Why Prudential Regulation matters

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Speech by Andrew Bailey, Director of UK Banks & Building Socieities at APCIMS Conference

Thank you very much for inviting me to speak today.

I have returned to the world of prudential supervision after a break of about 17 years, during which I was doing other things in the Bank of England. The last six months since I returned have occasionally offered a chance to reflect on what has changed and what hasn't, and more broadly on the challenges to the role that have been posed by the crisis. I have also been struck by how rapidly it is possible as a supervisor to move from being accused of under-doing it to over-doing it. In recent weeks I have seen a number of articles in the press asserting that the FSA is on a 'get tough' mission, with a variety of accompanying comments along the lines of 'about time', 'stable doors and horses bolting', 'excessive bureaucracy', 'shadow directing', etc. If you end up confused trying to work out how all of these things can be true at once, welcome to my world.

So, this morning, I want to try to be a bit more reflective and consider some of the big challenges we have on our hands as we seek to reform the system of financial supervision in the UK. I am going to talk about prudential supervision, which will be the responsibility of the new Prudential Regulation Authority (PRA). Consumer protection and conduct supervision will be for the Financial Conduct Authority (FCA). Let me start with a big question: do we understand sufficiently why we are undertaking this supervision? My answer is no. What I mean by this is that our objective as financial supervisors needs to be rooted in a public policy objective, which must be clearly stated and well understood. Parliament, as the representative of the people, needs to establish what it wants from us – the objective of the role. I don't think sufficient clarity of purpose has been achieved so far. When I look at the Bank of England's other public policy responsibility, monetary policy, I see a different state of affairs. You can argue about whether you agree with the MPC's decisions month by month, but what is undisputed is that the MPC has a very clear objective to achieve sustained low inflation and thereby contribute to stability of the economy, which is a precondition for sustainable growth. Parliament accepts that and holds the MPC accountable for achieving its remit. And there is a wider public consensus in support of the benefits of low inflation. This was a major, arguably the major, achievement of the 1997 reforms, and it has stood up well to the test of time.

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When I turn back to look at the situation on financial supervision and financial stability more broadly I do not see yet the same understanding and consensus around the role. Put simply, I don't think either the pre-1997 or the post-1997 systems achieved this objective of clarity around the objective of public policy. But without that consensus around the objective, the system could not be truly stable.

We have, therefore, another chance to get it right with the legislation and re-organisation that is currently under way to create the so-called 'Twin Peaks' approach and the Financial Policy Committee (FPC) of the Bank. For prudential supervision and the role of the PRA, there is a clearly stated new objective, which is to pursue our role in relation to the safety and soundness of firms in order to achieve the stability of the financial system. Fine words you may say, but what do they mean? Let me give you some examples. We will not be pursuing the competitiveness of firms for its own sake. Rather, we believe that a stable financial system is the best way to promote the competitiveness of the system and its members. The most successful financial firms have not been those which pared their capital holdings and funding buffers to the bone.

Second, we do not intend to pursue a 'no-failure' regime. Orderly failure, which is consistent with our objective of maintaining the stability of the financial system, is an acceptable outcome, and does not indicate that the supervisory system itself has failed. This should help to explain why we have put so much emphasis on resolution as a core part of supervision. Now I recognise that it will take a lot of effort to convince people that failure of financial firms is part of a stable financial system. But an industry in which no-one fails is likely to be one in which there is little new entry, and this stifles innovation and competition.

Financial supervision therefore needs to be anchored in a clear public policy objective, which Parliament and the industry can use to hold us accountable for our actions. This will also help to focus supervisory action. The FSA has, during the crisis, moved to what is often described as an 'intensive and intrusive' approach to supervision. But it has to be focused, and to achieve that we must have a clear objective for what we are doing. With that, the charges of over or under-regulating can be judged more sensibly against a better articulated standard.

This change of approach also requires another development, namely towards a more transparent system of supervision. This should begin with greater transparency around the disclosure of information on regulated entities. The process of setting clear objectives for supervision and judging them will be made more clear if more information is disclosed.

In summary, it is vital that the legislation to change the system of financial supervision in this country is grounded in sensible principles that can explain the objectives of the supervisors and provide a framework within which to hold them accountable for their actions.

Let me now move on to another point that it is central to our reform of financial supervision, namely the role of judgement on the part of supervisors. Again, this is something that we have said should be a core principle of the new approach. We have explicitly built judgement into our design of the PRA by creating a framework to guide early intervention in problem institutions and an explicitly proportional approach to regulating smaller firms. On the face of it, the use of good judgement sounds unobjectionable. But, again looking at the changes over the last 17 years while I have been away, there has been a plethora of rule-making, much of it coming from European rule-making. And we are promised more of it. What can we do to counteract the forward march of rule-making? This is an important question because it conditions how firms behave towards their supervisor. A rules culture shifts the debate towards the supervisor having to prove that there is a reason for the firm not to do something, rather than forming a view on whether the firms should do something judged against the objective of supervision. Again though, it comes back to the fact that unless we are given a clear objective in public policy, we will find it harder to exercise more decisive judgement.

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Exercising judgement well, which is what we should do, requires focus on the things that really matter to our objective. For the PRA it will be about judging financial soundness. One of my mantras is that I expect to engage with the boards and senior management of firms only on the (what should be) handful of things that really matter to our prudential objective. I usually express this in terms of the three things that matter. Of course, it requires a lot of work to identify and explain those things. It is like the old adage that it is harder to write a good short essay than a long essay. I do not expect to be coming to you with a long shopping list of compliance points, those are for your internal auditors and risk management. We may well point out things that we have found in our work, but our objective will be very much directed at the key points that we think give rise to a risk to our statutory objective.

An important point here is that in my view the risk management and internal audit functions of firms must be active and able to push their case strongly. To be frank, I think one of the relatively untold stories of the financial crisis concerns how little attention these functions have attracted. Boards and senior management are at the heart of the responsibility for running a firm. They must be supported by robust and well-functioning risk and audit functions (internal and external) to support them. Unfortunately, when I look across the landscape, I don’t believe that we are in the right place today in terms of the role and influence of these risks and audit functions. And, moreover, it is dangerous if the supervisor is assumed to fill the role of the risk and audit functions. That is not our job. If we were to operate at that more detailed level, we would be much larger and, critically, we would lose our focus.

What our job does require, however, is a capacity to be forward-looking. In my view, one of the problems post-1997 of the early days of the Tripartite system in this country was the attempt in banking supervision to introduce the notion that crises could be divided into liquidity and solvency problems, and the institutional responsibilities among the authorities could be allocated accordingly. This was a mistake. I did something wrong either in my earlier life or in a past life, but as a consequence I have ended up having to sort out problems in banks off and on for the last 20 years. One of the primary lessons I have learned from these experiences is that banks don’t fail because they are literally balance sheet insolvent in some accounting sense of the present. They fail because their depositors conclude that the probability of future insolvency has risen to the point where it is no longer wise to leave a deposit there. Deposit insurance can alleviate that risk to some degree, but few banks exist on insured deposits alone. Funding problems are, therefore, a symptom of a solvency problem, but a symptom that can and most likely will kill first.

Note here that by introducing the idea of the probability of future insolvency, I have described the activity of supervising banks in terms that must be forward-looking. This is important for several reasons. First, it means that supervision and monetary policy are more alike in what they do than has in the past been recognised. Both need to be forward-looking and assess expectations of agents, and tools like stress tests for capital and liquidity are, in essence, forecasts. The second important point about being forward-looking in supervision is that it explicitly introduces the need to exercise judgement on the part of the supervisor, because the future is uncertain. We have emphasised this in the design of the new regime so that we can link together the forward-looking and judgemental actions.

In conclusion, we are somewhere near to half-time in the process of turning the Chancellor's statement of June last year into a new statutory framework of supervision. In our world, half-time does not signal that we can go off the pitch for a rest and a motivational team talk. No such rest for us. We have done a lot of good work in the first half, the result of extremely dedicated people in the Bank of England, the FSA and the Treasury who have combined reforming financial regulation with continuing to deal with a severe financial crisis and a major international reform agenda on policy. But in the second half we have the crucial prize to play for, namely establishing the public policy rationale which will determine the success of our new regime.