resilience in the face of improbable and incalculable risks is an "ever present" concern, Jon says, and the motivation for international standards on bank capital and liquidity and for stress testing of the banking system. Another objective is to act against the "upward spiral of exuberance" that can set into the financial system. We can expect such action by macro-prudential authorities to be a feature of the banking landscape for the future."

A much stronger international governance framework, resulting from the creation of the Financial Stability Board reporting to G20 leaders, is a second feature of the new regulatory landscape. Here, Jon emphasises that as authorities move from the design of standards to implementation, a key challenge will be to ensure that standards agreed internationally are being implemented consistently across jurisdictions.

"If we cannot enforce consistent application of international standards, the result is very unlikely to be more unconstrained global financial activity of the sort we saw before the crisis. Rather it is likely to be the further rolling back of financial globalization to the detriment of the global economy as national regulators feel compelled take local action to protect their own jurisdictions."

Finally, Jon highlights the shift in prudential supervision to focus more intensively on firms that pose the greatest risks to financial stability. The UK's Prudential Regulation Authority, for instance, takes a judgement based forward-looking and proactive approach to supervision, not just of the activities of firms, but of the quality of governance at firms.

"The aim is not that the supervisors should run firms. But they should not be shy to question if executives and boards have the right capabilities, if they understand the business model and the particular risks to which it is exposed and, overall, whether that business model can be operated successfully while managing the risks it entails."

Turning to the impact on industry from the international reform programme, Jon observes that the most marked change has been in the increase in amounts of capital that firms are required to hold and, as a consequence, much reduced levels of leverage, which in turn will reduce shareholder returns.

A second big change is the rolling back of the implicit taxpayer subsidy from firms that are deemed too big to fail, which is driving up banks' cost of funding. "Taken together, lower levels of leverage and the removal of the implicit taxpayer subsidy will mean changes to banks' business models. It has started to happen, particularly in the US, but there is a long way to go."

One driver of low return on assets has been low levels of long-term interest rates, which have dragged on some banks' net interest margins, though these should improve as the economy recovers and monetary policy returns to more normal settings.

Another driver of low returns on assets and equity, according to Jon, is the fact that pay has not adjusted to the smaller returns banks are now earning. Banks' pay bills have been taking a larger share of a smaller pie, relative to shareholders. That may reflect the expectation that returns in banking are set to increase in future. But Jon concludes that given lower levels of leverage, it is unlikely that returns on equity will return to pre-crisis levels and pay bills may have further to adjust.

"It is important, in seeking to restore returns, that banks and investors do not think in terms of 'back to the future'. With less leverage and more liquidity in banks, required returns ought generally to be lower than prior to the crisis. Trying to offset that by taking excessive risk or evading regulation will not, I think, be tolerated in the new world."