Recent banking difficulties

In a speech to the Chartered Institute of Bankers in Scotland,[1] *the* **Governor** *considers some of the reasons which have been advanced for the recent poor performance of the banking industry worldwide. Part of the explanation, he suggests, may lie with the banks: in a climate of increased competition, and lulled by the strength and persistence of the economic upswing during the late 1980s, they may have become less sensitive to cyclical risks. But at the same time, the downturn that followed was more severe than the banks might reasonably have expected. The recent banking difficulties were not, the* **Governor** *argues, a failure of supervision: by giving warnings supervisors can try to ensure that banks are alert to the risks of particular lending, but their job is not to second-guess the management of individual institutions. Action was also taken by supervisors on a global level to strengthen the stability of the banking sector with the 1988 Basle Capital Accord which set a uniform minimum ratio for internationally active banks. Instead, the* **Governor** *suggests that much of the banking sector's current difficulties reflect the pronounced macroeconomic fluctuations, shared by other countries, of the boom years of the late 1980s and the subsequent recession. To avoid a repetition of these difficulties, the* **Governor** *argues that we need, above all, a stable monetary environment in which policy is geared towards avoiding macroeconomic shocks; and to continue to promote a stable supervisory environment for banks worldwide. For their part, bankers need to pay closer attention to the control and pricing of risk in the deregulated and highly competitive conditions of modern banking markets.*

I should like this evening to consider the recent performance of the banking industry. Internationally, banking has expanded remarkably rapidly over the past two decades, with total cross-border lending growing from $360 billion in 1974 to $6,300 billion in 1990. Recent years, however, have seen something of a slowdown, even in some areas significant retrenchment. This reflects the difficulties which the industry has been experiencing in the early 1990s. Provisioning has reached record levels in the United Kingdom and the United States. As a proportion of lending provisioning levels on non-ldc exposures have reached 2.4% and 1.25% in those countries, which is exceptionally high by the standards of the previous recession in the early 1980s. There have been a number of casualties—either failures or forced marriages. Banks across the world have seen their credit ratings reduced by the major agencies, and have suffered the ignominy of seeing some of their customers—and not just the bluest chip customers—able to borrow at finer rates in the capital market than they can themselves. In Scandinavia the banking system itself has required government support. The level of profitability in banking generally and the need to maintain or improve the capital backing of the business has raised doubts about the industry's capacity to finance recovery.

Such developments may lead some to believe that the outlook for the banking industry is bleak but I think it is easy to overstate the concerns; we should not forget that recessions are inevitably tough not just for commerce but also—and indeed as a result—for bankers. Rather than seeking to frighten you this evening with grim forecasts, I want to reflect on the causes of the recent poorer performance of banks worldwide and to encourage you to consider what lessons may be drawn from it. There are, no doubt, many reasons why individual banks face difficulties in 1993, but it is not these which I will discuss tonight. What I want to do is to look instead at some of the explanations that have been advanced. There are essentially three: that the banks were foolish, or allowed themselves to become so in the more competitive environment of recent years; that the supervisors were careless; or that macroeconomic policies were short-sighted.

Banks' behaviour following deregulation

Let us look first at the proposition that the banks brought it all on themselves. This is, I should say, an extremely popular argument, at least among non-banks, and deserves to be properly analysed. It can be argued, particularly with hindsight, that banks expanded their balance sheets too rapidly, notably by lending to risky businesses (including property companies) at margins that did not properly reflect the risks that were being taken on.

Undoubtedly an important factor in recent history is the increase in competition in banking, facilitated and indeed encouraged, though I would not say caused, by financial deregulation. In the United Kingdom, the most important step was the abolition of Exchange Controls in 1979; direct controls on bank lending were removed shortly afterwards,

(1) On 18 January 1993.

and the final element in what used to be called directional guidance disappeared in the mid-1980s. These were, however, local manifestations of a much broader global pattern. The increased competition in banking owes a great deal to developments in information technology, to financial innovation, and to the integration of previously distinct financial markets—local as much as international. It is not of course new: in this country at least, it is simply the latest stage in a process that could be said to have started with the abandonment of quantitative monetary controls brought about by the competition and credit control regime in 1971 and encouraged by our traditional openness to banks from overseas. And another particular domestic factor was the growing involvement of banks in the mortgage market and of building societies in providing banking services.

It is certainly true that there was a very pronounced reduction in bank margins during the 1980s. Moreover, although there have been many claims to the contrary, margins have in fact not risen very much in the early 1990s. And, given their new freedom and a growing economy, it was not surprising that banks sought to increase the volume of their lending. Of course, you need two parties to make a loan, and the lending increase would have been nothing like as strong if the economic conditions of the day had not given borrowers too the confidence to take on substantially increased gearing. Even so, the banks were in expansionist mood; and it is a brave director who advocates a low growth strategy when the competition is aggressively putting on book, or who holds out against matching lower prices which his competitors appear able and willing to offer. It may well be that banks, lulled by the strength and persistence of the upswing, became less sensitive to cyclical risks.

There are several questions bankers must ask themselves. Do they really pay sufficient attention to the lessons of history—for example the property crisis of the early 1970s? Did they really monitor the credit criteria which had served them well in the past? The importance of careful attention to credit control, particularly by senior and experienced staff, cannot be emphasised too often: this is what the famous management textbook by Porter would call 'sticking to the knitting'. And were the incentives given to loan officers really appropriate, or did they encourage new business at the expense of *sound* business?

One of the casualties of the more competitive environment has been the stable and supportive relationship that used to exist between companies—especially middle-market companies—and their bankers. As companies found it easier to shop around for credit, those relationships tended to become more fragile, even to break down. With customers displaying less loyalty to their bankers it was not surprising that the banks came to view some of their relationships differently. I find it hard to blame the banks for this: as I remarked at this dinner four years ago, a company that chooses to pursue a transactions-based approach, shopping around for the cheapest deal and playing off bank against bank, cannot expect its lenders to view the arrangements in any different light. But I think that both bankers and their customers have now come to see the merits of that more traditional approach, and that may well be one of the lessons well-learnt from the current recession.

Supervision

It may also be asked whether there was a failure of supervision, either in respect of individual institutions or more widely. Supervisors, of course, cannot and should not second-guess the management of individual institutions. They seek to ensure that institutions have adequate capital and liquidity, fit and proper directors, managers and controllers and that there are systems and controls to monitor and contain the risk assumed. While the individual judgements, the knowledge of the customers, and the development of the competitive strategy may be questioned by the supervisor, the decisions themselves must remain the responsibility of each institution. Being a supervisor does not make me a shadow director of 500 authorised banks, nor should it.

But that does not mean that I cannot form views and express them, either privately or publicly. Many of you will know how closely our supervisors questioned banks in the 1980s about their exposures to property and to highly leveraged companies. Our concern was not necessarily to change the banks' strategies, but to ensure that they were alert to the risks and were monitoring them effectively, and to ensure that we too could understand the risks and set our capital requirements accordingly.

Of course, at a more general level—that of the banking system as a whole—supervisors become more closely involved in assessing risks, and during the 1980s much work was undertaken to standardise the management of, and where possible to reduce, the risks in the world banking system. The concern, in a nutshell, was whether banks were running more risk, both on and off their balance sheets, than their capital could realistically support. This had to be tackled at an international level because the process was in part driven by inequalities in international competition and regulatory treatment. The upshot of that debate was the 1988 Basle Capital Accord, which set a uniform 8% minimum ratio for internationally active banks; this came fully into force at the beginning of this year.

In the United Kingdom, the Basle agreement was implemented in 1989; indeed, British banks, by and large, already met the Basle requirements; and the capital strength of our banking system has enabled it to absorb the high levels of provisioning of the past two years. Elsewhere, the Basle agreement did imply some increase in the capital required of banks abroad, or a reduction in their risk-taking, or both. Some countries' banks had to make quite significant adjustments, and this has undoubtedly fuelled a contraction in the international banking market as measured by interbank transactions.

Supervisors did come under some pressure to relax the Basle rules or to delay their implementation. It would have been wrong to accede to such pressure. The arrangements were put in place precisely to ensure that the world's banking system was sound and capable of withstanding the pressures of a downturn. To permit banks, in effect, to run their affairs in a riskier way is no answer to the short-term pressures of financial fragility, and has long-term implications which I think supervisors—and those markets which assess bank risk—would find quite unacceptable. And as I have said, the UK banking industry is well-placed to absorb the pressures of the longest and deepest recession in many decades, and to meet the financial demands that its customers will put on it when the upturn becomes more firmly established. Its capacity to do so will of course increase as profitability returns.

Macroeconomic management

That leaves our third potential culprit, macroeconomic management. And here I cannot resist quoting from the redoubtable Colonel Torrens: he was one of the advocates of the 1844 Bank Charter Act which imposed on the Bank of England one of the firmest and longest-lasting monetary rules in our history—the gold standard. Colonel Torrens remarked that the Act would be 'delusive' unless it did 'effectually prevent the recurrence of those cycles of commercial excitement and depression *of which our ill-regulated currency has been the primary and exciting cause*'. And I am bound to say that I find his analysis rather persuasive: a stable financial system, stable and sustainable economic growth, depends on the achievement by the authorities of monetary stability and the avoidance of bouts of inflationary pressure which debase the currency and impart such uncertainty to business life.

The weakness of some asset prices in recent years, and the other features of the recession from which we may now be emerging, needs to be set in the context of the boom years of the late 1980s. I have spoken on other occasions of the analytical and policy mistakes that caused us to be too slow to respond to the overheating in our domestic economy, and consequently meant that the tightening, when it did come, had to be so sharp and so painful in its consequences.

But other countries made the same mistakes and the tightening here coincided with similar moves in other major countries—notably the United States, Japan and (for its own specific reasons) Germany. These policy changes delivered a significant shock to the world economy, which, coming after a period of considerable buoyancy and optimism, was severe. It had not been expected by the banks or by their customers and many financial arrangements that had seemed reasonable in the heady days of the 1980s, reasonable even against normal expectations of cyclical behaviour, were fatally undermined by the length and the depth of the recession. Macroeconomic fluctuations of this scale are highly disruptive to all participants in the economy—banks, industrial companies and individuals. The lesson for policy-makers is that we can never afford to take risks with stability. This is now widely understood and I hope the lessons have been learnt. And as you know, following our withdrawal from the ERM we have made the commitment to price stability an absolutely explicit objective of policy.

Conclusions

The key lesson that I draw from this story is that we need, above all, a stable monetary environment, one in which policy is geared to the achievement of price stability, and which avoids generating macroeconomic shocks, whether of the pleasant or the unpleasant variety. And we need to continue our work to promote a stable and predictable supervisory environment for banks worldwide. The Basle agreement forms an essential base for this, and in coming years it will be amplified with new and more sophisticated treatments of the market risks run both by banks and securities firms.

Over and above this, there are lessons for bankers. Close attention to the control and pricing of risk is a theme that I have brought to your attention before now, but I make no apology for doing so again. It is at the heart of the banker's professional life, and no amount of competition or marketing strategy should ever divert us from it.

I have seen it suggested that deregulation was an appalling mistake which should be reversed: that there should be a range of monetary, supervisory and even fiscal measures to put some of the grit back into the machine. My view is that the process was *inevitable*, is *irreversible* and is still in any case *desirable*. Inevitable, because of international trends not least in information technology and the freedom of movement of capital. Irreversible, because we simply could not, even if we wanted them, reimpose the exchange controls that would be needed to isolate our banking system from the rest of the world. And desirable, because industry and commerce is best served by a banking industry which competes to provide the best and most cost-effective services.