BANK OF ENGLAND

Speech

Broken glass – moving towards sustainable financial regulation

Speech given by

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It is a pleasure to be in Bristol today. Those of you who are interested in financial history may know that here in Bristol John Vaughan set up business as a goldsmith in the Dutch House on the corner of Wine Street and High Street back in the early 18th century. To many he was the father of banking in the West Country. But the first true bank in Bristol actually didn't open until 1750. At the time it was one of only a handful of banks in England outside London and proved a success. That original bank may have changed names, and reincarnated itself a few times over the years, but it still is with us in spirit. Oval plaques on the National Westminster Bank in Corn Street keep alive the name of Bristol's first bank. Interestingly, they were also once on the building opposite which is now Pizza Express.

There was also a branch of the Bank of England in Bristol between 1827 and 1997. It occupied a number of buildings over the years, but its final resting place was in a purpose-built structure, opened in 1963, on the very site of the Dutch House on the corner of Wine Street and High Street, where Bristol banking had begun (the Dutch House itself having been destroyed in an air raid in the Second World War). The branch was closed in 1997, but the building remains uninhabited and dilapidated to this very day. The economic intelligence functions of the branch were transferred to the Agency for South West England, housed in a different building, which began life in Bristol but is now located in Exeter.

I mention this as I believe understanding financial history is important in thinking about the future of finance. In fact I think regulators should require all those who are deemed to be an 'approved person' to study financial history.

The Governor of the Bank of England spoke recently about the limitations of monetary policy in fixing the current economic demise.[1] He was candid and forthright about what can, and cannot, be done by policymakers and warned that it will take time to heal much of what's wrong with the UK economy. On the back of his statement and the excellent publications by the PRA on how it will regulate financial institutions,[2] I think we need to assess what we can reasonably expect the authorities to accomplish in regulating the financial industry. I will focus on the activities of the Financial Policy Committee ("FPC"), while touching on the roles of the Prudential Regulation Authority ("PRA") and Financial Conduct Authority ("FCA"). The PRA and FCA are the new bodies that will come into existence after the restructuring of the Financial Services Authority ("FSA"). The PRA is tasked with microprudential, and specifically prudential, regulation of deposit takers, major investment firms and insurers. The FCA will try to make markets work well so consumers get a fair deal and will be responsible for regulating the conduct of financial companies and it is the prudential regulator for all the other authorized firms.

[1] King (2012).
[2] See Bailey (2012) and the FSA's website for further information on the PRA's approach to supervision http://www.fsa.gov.uk/static/pubs/other/pra-approach-banking.pdf and http://www.fsa.gov.uk/static/pubs/other/pra-approach-insurance.pdf .

A macroprudential focus

The Financial Policy Committee was set up (on an interim basis) within the Bank of England in 2011 to do macroprudential regulation of the UK financial sector. The FPC has two objectives: first and foremost, it is charged with identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. But that is accompanied by a secondary goal to support the economic policy of the government. In other words, subject to ensuring resilience, the FPC's actions should aim to be supportive of the government's objectives for growth and employment.

The FPC is trying to look at the entire financial system. So, for instance, we are not supposed to worry about the capital, leverage or liquidity of an individual bank but of <u>all</u> the UK banks collectively. We try to look for activities that, in isolation, may prove fine for a single institution to dabble in but, for the system as a whole, are potentially far more dangerous.

It is not easy to keep to the big picture without seeking granularity on the many forces that make up its constituent pieces. For some of our first 18 months we have found ourselves straying occasionally into the "microprudential" sphere. In part this is due to the concentrated nature of British banking – the top five banks in the UK account for around 90% of all personal current accounts and lending to SMEs. As such, it can be argued that an issue at any one of the big five banks in the UK becomes both a micro, and a macro issue, for the authorities.

The FPC currently has 11 members, the Governor, Deputy Governors and appropriate Executive Directors of the Bank, the Chairman and interim CEO of the FSA/PRA and four external members of whom I am one. The head of the FCA and a representative of Her Majesty's Treasury ("HMT") also attend our meetings. We meet quarterly and put out policies along with a Record of our meetings. We are also responsible for the bi-annual Financial Stability Report.

In our first 18 months we have had more than enough to worry about. We have spent most of our time concerned about the risks UK banks still hold from the "bubble days", as well as the events on the Continent and trying to figure out the appropriate modus operandi for the statutory FPC once the Financial Services Bill achieves Royal Assent. Overall, I think we have learned a lot and I am confident that macroprudential regulation will play an important role alongside microprudential regulation going forward here and elsewhere. As an aside, much of the work being done by the Bank on macroprudential regulation is unique in the global financial system and it is another area where the UK is acting as a thought leader.

Spotting the next 'big' one

At the heart of much of the current policy debate is how the FPC, PRA and FCA develop better processes for anticipating the next problem – whether the problem is an asset bubble, poor risk mismanagement or a flawed or misunderstood financial product. And these are important steps to take. But it seems to me there is an inherent tendency for policymakers to re-fight the last war. As I said above, I am a believer that understanding the past provides a foundation on which to assess the future. But we shouldn't pretend we can eliminate financial crises completely. Nor that the next crises will necessarily be a carbon copy of the last one.

My anxiety about getting financial regulation to better mitigate future risks has its roots in the issues one sees in the financial crises of the past couple of hundred years or so. Virtually every type of financial institution has been the cause of a crisis at some point in history – country banks back in 1825, universal banks in 1931, small banks in the 1970s, savings and loan companies in the 1980s, international banks in the 1980s and 1990s (debt crises in Latin America and Asia respectively), and even a hedge fund in 1997.

Pretty much all types of financial institution got involved in the problems of 2007/2008. The roll call included insurance companies (although thankfully not those in the UK) alongside investment banks as well as some more traditional commercial and mortgage banks. I find it hard to see a common thread (other than high leverage ratios) amongst the types of institutions that struggled or the mistakes that they made. It is not clear that the reforms we are putting into place today would have, or could have, averted all the problems faced in these crises. Therefore, experience tells me its origins are unlikely to be in an institution and from a product that is obvious to us now.

I realize this uncertainty is rather unhelpful. Perhaps I can start with what we definitely don't want to do – create such Draconian financial regulation that we end up with "the stability of the graveyard".[3] We may be able to define a better end point but managing the transition to that end point is proving rather tricky. So where does that leave us? Perhaps the now discredited concept of allowing financial companies to blow themselves up, and then try and better deal with the fall-out, may be whether we like it or not, the reality of where we end up.

Of course the obvious problem with that outcome (which had been advocated by Alan Greenspan prior to the crisis) is that, at least in the UK, the blow up from 2008 was so large, so costly and so wide reaching that it behooves policy makers to try and design better regulation to prevent its recurrence. There is certainly a lot of work being done. Paul Tucker, Deputy Governor of the Bank responsible for financial stability, amongst others, has been working hard to achieve international consensus on the regulatory framework (and as I shall discuss in a moment on the "too big to fail" issue). But, speaking from my experience in the past

[3] Turner (2012).

18 months, getting international agreement on the correct policies, getting those polices turned into statute and then implementing the new rules is not straightforward.

A step in the right direction

Away from these activities at the Bank, there has also been thought given on how best to structure the banking sector to create more stability, including the Liikanen report in Europe[4] and last year's Independent Commission on Banking (Vickers) report.[5] To implement Vickers, a draft bill is being prepared. And in the USA Dodd Frank has already been enacted in part. If Liikanen and Vickers are enacted in full force there will be a considerable benefit, particularly as they both should make complying financial institutions that much easier to put into a resolution process should they fail. But, unless a fear of failure changes the behaviour of bankers and investors (even in the good times), and unless new statute implements them fully – Vickers for instance called for 17% to 20% loss absorbing capital and a leverage ratio of 4.06% – I don't believe they will necessarily make financial institutions much less likely to fail although they are an important step forward.

As we design regulation to avert crises (or at least lessen the impact and severity) I think it would help if we spent less time worrying about precisely how financial institutions are structured, or indeed the regulatory model we utilize to watch over them. Instead we need to assign more time to worrying about the resources, tools and mandates we give to the regulators. In my mind, not enough time has been devoted to the practicalities of how, for instance, we allow a major bank to default and go into receivership without unduly hurting depositors, the payment system or creating contagion. There was an excellent piece on the structural aspects of this "too big to fail issue" recently by Andrew Haldane[6] and, as mentioned, others at the Bank are also working on this.

Global issues, local solutions?

Internationally, the challenge is perhaps even more complex. We need to consider how we create a better global "college" of regulators. The international regulatory framework at the moment is complex, particularly on resolution that crosses regulatory boundaries. As a result, the global financial institutions became experts in "global regulatory arbitrage". While there are still some large gaps between policy makers in different countries on regulatory topics, we are making progress on closing down regulatory arbitrage.

One of the most important global issues is trying to resolve too big/important to fail. As long as financial institutions, and those who fund and own them, believe that the state will rescue them when they are in distress we will continue to have the problems that manifested themselves so brutally in 2007/2008. We will not be able to instil the culture we want in financial institutions if this issue is not tackled. Nor will we get the

[4] EC (2012).
[5] ICB (2011).
[6] Haldane (2012).

banks to revert to a business model which is client oriented as long as the incentives created by bankers being paid partly on profits received from the implied state subsidy continues.

Related to both of these points is how do we change the culture within finance to something with which society will be more comfortable. Thankfully the recent scandals don't appear to have created much lasting economic damage. But, it was a real wake up call for many as it clearly showed just how much there is to do to get a proper culture within our banks. Reading, in one case, about traders shouting across the floor to submitters asking them to submit preferential rates, has shocked most people. The cultural problem seems to have extended from the trading floor right through middle management to senior management. There looks to have been an inadequate response from both the executive officers and the Board of Directors. It is not clear to me that the shareholders were very concerned once the news broke. This incident and others, primarily relating to conduct related issues, show just how much work there is to do to create financial institutions with a culture of producing the best product possible and caring for the client's interests first.

Getting the culture right is something that only management of financial institutions (and the owners) can do. I don't think this can be forced down from the regulators, although we can help by ensuring that incentives relating to conduct are appropriate. Putting in place the appropriate checks and balances to ensure products are appropriate for the target client base and performing the risk management function (which includes reputational risk management) is something that Boards and senior management have often neglected. In part this appears to be because it hasn't been of much interest to shareholders. Given the dramatic impact current conduct settlements are having on financial company earnings, one hopes this will change.

While the culture within the City has changed for the better in the past two years there is much more to do. This will only get done if all the constituents within the financial community agree that "success" is not simply measured by return on equity. Instead, "success" needs to be measured by a combination of factors. These include properly risk adjusted return measures that track service to the client base, as well as a report card from the regulators in terms of safety and conduct and useful innovation.

Too big an issue to duck

As already stated, for me the big issue facing the regulation of financial firms is the too big/too important to fail ("TBTF") dilemma. If we really believed we could allow a big bank, investment bank, hedge fund, exchange which does central counterparty clearing, asset manager or insurance company to fail in a "controlled" way, the battle would be materially advanced. It's not that policy makers are not focused on this – they are – but I think more urgency is needed on this key problem. To satisfy ourselves that we are heading in the right direction a number of important issues need to be resolved.

Firstly, we must accept that both shareholders and debt holders can, and should, suffer losses when a financial company goes into receivership.

Secondly, we must make the financial enterprises less interconnected by forcing more transparency on the funding and swap arrangements between financial institutions so that we better understand first order and second order counterparty risk.

Third, we should fully support the PRA's concept that financial institutions that operate in the UK ensure they are structured such that regulators are able to do their job, in other words financial institutions must ensure they can be regulated.

Finally, the owners of financial companies should put more pressure on management to explain the benefits of being global and being big – it is clear that under almost any set of parameters many large financial companies[7] are both too big and complex to be managed and too big and complex to be resolved without a lot of broken glass.

Absent a clearer explanation of the benefits of size and need to be global, the regulatory bodies should consider penalties or taxes on the largest banks to create "insurance funds" which will be used when resolving one of the exceptionally large financial companies and to create an economic incentive for the firms to down-size. This would be in addition to the 2.5% capital surcharge that Basel has recommended. One of the key intentions of the structural changes discussed above is to attempt to reduce the value derived by big banks from TBTF subsidies. Adding further pressure with a credible resolution regime and additional taxes/surcharges for overly large financial institutions should be considered.

In my view (but not necessarily a view of the FPC) we shouldn't wait until 2019 to implement these new rules. Banks can downsize and de-lever without unduly impacting their ability to provide necessary services to their clients if they so wish – have a look at most banks' balance sheets and you will find a large percentage of the assets are not loans but other, typically trading-related items, which could usefully be sold/eliminated in order to downsize. For the Major UK banks, intra-financial system assets continue to account for over a quarter of total assets, suggesting there may be scope for a further reduction without disturbing credit supply.

In order to get the right regulation we must know what we want from the financial industry. Given the macroeconomic situation many countries find themselves in there has naturally been a massive effort to create the right conditions for banks to increase the size of their loan books to stimulate economic activity. But a bit of caution here is useful. Leverage, or borrowing too much money, whether within a financial

[7] Global systemically important financial institutions (G-SIFIs) as based on the methodology set out in the BCBS document 'Global systemically important banks: assessment methodology and the additional loss absorbency requirement'.

institution or a corporate or at the household level, is a depressingly common cause of financial crises. The current low levels of lending are partially because creditworthy companies and households have decided to either get their house in order or deleverage to protect themselves from the storms we currently are feeling or they see coming in the next few years. The importance of lending to stimulate economic growth is clear. However it is rational and prudent for companies and households to take debt levels down in times like this. If we push too hard on the lending theme we will simply raise default levels, as more of the borrowers will not be creditworthy. There is no silver bullet to quickly fix the current economic situation.

Towards a more stable financial system

To create a more stable financial industry in the UK a number of conditions must be met. Firstly, somebody needs to think about the financial system as a whole – the new FPC is tasked with this. Admittedly it is early days but my initial experience on the Committee gives me confidence the macroprudential experiment in the UK will prove a successful addition to the regulatory armoury.

Secondly, we need a strong and consistent microprudential and conduct regulator that is well plugged in to the FPC. Any successful macroprudential overlay will be dependent on the input and outlook of those on the ground. The PRA will soon become part of the Bank and will be represented on the FPC. To maximize the synergies putting policymaking for macro and micro prudential regulation, resolution of failed financial institutions – the Special Resolution Unit at the Bank – and monetary policy under one roof was a good development. The FCA and its focus on markets and conduct also adds a unique perspective. I think they will prove to be an important member of the FPC.

As well as dialogue between all these parties, we also need ongoing and constructive engagement on the rules, and how the rules are to be enforced, between Parliament, HMT and the Bank. Transparency in accountability will be extremely important to the success of macroprudential policy. It seems to me that in order to assure accountability there needs to be even more dialogue between all the units of the Bank and Parliament, preferably through the Select Committee of the Treasury ("TSC"). Currently there are regular sessions with staff from the Bank, normally including the Governor, giving evidence to the TSC. I think that more dialogue is needed from a broader group at the Bank – more sessions with the Deputy Governors and Executive Directors for example – given all the changes afoot and complexity of the task at hand. These sessions with the TSC work best when representatives from the Bank are used as "expert witnesses" on a particular policy issue.

The Bank and HMT would also benefit from additional communication and cooperation (which leads to common policy) with the European, American, Japanese and Chinese authorities on topics relating to financial regulation. Further, it is also necessary to ensure that the lines of communication between the Bank and management of the financial enterprises is more frequent to ensure better understanding of the thinking of the FPC in particular. In that vein, I believe it might be useful for the FPC to produce a document, similar to the one that the PRA just produced, setting forth its agenda for macroprudential regulation.

In addition to ensuring proper communication it is important that the Bank is given appropriate tools so that it can back up the many sermons it gives with hard action when required.[8] Doing this requires a robust process between the Bank and Parliament to ensure all direct actions are properly debated and explained before, and after, implementation. I think the externals on the FPC can play an important role, with the Bank and PRA executives leading the way. Finally, I believe it's better to err on the side of caution – we should worry more about ensuring that our financial institutions are well capitalized, are very liquid and have lower leverage then worrying so much about the effect that regulatory actions might have on their behaviour.

Most of the work being done makes sense and we are moving in the right direction. But, as the memory of the crisis becomes more distant, momentum on regulatory reform might slow. We need to keep keen focus – more time spent on debating the tools the FPC needs, how we tackle the too big to fail issue, how we entice the banks to change their culture and ensuring financial companies have appropriate capital, liquidity and leverage – and once the statue is in place move quickly to implement the new regime.

For the students in the audience today – I envy you. You have the chance to help fix the economic models that didn't work well in the past couple of years. You might be part of a financial industry that is changing to adapt to what society wants. The response to the crisis in 1929 was profound and served us well for about 70 years. When students study the crisis of 2008 they will be struck by the unprecedented global damage that was done but hopefully, also, by the appropriate policy that was taken to put things right.

[8] For a discussion of instruments of macroprudential policy see Bank of England (2011).

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