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A macroprudential approach to bank capital: serving the real economy in good times and bad – speech by Alex Brazier

In a speech to the Institute of International Bankers Annual Washington Conference, Alex Brazier, Executive Director for Financial Stability Strategy and Risk, explores the framework of capital requirements for UK banks which was finalised by the Financial Policy Committee in December 2015.

Alex begins by observing that investors' questions about returns have not translated, as they have done before, into questions about resilience. When UK bank price-to-book ratios were this low in 2009, senior unsecured debt spreads were over 350bps - compared to 73bps today. Underlying that is the transformation of bank capital. In the 2015 stress test, banks absorbed losses of £37bn – over twice the losses of the system in the crisis – even while continuing to grow credit to the real economy.

In December, the Bank of England gave a clear statement about the appropriate baseline level of capital for the systemic part of the UK banking system. Across major UK banks, no less than 3.75% of total assets should be funded with tier 1 capital. On current measures of risk, we expect these banks to fund no less than 13½% of risk weighted assets with tier 1 capital.

Alex says that "after a long march to build capital strength, UK banks are within a hair's breadth of that [expectation] today. And the rewards of greater resilience are being reaped".

It was obvious in the aftermath of the crisis where bank capital needed to go. Up. A lot. And with market confidence so low at the time, more capital not only boosted resilience, it also was needed for lending to resume. Alex emphasises that "capital was good for resilience and good for growth".

However, after a point, another unit of capital buys a much smaller fall in the probability of bank failure. And the evidence that higher capital requirements can push up bank funding costs – costs which will be borne by real borrowers and real savers - cannot be ignored.

How to best protect the real economy without holding it back? The UK answer has three parts.

First, to protect the economy from the consequences of bank failure. And to do so at minimal economic cost. Effective bank resolution unlocks this, opening the door to preserving the functions of failed

banks without recourse to the taxpayer. The G20 agreement on Total Loss Absorbing Capacity (TLAC) standards is “a game changer because it hardwires the recapitalisation of failing banks”. Rapid recapitalisation of failed banks speeds economic recovery. International estimates suggest that the removal of the ‘too big to fail’ subsidy cuts the risk of failure by a third. Alex says that “it is essential that efforts to ensure even the largest banks can be resolved remain on track”.

But even with an effective resolution backstop in place, the costs of systemic bank failure are far from insignificant.

So the second part is a baseline capital standard that makes the economic disruption caused by a weak banking system extremely rare. But not more so. In the UK, even the two biggest failures of the crisis suffered losses comfortably within the baseline described above. Going further could have a sharply diminishing further effect on the probability of banking failure and could run the risk of economic cost. The biggest banks will be subject to a baseline capital buffer of nearly 5% of risk weighted assets, sitting on top of an 8.5% hard floor for tier 1 capital. This “gives room for systemic banks to absorb losses without being forced to close their doors and cease their service to the economy. It achieves not just greater bank resilience, but greater resilience of service to the macro economy”.

But it would be a mistake to think that a 5% capital buffer is always and everywhere the right one.

So the third part is flexibility. Flexibility to raise capital buffers if the threat of future losses grows, and cut them again if those threats materialise of recede. This avoids what might otherwise be a need to capitalise the system for the very riskiest times, all the time. Alex explains that the Bank is “seeking to match the size of those [capital] buffers – the strength of defence – to the threat of future losses as they change over time”. With the stress scenario varying systematically with our assessment of the risks, the stress test will guide as to how – given banks’ exposures – the Bank’s judgement about the risks should be reflected in capital buffers. The Bank will have a bias to acting early and gradually. It expects to be adding around 1% to the countercyclical capital buffer on UK exposures of all banks, even before the overall threat of future losses looks high. These capital buffers will go as far as needed to ensure banks’ defences keep up with threats if they grow. And if threats materialise, or shrink, the Bank will reduce its expectation for capital buffers back towards the baseline level.

Flexibility extends beyond moving capital buffers up and down. We are learning about the effects of higher capital and leverage requirements. Developments such as the signs of reduced liquidity in sovereign repo markets are prompting us to assess whether targeted amendments to the design of regulations could benefit the real economy, without exposing it to more risk. Alex says that “the design of new requirements was macroprudential. So must be their implementation”.

Alex concludes that “with resolution regimes well advanced and game-changing bail-in principles established, the upward march to higher capital levels can soon reach the new baseline. A baseline that, on what we know today, protects the real economy without unnecessary risk of holding it back. And with the flexibility to adapt and continually align resilience with threats, we have a compelling answer to the question

of how to marry prudence with macroeconomic sense. So that you can protect and serve the real economy in good times and bad”.

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