



BANK OF ENGLAND

Speech

Macro and Microprudential supervision

Speech given by

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Introduction: redrawing the Social Contract for banking.

The past month has been pretty busy. It has seen the publication of the draft legislation for reforming the UK's regulatory architecture; the launch of the high-level blueprint for banking supervision under the future Prudential Regulation Authority; the Chancellor's comments on the Vickers Report; and the first meeting and decisions of the Financial Policy Committee, the UK's new macroprudential body. That's just in the UK! There is plenty going on internationally too. Next month the G20 Financial Stability Board will publish two consultative papers: one on the greater loss absorbing capacity needed by systemically important financial institutions, and the other on overhauling resolution regimes to cope with distress at SIFIs.

It is understandably hard for the banking system and the market to make sense of how all this fits together. I therefore want today to organise it in terms of redrawing the Social Contract between banking and the rest of society.

Traditionally, the Contract was as follows. As deposit takers, banks are permitted to issue money, enabling them to profit by providing liquidity-insurance services to the rest of the economy. They earn a spread between the rate paid on transactions deposits and the rate charged on loans that, on average, more than compensates for credit risk. But the maturity mismatches inherent in bank balance sheets makes them susceptible to runs and so to collapse. And their role in the economy's payments and credit system makes their failure especially costly. In consequence, sound banks have long had access to liquidity from central banks; and they are also compelled by the state to join industry-wide deposit-insurance schemes that mutually guarantee the value of transactions deposits. Those state-sponsored measures reduce the probability of unwarranted failure, but they also increase the private returns to bankers and their shareholders by transferring some risk to the state. The final part of the Contract is, therefore, that banks' business should be subject to regulation and supervision, so that the state can influence the risks that banking poses to the wider economy.

In pretty well every dimension, that Social Contract was found wanting.

The regulatory regime was revealed to be riddled with design faults. Supervisors in many countries did not compensate for those regulatory flaws. And they even drifted away from focusing on the soundness of the system as a whole, to a narrower interest in consumer protection: a perverse development as consumers' most basic financial need is the safety of the banking system.

Central banks' liquidity-insurance facilities were also found in need of running repairs. And in some centres, notably the US, it turned out to be necessary for the monetary authorities to extend liquidity temporarily to non-banks.

Neither liquidity from central banks nor the availability of deposit insurance was enough to sustain confidence in ailing banks or to contain the economic costs of failure. Many banks proved to have fundamental problems of solvency or viability. But a number of countries, including most painfully the UK, were exposed as lacking regimes for absorbing the failure of even middle-sized banks. And no country was in a position to cope with the failure of its largest and most complex banks and dealers.

The profits from maturity transformation and leverage had been enjoyed, but the authorities' framework-regulation, supervision and crisis-management – had been found wanting. Partly because banking has evolved beyond the simpler structures contemplated when the existing regulatory framework was conceived.

It is timely, therefore, to review progress in redrawing the banking Social Contract. In particular, I shall describe the work underway to return banking supervision to its historic mission of systemic stability, and of the new Financial Policy Committee role in that.

Liquidity insurance and shadow banking

On central banks' provision of liquidity insurance, the Bank of England launched new permanent facilities in a series of steps from October 2008 onwards. Through our Discount Window, we stand ready to lend against a very wide range of collateral, including portfolios of raw loans meeting published criteria. Publication of use of the Window is delayed and is confined to aggregate, average use over a quarter, so I trust there is no need for use to be stigmatised. Following practice in the USA, we encourage banks to pre-position collateral with us. It is only prudent to do so. Banks' boards, as well as their supervisors, should take an interest in this as part of ensuring banks have sensible contingency funding plans. The Bank also holds a monthly auction of funds against a reasonably wide range of collateral. The size of those auctions could be increased to cope with stressed markets, and we are ready to do so where desirable.

Access to our liquidity-insurance facilities remains confined to banks, as monetary institutions. But as I noted earlier, non-banks – including money funds and finance companies – turned to central banks for liquidity during the 2007-08 crisis. The prevalence of non-bank banks as they used to be called, or shadow banks as they are now known, was a deep faultline in the international financial system. Things cannot be left where they are. The status quo was deeply unsatisfactory, and if we do nothing it will be made worse by the re-regulation of the banking system, which creates powerful incentives to reinvent the economic substance of banking beyond the perimeter of prudential regulation and supervision. The authorities internationally, led by the FSB and with the active involvement of Adair Turner and myself, are debating how to tackle the phenomenon of 'shadow banking'. A preliminary, but I hope substantive report will go to G20 Ministers and Governors in October. And in the UK, we will be helped by the FPC's responsibility to advise the government on when the perimeter of regulation needs to be altered.

Deposit insurance and resolution

The reforms of Deposit Insurance are hardly less important. In the UK, there is a push towards the deposit insurer, the Financial Services Compensation Scheme, being able to pay out within 7 days. The Bank attaches very high priority to this indeed. There is still work to be done. It will entail costs for banks. The weaker standard of 20 days being contemplated by the EU is a serious mistake. That will eventually become apparent when, somewhere in the EU, depositors in a failed bank protest that they are suffering severe hardship from being cut off from their current account for weeks. Those are circumstances in which there would be calls for the state to step in to prevent the closure of ailing banks.

This highlights the biggest hole in the old Social Contract – the absence of a regime for resolving distressed banks in a way that avoids both taxpayer support and systemic disorder. How to go about doing this was the principal subject of my speech here two years ago. Much has happened since. Next month, the G20 Financial Stability Board will publish a consultative document on the resolution of systemically important financial institutions (SIFIs). It will cover resolution instruments; cross-border co-operation; and steps needed to reduce obstacles to resolution inherent in the organisation and practices of firms themselves. I will confine myself today to just a few words on the third of those planks. However good the resolution instruments given to the authorities by their legislatures, and however much progress we make in tightening up cross-border co-operation, formidable obstacles to the resolution of the big global firms will persist so long as their organisational structures and practices remain so complex. Indeed, one useful way of thinking about the ICB's recommendations on ring-fencing UK retail banking is to make it easier to apply different resolution tools to different parts of the business. Whether or not other countries adopt that approach, it will be necessary everywhere for firms to document and simplify intra-group transactions, and to ensure that IT and other services provided by one group company to another could be sustained for a period if they were separated in the course of resolution. It is striking that supervisors almost everywhere allowed such spaghetti to develop, especially given the key lesson of the BCCI saga – legislated for in the EU – of not to allowing unsupervisable structures.

In the UK, the emphasis on resolvability has informed the review of banking supervision that we have been undertaking with FSA colleagues.

Microprudential supervision and resolvability

Traditionally, bank supervisors worked to reduce the probability of firm failure. They did so, of course, because of the costs of failure. Yet they did not spend much time working out how to handle a firm's failure in the event of prophylactic supervision proving insufficient. That was a major problem in the very conception of prudential regulation and supervision, going back decades.

In future in the UK, a core role of supervisors will be to work backwards from what would happen at the point of failure. A bank's resolvability and the likely consequences for the system if it failed will be incorporated into the Prudential Regulation Authority's planned risk-assessment framework, which will replace ARROW as Hector Sants has explained. Recovery and Resolution Plans – or 'living wills' – will be required to ensure that failure does not lead to avoidable disorder.

In pursuing this, the supervisors will need to work closely with the team in the Bank who operate the UK's Special Resolution Regime. That should be helped enormously by the planned new Proactive Intervention Framework or PIF, a major reform involving each firm being 'Staged' for internal purposes by the prudential supervisors. My personal expectation is that it would be an odd world if there weren't quite a few firms at Stage 2 even in a more benign economic and financial environment. And as a bank's PIF ranking rises, the Resolution team will progressively become more engaged with it. The details of this need to be worked on by Hector and me with our teams, but it will be a big change from the past.

A central element of the new Social Contract for banking is that firms must be fit to fail in an orderly way. Working backwards from that ultimate objective will necessarily change the dialogue between banks and their supervisors.

Microprudential and macroprudential

This is consistent with the government's plan that the statutory objective of banking supervision should be recast in terms of firms being sufficiently safe and sound to ensure the stability of the system. That is a profound change.

Supervisors will need to focus on the big issues. Analysing bank balance sheets and businesses. Applying judgment. To my mind a great bank supervisor is forensic; is capable of substituting their judgment for those of management; but is wise enough to do so only where necessary; and has the personality to conduct the regulatory relationship without unnecessary conflict.

In another return to the distant past, the supervisor cannot treat firms as islands. They are part of a system. So, at the very least, supervisors will need to look laterally across peer groups of firms for oddities, and stress test firms' resilience against short-term and longer-fuse threats from the environment. They will, therefore, need to draw on market intelligence on industry trends from the Bank's Markets area; insights from the operators and overseers of the clearing, settlement and payment systems; and analysis from the finance and monetary researchers in the Bank. Conversely, the Financial Policy Committee will – and already has - drawn on briefings from the supervisors as well as the Bank's existing staff. In other words, this is going to be about making connections, pulling together a varied range of inputs. A measure of the Bank's success when prudential supervision transfers will be how well we knit them together. The Court of the Bank will play an important role in ensuring that the executive of the Bank delivers on this.

What all this amounts to is framing microprudential regulation and supervision to deliver *macroprudential* objectives.

Experience around the world demonstrates that it is hard to keep supervisors focused on the stability of the system as a whole.

The UK's Financial Policy Committee is designed to achieve that. By creating a new institution within the Bank of England, the government is ensuring that stability does not fall by the wayside, into the gap between monetary policy at one end of the spectrum and the regulation of firms at the other. As the Governor of the Bank said recently at the Mansion House, an important part of the FPC's role will be to steer, to orient the work of the microsupervisors in the light of the assessment of short-term and longer-term risks to stability. That was in evidence at the FPC's very first meeting, a fortnight ago.

The Financial Policy Committee's first decisions

The decision and Record of that meeting were published last week. They increase transparency around financial stability policy, and are instructive for what lies ahead.

It will have been no surprise that the Committee regards the current economic and financial environment as presenting very real risks to stability, with the euro area's problems foremost amongst them. The Committee decided to advise the FSA to find out more about the banking system's exposures, to disclose more, and to get the banks themselves to disclose more. As part of that, FSA will be looking more closely at banks' forbearance policies and practices. That is not just about internal systems and controls, important though they are. It is, centrally, about forming judgments on the adequacy of provisions. As such it is a step towards supervisors satisfying themselves about the broad robustness of bank's asset valuations and risk weightings – a vital element of assessing capital adequacy.

Crucially, beyond that, the Committee asked the regulators to ensure that, in the quarters ahead, banks should build their capital resources by retaining more than usual of their profits when profits are buoyant. Although the FPC does not yet have statutory powers, this was a sizable step away from the role played by the Bank over the past decade or so. It is not a sermon. It is a plan.

To give it teeth, the Committee considered whether or not to set quantitative limits on distributions and/or qualitative guidance on what should be treated as 'buoyant' profits. But given the highly varied circumstances of UK banks, we concluded that it is more sensible in the first instance for FSA to work out the details in its supervision of individual firms. These will be meaningful discussions, and FSA will report back to FPC on progress.

That measure is being taken in order to make the UK banking system more resilient, and so better able to maintain credit supply, in the face of threats that could crystallise any time over the next year or so.

The FPC also looked at whether any developments in markets might pose a longer-term threat to stability. We were struck that a renewed Search for Yield is already evident in some markets, and that this is reflected in innovations that could add to the complexity and opacity of the system. The drift of Exchange-Traded Funds away from their original bearings is striking. The Bank team have briefed various international bodies, including the Financial Stability Board, on this over the past year. Compared with their vanilla forebears, there are now ETFs incorporating leverage, active management and synthetic structures. As FPC discussed, it is important for the European Securities Markets Authority to act to ensure that its regime for investment products does not fall further behind. HMT and FSA lead those negotiations for the UK.

More locally, FPC asked the FSA's bank supervisors to ensure that banks' liquidity management takes proper account of any maturity mismatches associated with using ETFs as a direct or indirect source of funding. Although the main bank sponsors of synthetic ETFs are not currently UK banks, there is a signal here for UK banks – and, in fact, one for our international peers too. As I explained at last Friday's FPC press conference, this is part of a bigger issue around the use of collateral swaps or other similar transactions for funding. The authorities have not done enough, in my personal view, to encourage robust practices in repo and securities lending markets. That is likely to form part of the FSB's work on shadow banking.

The broader point here is that the FPC will try to nip incipient problems in the bud. If only someone had taken action to contain the mutation of securitisation a decade ago.

On each of these fronts, the FPC is acting through the microregulator, the FSA. That is partly because the legislation has not yet passed, and so the statutory powers lie with the FSA. But, more basically, it is because macroprudential interventions will nearly always involve the systematic application of microregulatory instruments in the interests of the resilience of the system as a whole.

In the future, that will sometimes involve the Financial Conduct Authority as well as the PRA. What is different between the macroprudential regime we now have and the past is that the FPC will be steering and, once the legislation is complete, Recommending and sometimes Directing the microregulators to take action. That is a major change in the UK's regime.

And it will occasionally mean Taking Away The Punchbowl, leaning against excess. No set of static regulatory requirements will suffice for all seasons. The FPC will be ready to alter regulatory requirements dynamically, so far as the constraints of EU legislation are consistent with actions to preserve stability.¹

¹ See Tucker P M W, 'Macroprudential policy: building financial stability institutions', April 2011.

Conclusion

The new Social Contract for banking insists on resolvability and on the health of the system as a whole. In doing so, the goal is to move towards a financial system that is able to keep lending even during dark times.

Rapid payout from deposit insurance; liquidity provision against wider collateral; constraints on shadow banking to limit regulatory arbitrage; simplification of SIFIs' internal structures and practices to aid resolvability; powers for resolution agencies to reconstruct the capital structure of a distressed bank or dealer, to avoid the disorder of orthodox liquidation; a capital surcharge for SIFIs; the FPC temporarily raising capital or liquidity requirements in the face of stability-threatening exuberance – these will all be parts of the new Contract. It is unfinished business, but the shape should be clear by the time of the G20 Heads of Government Summit in November.

As you can see, the lessons of the crisis fall into two broad groups: Repairs and Revolutions. The changes in capital and liquidity regulation, however big, are essentially repairs. They improve on what was there before.

There are revolutions on two fronts. Resolution regimes. And macroprudential regimes. As I have explained today, both will have a profound influence on supervision. Indeed, it is no exaggeration to say that, in the UK, the approach of the future Prudential Regulation Authority to banking supervision is being framed by the needs and goals of resolution and macroprudential oversight.

Supervisors will focus to a much greater extent than ever before on coping with failure and on the stability of the system. That will become apparent in the years ahead.