Speech by

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Thank you for inviting me to speak today. My original title was something of a holding strategy, or you may say a breach of trades' description. Things have moved on and today I am going to talk about two subjects: the future of prudential supervision and the new role of the Bank of England; and the future resolution of problems in large banks. I will start by talking about the newly-announced changes, and then say something about the resolution of large banks when they experience problems.

Although I want to talk about the future of prudential supervision, I will employ some history, which I think provides important context. Twenty years ago, when I was working in the policy area of banking supervision at the Bank of England, we spent a lot of time on the subject of the architecture of supervision. Bear in mind that in those days the Bank supervised banks, but only for prudential purposes, the Securities and Investments Board and the Self-Regulatory Organisations were responsible for securities, asset management and all related activities, the Building Societies Commission for building societies, and the DTI for insurance companies. It would be hard to describe this as a planned and logical structure; rather, it had evolved, often in a reactive way to problems. Meanwhile, the big financial institutions had become increasingly diversified in ways that introduced a patchwork of supervision for each firm. Our thinking was therefore focused around what we called functional versus institutional supervision (do you split firms' activities by function, as the system then did, or supervise all activities in one place?) Key challenges were how best to achieve effective so-called consolidated supervision of the whole group, and thus how to achieve effective co-ordination between the various supervising bodies. The most I can say about this system is that it had to be made to work.

Let me say two things about the role of the Bank of England at the time. First, the Bank's role in banking supervision had grown out of its role in providing liquidity to the banking system, and thus by acting as lender of last resort. In other words it came out of the counterparty exposures that were the natural product of its role as the central bank. Second, the Bank did not carry out any conduct of business or consumer protection supervision of the banks. The public sometimes didn't like our refusal to do this, and it became an increasingly difficult line to hold, but that was a very clear

interpretation of what a central bank should, and should not, do in order to achieve its prudential objectives.

There has, naturally, been quite a lot of commentary on the Bank's record as a supervisor in the wake of the announcement of the new arrangements by the Chancellor. My own view on this record is that the Bank was relatively good at the prudential competencies of capital adequacy and liquidity, but it was relatively weak at identifying and dealing with fraud and abuses of risk controls. The world is now a very different place to the 1990's, and it is very important to be clear that the new organisation of supervision will not be a return to the way it used to be done at the Bank. There were certainly good elements of that approach, but a slavish return to the past would be a mistake.

It is also important to be clear that we are not trying to design a regime in which no bank should ever fail. That's not what happens in other industries and it would not create the right incentives around risk taking. Moreover, it tends to follow that if failure is prevented, so is new entrance to the industry, and then we run the risk of having entrenched interests in an industry that does not meet the public's wishes in terms of service.

But why should the Bank of England take on this role of prudential supervisor? Let me start again with some history, but this time from 1997 onwards. The changes instituted in 1997, with the creation of the FSA as the unitary supervisor, did on the face of it deal directly with the problem of having to make the old patchwork system work. But they also separated the Bank from its role in supervision, while leaving it as the central bank responsible for providing liquidity to banks, and thus in its role as lender of last resort. This point was dealt with in the Memorandum of Understanding established in 1997 by stating the Bank would be able in exceptional circumstances to undertake official financial operations in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system. The MOU also stated that the Bank and FSA would each take the lead on all problems arising in their area of responsibility. The lead institution would manage the situation and coordinate the authorities' response.

In my view there are two problems with this approach. First, of necessity the responsibilities of the Bank and the FSA overlap in some areas. The most obvious is liquidity: the FSA is responsible for prudential supervision of liquidity, while the Bank is responsible for lender of last resort and the provision of liquidity insurance to the banking system. Second, the Government, in the form of the Treasury must be responsible for the use of public money. Creating the Prudential Regulation Authority will provide a means to tackle the issue of overlapping responsibilities. It will not on its own though solve the reliance on public money – I will come to that later.

What about the lessons from the past, and particularly how we should handle the creation of the new PRA? For me, there are three guiding principles. First, that the process must be harmonious and constructive. Hector and I are fully committed to working together to get the right outcome, which is a robust, fair and transparent system of prudential supervision. And for the Bank and the FSA, there are no winners and no losers in this process. It’s a big job, and its one for the FSA staff and the Bank staff to do together. The PRA will be part of the Bank of England, and it will have a close link with the Financial Policy Committee to be established in the Bank. But the PRA’s role will be distinctive. Its approach and culture will be built around judging and dealing with the build-up of excessive risk in the financial system, and thus the robustness of the business models of individual institutions. This approach does require the exercise of skilled judgment and the ability to use that judgment to influence management and boards. It will not shirk that responsibility or be brow-beaten.

The second guiding principle is that this job involves being very clear on roles in the future. The various parts of the system must work together, but they must do so on the basis of having clear roles and modes of operation. The part of the 1997 reforms that has worked well is the framework for monetary policy. It was very clearly defined. Institutions and their design do matter in terms of successful policy-making.

My third principle concerns the Bank of England. We have been portrayed as an ivory tower, and out of touch with the financial sector. When it comes to the culture of the Bank, there is more to us than you might think.

We have two core purposes, monetary and financial stability. This is the bedrock of the Bank of England, and it is a very good foundation. We originally put these core purposes in place 20 years ago to overcome the rather disparate sense of purpose that had existed. But we do a whole range of things to make the core purposes a reality. Let me illustrate this with my own area of the Bank. Every day we operate settlement of the payment systems, which is around £750bn; we manage around £250bn of collateral as a consequence of the liquidity provided to banks by the Bank of England; we manage the distribution of the 2.6 billion Bank of England banknotes currently in issue, amounting to nearly £50bn in value; we are the regulator of the note issue in Scotland and Northern Ireland; we are working with the FSA and the pilot banks involved in putting together the first recovery and resolution plans (formerly know as living wills); we act as the resolution authority for failed banks (which we had to do last year for the Dunfermline Building Society); we provide banking services including emergency liquidity assistance when that has been needed and activities to mop up the after effects of problems such as Lehmans; we have the second largest gold repository in the world supporting the London gold market; and when called upon we provide the so-called London Approach in which the Bank of England uses its authority to assist in concluding debt restructurings or other financial workouts for companies where an extra degree of creditor co-ordination is called for. And a common feature of this list of activities is that we work closely with banks on all of them. You may also deduce from this that I am immensely proud of what my colleagues have done over the last three years.

The Bank of England will change as a result of the creation of the Financial Policy Committee and the Prudential Regulation Authority, of course it will. But we don't start as the ivory tower that I sometimes read about. We are closely focused on our core purposes, rightly so, but to achieve them we do a number of things.

Now I want to move on to say something about the future resolution of problems in large banks. My comments draw heavily on my experience of running the Bank of England's resolution work over a number of years to sort out problems and particularly failed banks. My first resolution was in 1994, when the Bank acquired National Mortgage Bank, the largest failure in the early 1990's.

I said earlier that the last three years have demonstrated that in our current system the Government in the form of the Treasury has had to take responsibility and use public money to sort out problems of solvency where those involve banks that are large and important to the financial system and thus the wider economy. Several very important messages stem from this.

It is unacceptable that any industry should operate on the basis of such a dependency on public money. I have not met anyone who disagrees with that proposition, but that does not of course solve the problem. Part of the solution lies in the quantum and form of capital issued by banks. The Bank of England's most recent Financial Stability Report emphasised that UK banks have raised their capital and liquidity buffers substantially, which has helped them to weather recent tensions. But they need to maintain this resilience while refinancing substantial sums of funding in the period ahead and providing sufficient lending to support economic recovery, something that is in their collective interest. Over time they will need to build larger buffers to meet more demanding future regulatory requirements, notably the new Basel regime. But the Report was very clear in stating that an extended transition to the new quantums of capital and liquidity will enable banks to build resilience through greater retention of earnings, while sustaining lending.

The issue with the form of capital represents a mistake that was made in the late 1980's when the Basel I framework was put together. This allowed instruments to count as capital – including subordinated debt – which do not absorb losses except when a bank fails and enters an insolvency process. But this approach would only work if we could be sure that banks can enter insolvency without putting the surviving system at risk. But here we run into the Too Big or Important to Fail problem. As the recent record shows, large banks currently cannot safely be put into insolvency. And so public money has had to be used ahead of losses being absorbed by so-called capital instruments. That is wrong. Now I know that holders of these instruments will counter that they have taken losses through non-payment of coupons and buy-backs. But these are very messy, unpredictable and sub-optimal processes. So, the first message is that the capital instruments issued by banks must absorb losses in situations either where the bank is preserved as a going concern, or where it is wound down through the resolution process as a gone concern.

Fairly naturally, this brings us to the issue of whether banks should be restructured to facilitate the end of the Too Big/Important to Fail issue. If we are going to do that, we need to take one or both of two approaches. The first approach is to separate out the deposit base that should be protected and restrict that to narrow banks that have an appropriately low probability of failure. The permitted asset classes would be high quality, and the return to depositors would reflect that. We used to have such a thing in this country. They were called the Trustee Savings Banks. It would be interesting to see what the take-up by depositors would be if we had them today.

The second approach to dealing with Too Big or Important to Fail is to require banks to restructure and downsize themselves so that they can fail. My view is that even with narrow banks we would need this type of approach, because the remaining "non-narrow" section of the industry would not be guaranteed to pass the test of being unimportant enough to the surviving system to fail. Remember, Lehmans wasn't a bank in most countries.

What do we mean by restructure to allow failure? This is a crucial question. Wearing my resolution hat, the test here must be rigorous. A Volcker Rule, or similar restriction, doesn't turn a bank into something that can be dealt with if it fails. Don't get me wrong, there are good arguments on risk grounds for adopting such rules, but on their own they do not solve the Too Big/Important to Fail problem. They don't turn banks into entities that can be dealt with over a weekend using the tools of a resolution regime. So as the head of the resolution regime I want more because with any solution we must be confident that we could and would use the resolution tools on the bank in question without either damaging the financial system or resorting to using public money. But I am not convinced that there is a solution along these lines which leaves the industry fit for purpose.

There is another approach to solving the Too Big/Important to Fail problem. I mentioned earlier that one of my roles involves the London Approach, where typically a debt restructuring is undertaken for a non bank company. What happens here is that creditors agree to restructure the debt of the company on the basis that this offers better value than an insolvency.

One way or another there is debt forgiveness, so that lenders to the company bear the cost. They do this because – in technical terms – they believe that the loss given default would be higher in an insolvency. But typically it takes some weeks or months and much haggling to achieve this outcome. When I get involved wearing the London Approach hat, it is often the final stages, when a few heads get politely knocked together. The reason I mention the elapsed time is that with a non bank that is possible – the creditors usually cannot run. But of course with a bank this is not possible. A loss of confidence in the bank causes the creditors to run very quickly. So with banks – now wearing my bank resolution hat – everything has to happen very quickly, over no more than a weekend. I call it speed M&A – it is not good for the nerves.

But the non bank solution has the advantage of being a market solution – it doesn't involve public money. The idea for bailing in banks, or creditor re-capitalisation, has therefore arisen as a way to bridge these two positions – to seek to achieve bank recapitalisation using speeded up non bank tools. The importance of this is that our current resolution regime tools, outside public ownership, are really smaller bank tools. We need something to give us a credible chance of covering the losses and most likely recapitalising a big bank. Such an event should avoid the use of public money. The idea is that the whole of the capital structure could be written down if necessary, and beyond that it would be possible either to haircut a portion of unsecured creditors, or (more likely in my view) carry out a partial debt equity swap. It sounds radical, but it isn't in the non bank world.

My own view is that having a resolution tool which would allow the authorities to impose this solution would focus the mind of a bank's managers to put in place buffers to lower the risk of a write-down or conversion of their claim. That would be a good thing, with the resolution tool acting as the back-stop but the preference being for a prior solution to be found.

This is clearly a very big departure in the world of bank resolution, and there are very big issues to work out in order to determine whether it can be a reality. The advantage is that it tackles the use of public money problem head on. It is worth serious investigation, something that is now happening in the work of the Financial Stability Board.

I want to finish on a different, and unfortunately sad, note. Earlier this year a very fine ex-President of the BBA passed away. I am referring of course to Brian Pitman. I consider myself very fortunate that over the last two or so years our paths had crossed from time to time and I had thereby benefited from hearing Brian's thoughts on the causes and remedies for the financial crisis. The last time I saw Brian was about a month before he passed away when we were the speakers at a dinner for a small group of senior bank executives. Brian was typically trenchant – my role was to egg him on to state home truths, and he did so on remuneration and of course his trademark subject of creating long-term shareholder value. Brian commanded his audience. Nobody argued back. It was a reminder – poignant as it turned out – of the respect with which Brian was held. Brian was upset by what had happened to change the reputation of banks. He found it hard to believe that some senior figures had let his industry down so badly. In our respective roles, Brian and I tried to resolve Northern Rock without recourse to public ownership. We failed. Afterwards I said to Brian that it was probably inevitable and perhaps we tried for too long. Brian said no – we owed it to the customers, staff and the taxpayers to give it our all. It was a duty. Let's not forget the principles and values that Brian stood for.