Remarks by

ANDREW BAILEY

EXECUTIVE DIRECTOR FOR BANKING SERVICES AND CHIEF CASHIER

BANK OF ENGLAND

# FINANCIAL REFORM

THE LORD MAYOR’S CITY BANQUET, LONDON
21 September 2010

**REMARKS ON FINANCIAL REFORM**

My Lord Mayor, Ladies and Gentlemen. Can I thank you Lord Mayor on behalf of the Bank of England for inviting us to contribute to your regulatory Banquet. Adair and I first met in our current roles when he was literally I think in his first day on the job, which was incidentally the weekend of the resolution of Bradford and Bingley. It is a great relief that the experience of that weekend did not cause him to have second thoughts, because we have all benefited from the leadership that he has provided since then. On the subject of the time of year, I should add that being here in September, enjoying your hospitality Lord Mayor is a distinct improvement on some recent Septembers when we were recovering banks. An evening at Mansion House beats the pizza and all night session at the Bank of England by a very long way.

I am going to speak tonight about why the public interest in the stability of the financial system matters to all of us. Calmer times are the necessary environment for the task of re-building financial stability. It is a task that belongs to all of us, and it is certainly not just the task of regulators, central banks, or the authorities more generally. We cannot achieve and maintain financial stability on our own. Above all, it requires recognition of the public interest in financial stability.

Thirteen years ago, at the annual banquet for the Bankers and Merchants of the City, in June 1997, just over a month after the Election of that year, commenting on the new regulatory arrangements, the then Governor of the Bank, Eddie George, said that the direction of financial services regulation was driven in part "by a rising tide of public expectations in terms of both the prudential and the behavioural standards required of financial intermediaries". Eddie George was undoubtedly correct that the public will and should expect more in terms of the standard of business of firms. But history now tells us – painfully – that on the way to higher standards there was a terrible lapse in which too many people in our industry forgot that preserving financial stability is the duty that we all owe to the public. The fact of the matter is that the public has every right to expect us to act in their interest.

This means that we cannot have attitudes which put short-term gain first on the basis that the stability of the financial system can be tomorrow's objective, for the next person. But in order to achieve this, we need to be very clear on the benefits of financial stability. One of the questions I get asked most frequently is how we will ensure that the lessons of the crisis stick. We can only achieve this if the case for financial stability is well understood. There is a very clear parallel here with monetary policy. The success of monetary policy is founded on public acceptance of the benefits of sustained low inflation. That did not come easily, as the experiences of the 1970s taught. But once that public acceptance and interest started to become embedded, the task of monetary policy became easier – not easy, but easier. In this important sense, no such policy making apparatus can be independent of the will and interest of the public. And nor is the task of ensuring public acceptance ever finished. Monetary policy has demonstrated that a firmly established and lasting institutional framework for policy making is a necessity.

But exactly what is the public interest in financial stability? This can be a harder question to answer than for monetary policy, because financial stability cannot be so readily summarised in a statistical series. There is a temptation to generalise that you certainly know it when it isn't there. I think there are at least four things that the public should want as part of the overall stability of the financial system. First, that they can have confidence in the safety and soundness of the institutions that hold their money and savings and write policies to protect them against risks. Second, that those institutions have the capacity to undertake the stable and sound provision of financial services to the economy, including of course lending. Third, that the system does not do business and exist on the basis of an implicit commitment that the State will have to use public money, the public's money, to bail out firms that get into trouble. And fourth, that the public can place trust in firms and markets based on their reputations and the transparency of their dealings. Regulation is important and it can help to foster that trust, but it cannot substitute for the trust that the public needs to have, in firms and markets. The State is not there to support the industry, and regulators are not there to substitute for trust in and the reputation of firms and markets.

Some important principles follow from the identification of the public interest in financial stability. First, a competitive financial system can only exist if it is rooted in stability: competition and stability cannot be traded off in a binary sense. Second, the public should not define financial stability as preventing all financial firms from failing. In other sectors of the economy firms fail without putting at risk the funds of the public or taxpayers' money. We will not truly have solved the too big or important to fail problem and thus the public money problem until we have tools at our disposal which enable us to resolve large institutions if they get into trouble. This will create the right incentives for risk management. And third, regulators must use their judgement to mount a robust challenge to stop dangerous business models and investment practices. This last point is vital. Financial services is an industry where arbitraging rules and regulations is habitual, even addictive. Money is made this way. We have no desire unduly to suppress enterprise and innovation, but doing the right thing and preserving financial stability means accepting the spirit of the rules. This is not a small change. Let me give you one important example. The new Basel agreement emphasises loss-bearing capital – capital that can bear losses outside insolvency. It must stay that way, and not be chipped away under the banner of arbitrage masquerading as innovation. I have been asked a number of times in the last week whether I think that the new Basel agreement sets capital requirements high enough. My answer is that if the capital buffers are in future genuinely loss bearing capital with no tricky wrinkles, and we keep to this outcome, we have taken a good step forward. Sadly, that was not the case with Basel 1 in the late 1980s when I started out as a banking supervisor.

The consultation document on regulatory reform in the UK published by the Government at the end of July emphasised the need for a judgement-focused approach by regulators “so that business models can be challenged, risks identified and actions taken to preserve stability”. What does this mean?

A primary focus of the new Prudential Regulation Authority will be on determining whether the business models, governance and systems and controls of firms will enable them to satisfy the public interest in financial stability in future states of the world. That requires both a macro and micro prudential view, and for the two to come together to reach forward-looking judgements on whether financial stability is likely to be preserved in a range of plausible future outcomes. This range of outcomes is important, and it also underlines the need to build up the role of stress testing. Such testing is an important mechanism for describing the forward-looking view though it should continue to evolve from a binary pass-fail world into one where it is a toolkit to test a range of possible future states of the world and thereby judge the wider resilience of firms.

The PRA will exercise judgement in the supervisory actions it takes, so that firms are likely to be able to meet its objectives, policies and rules over the medium term horizon. Firms will need to demonstrate to the PRA that they are robust to a variety of states of the world, including unanticipated stress scenarios. However, since it is not possible for any forecast to cover all possible outcomes, there will always be some probability of firms failing. Working with the Bank of England’s Resolution team, the PRA will need closely to integrate recovery and resolution planning within its supervision; and in my view should embed a proactive intervention framework akin to the US Prompt Corrective Action within its supervisory approach to deal with the inevitable situations where firms get into the danger zone. Above all, these tools should support competition in the industry, by accepting that there will be winners and losers.

In two years' time, we will have a new system of financial regulation in the UK. Those of us involved can assure you that the transition is not a small task, but I can also assure you that the Bank is fully committed to working with the FSA to ensure a smooth transition.

There is a great deal to be done to implement the new system of regulation, to articulate and build the public interest in financial stability, and thereby to improve the stability of the system itself. Basel III, macroprudential tools, countercyclical buffers, are all things that Adair and I get excited about. They are important foundations of good policy. But on their own they don't win the public interest argument for financial stability. To do that, we have to build the case that the industry will serve the needs and interest of the public. The authorities cannot do this alone. Building confidence in the financial system takes effort and time. It is a common goal and in the interest of everyone.

Lord Mayor, the government of the City of London is an important part of the fabric of financial services, and we appreciate all that you do to support the industry and the objective of stability in the financial system. It is therefore my great pleasure to propose a toast to the Lord Mayor and Lady Mayoress.