Promoting a prudent and stable financial system

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Speech by Andrew Bailey, Director of UK Banks & Building Societies, at the Future of Retail Banking Conference, London

1. Thank you for inviting me to speak this morning. I don't think you could have chosen a better time to assess the future of retail banking – there are more challenges to your business today than any of us have seen previously in our working lives. Whether you regard this as an opportunity for change, or as a threat, depends on your outlook on life as much as anything. A crisis of the scale and severity of the one we have been in for over four years will prompt profound changes in the industry, I am sure of that. I am in the camp that the crisis is an opportunity to change for the better. But then I have been responsible for resolving problem banks, and now I am responsible for supervising banks – you have to be an optimist in my job.

2. I am going to speak this morning in the style of a game of two unequal halves. In the first half I am going to talk about the pressures on the industry, and the pressures in retail banking today. And then, in the second half – which is shorter than the first – I am going to draw on my experiences of seven years as the Chief Cashier of the Bank of England to talk about one or two of the conclusions that I reached from what I saw of the banking industry in that role.

3. What are the perceived problems and challenges of banks today? I think the resilience of UK banks has improved substantially since the dark days of 2007 to 2009 when a large part of the industry was under extreme stress. Today, UK banks are not front-and-centre of the problem. The solvency position of UK banks has materially improved over the last three years.

4. A start has been made towards reducing balance sheets, and particularly so-called non-core assets. Up to the summer of this year, this improvement was evident in the larger volumes of wholesale term debt that UK banks were able to issue. And this was crucial to achieve a number of objectives. It enabled the repayment of the Bank of England's Special Liquidity Scheme, and now the government's Credit Guarantee Scheme. Over the last 18 months, the

UK banks have achieved a major reduction in the official funding support provided to them in 2008 and 2009. That is a big achievement.

5. The second objective of stronger funding conditions was to enable the banks to build up larger liquidity buffers to provide more protection against stress in the future. This was an explicit objective of the FSA. I would be misleading you to think that any bank thanked us for pushing for early adoption of what is in effect a proto-Basel III liquidity standard. It was a unilateral UK action. All I can say is that what happened next demonstrated that it was the right thing to do.

6. Since the beginning of the summer conditions in funding markets have changed. A generalised risk aversion has emerged, due primarily to developments in the periphery of the eurozone. The UK banks are not singled out in this development, but we have seen a broad-based reduction in the term of funding, and in some parts of the market there has been a clear shift in preference towards secured over unsecured funding. Funding buffers are there to absorb this sort of pressure, which is why the UK authorities have been strong supporters of a robust liquidity regulation framework in Basel III. It is why my staff at the FSA devote large amounts of time to understanding the strengths and weaknesses of the funding positions of our banks.

7. The current phase of the crisis has not singled out the UK banks, most likely because – as the European Banking Authority (EBA) disclosures have shown – they do not have large direct exposures to the vulnerable eurozone economies. Moreover, at least in a relative sense, attitudes towards UK sovereign risk appear to have improved. But we cannot be – and are not – complacent on this front. There is naturally uncertainty in relation to the possible impact of indirect exposures to the vulnerable economies, stemming from the network of counterparty relationships that the banks maintain. And, as you would expect, as supervisors we are very keen to see that the banks plan for any disorderly consequences of the euro-area crisis. Good risk management means planning for unlikely but severe scenarios, and this means that we must not ignore the prospect of the disorderly departure of some countries from the eurozone. I offer no view on whether it will happen, but it must be within the realm of contingency planning.

8. Looking ahead, what are the main challenges on the prudential front for banks? We will need to return to the agenda of banks building up their longer-term funding, and thus their buffers. These buffers should be used in times like the present – that's why we insisted on moving early on the proto-Basel III approach. But then they will need to be rebuilt.

9. Many banks still have excessive leverage, and there is a need for a clear path to reduce leverage, but to a timetable that does not damage the wider economy. I think this is the toughest challenge we face today. As prudential regulators we really are conscious of the balance to be struck between strengthening the resilience of the system and avoiding bad outcomes for the wider economy. That is not easy.

10. As a microprudential regulator I do appreciate the force of the argument that in difficult times we should do what we can to avoid excessive 'risk off' behaviour by banks. But you can best do that when the credibility of the system – the basic resilience of banks – has been proven. We are not yet there. Over time we can get to that better place, but it will require a measured but serious reduction of the size of banks' balance sheets. And in some countries this means that the banking system can no longer absorb government debt on the scale that has been seen.

11. There is also little doubt that the package of regulatory reforms taken as a whole, including Basel III, will prompt a re-think of the role of position-taking investment banking activities within banks. One of the features of the growth of the balance sheets of many of the large banks in the decade before the crisis was the substantial growth of on-balance sheet position taking in what could not – quite honestly – be described as assets that were all likely to remain liquid in terms of the ability to trade them in times of stress. Many of these assets are now regarded by banks as non-core, and the focus, rightly, of sale and deleveraging plans. Many of these are the sorts of assets that can be removed from balance sheets without jeopardising the real economy. And they need to be removed to restore the confidence in the balance sheets of banks.

12. That is happening among the UK banks, but we should not underestimate the scale of the remaining task. Tackling this reduction in non-core assets is also an important signal that management of banks are aware of and committed to the sort of structural change to their balance sheets that is required to convince investors, regulators and the wider public that

the need for change is understood. Actions speak louder than words here. My best guess is that we will see a sharp reduction in the scale of investment-banking activity undertaken in the banking sector. The reforms to regulation are raising the cost of that activity, and rightly so. I don't think we should rule out that for some banks an exit from investment banking, beyond perhaps continuing to provide services to corporate banking clients, is the sensible outcome.

13. Your focus today is on retail banking; the services that we all need from our banks to sustain our everyday lives. The fact of the matter is that whatever people think of banks these days, they are an essential part of the fabric of any economy. One of the critical – arguably the critical – definitions of our financial stability objective is the continuous supply of necessary financial services to the economy. But retail banking too is under strain today.

14. One of the most obvious differences between the crisis we are going through now and previous recessions is the response of monetary policy, not just in the UK but elsewhere, to cut interest rates and sustain them at very low levels. This is undoubtedly a measure of the success of the framework of monetary policy. If you go back to the early 1980s and early 1990s, this was not the case. For retail banks, the experience in those times was one of sharp increase in loan loss and arrears rates as the cost of borrowing and debt servicing rose rapidly at a time of weak economic activity. The contemporary experience is different. Loan loss and arrears rates are low today by historical standards, no doubt due to the low cost of debt servicing. But the pressure on retail banks is coming today from the impact of very low rates on interest margins – the difference between banks' cost of borrowing and rates on lending. This goes across retail and wholesale funding in banks.

15. One striking piece of evidence to support this conclusion on margins is the spread between the official Bank of England interest rate and typical term retail deposit rates in the UK – the one, two or three year fixed rate deposit offered to the public. The spread is at a level substantially out of line with history. The good news for the public is that it is a sign of competition for deposits which is providing some spread over the very low official rate. But it is putting heavy pressure on margins in banks, and more broadly it constrains the transmission of monetary policy into the economy by limiting the fall in the effective rate of interest in the economy.

16. Now, I have to say that a reasonable reaction to signs of squeezed margins in banks is that it ought to reduce the remuneration of bankers. True enough. But, I suspect the pressure goes beyond that, and as a regulator I am conscious that while we have, sensibly, set quite long deadlines for banks to accumulate the additional core capital needed to meet the Basel III standard, prolonged low returns could jeopardise that trajectory. At this time, we are at the point of watching carefully and encouraging banks to be active in raising capital where they can.

17. Low returns in retail banking also bring into focus the issues of pricing for services, because ultimately that is a variable that can adjust in any industry. Most of the rest of my remarks will be based around this theme.

18. I think there is something of a paradox in retail banking. There is no doubt that the crisis has reduced competition. Many of the foreign banks that were active in this field have pulled out. And, the second tier of UK retail banks has been heavily hit by the crisis. As I have said on other occasions, the crisis revealed deep flaws in the business model of demutualised building societies. Not one of them survives today as an independent entity. This evidence provides strong support for the conclusion – as set out by the Independent Commission – that retail banking needs more competition, and I do not disagree. Likewise, I welcome the greater competition that will come from making it easier for consumers to switch banks. But, the paradox is that in certain activities there was arguably suicidal competition in the run-up to the crisis, of a sort that we do not want to see repeated.

19. The most obvious case of this was mortgages, where margins on lending were squeezed heavily in the decade running up to the crisis, and we also saw another, I would say undesirable, development of the retail banking scene, namely the recourse to earning returns from opaque fees. The business model of squeezed lending margins and mis-sold products, whether it be payment protection insurance (PPI) or mortgage products, was wholly undesirable. Today, lending margins remain squeezed, and there are substantial redress payments under way in PPI. Alongside this is a squeeze on new lending, and the terms of it. This is not surprising, but nor is it sustainable. I don't believe that it is sustainable to have the average age of a first-time home buyer getting near to 40. We have to rethink the terms on home lending, as well as seeing some adjustment in the price of housing. Those of us who are responsible for the stability of banks cannot jeopardise that

again, but there is an urgent need to examine ways to improve the form and terms of lending, to households and small businesses.

20. I think that the pricing of retail banking is a problem in this respect. The notion of free banking has in my view distorted the landscape. There is of course no such thing as free banking. What it really stands for is that charges are levied inconsistently across products supplied by banks, with the consequence that some appear to be free. It also leads to what in my view are unhelpful and damaging decisions on the supply of products. The philosophy should be, give the public what they want but at a fair price which is transparent to them.

21. Let me give you two examples from the world of payments. Until the end of March, I was the Bank of England's Chief Cashier, a post I held for just over seven years. One of the responsibilities of Chief Cashier is Bank of England banknotes. When I became Chief Cashier at the end of 2003, the total value of notes in circulation was around £35bn. When I came to the end of my time earlier this year, the total was around £52bn. That was a big increase, since it had taken over 300 years to reach £35bn. We could debate at length why the increase happened, but on one thing I hope we could agree, we met the public's demand for banknotes, or at least the total value of cash. But from time to time, I was asked if I had a strategy to end the use of cash, as an outmoded instrument. My answer was no; rather, I had a strategy to give the public what they wanted. It happened to be more notes. Now in one respect we did not achieve the public's wish, at least so far as I could tell. We did not get enough £5s into circulation. So, we set about solving the problem, and I was pleased to hear recently from my successor, Chris Salmon, that the target for dispensing more £5s from ATMs is well on the way to being met. Whether this meets the public's need, we will see, but here is an example of trying to meet the public's demand.

22. The second, and final, example I want to give is the Faster Payments Service. A lot of money was spent by banks in this country developing this system. It has state of the art features to enable same day low value payments to be made. It answers a need that has been consistently expressed by the public. In my, non-technical, opinion it could be a platform for a profound change in mobile electronic payments for those members of the public who want such a service. And yet, several years on its potential has not been realised and it has been poorly marketed. Why? This is an own-goal to be honest. The banks developed

something that could be very good, spent a lot of money on it, and then failed to put it to use. This is more than sad for an industry that needs to work on its standing.

23. In conclusion, challenges are everywhere. Today, there is huge pressure on the retail banking industry. But there are huge opportunities to change the model, and above all, give the public what it wants at a fair price, with transparent terms. Thank you.