BANK OF ENGLAND

Speech

Let's make a deal

Speech given by

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Ladies and gentlemen – good evening. When I first met Bill [host William Smith, CEO Lazard Asset Management UK] I was a fund manager and industry representative. I am now a regulator. Specifically, I am an external member of the Financial Policy Committee of the Bank of England. The "FPC" is the focal point for something called "macro-prudential policy." The objective is to identify and mitigate threats to the financial system of the UK. At the moment our priority is to protect the banks from the financial system - and the financial system from the banks.

Banking regulation is an unappetising subject for a dinner speech. Yet one can hardly avoid the topic today. Indeed, some feel and I quote: that "The remorseless rise in regulation has become the greatest risk facing the banking sector." Have you heard that one before? Who hasn't? How many of you agree? One thing is certain: regulation is a growth industry.

But just what exactly are the “risks” from this rise in regulation? Well, banker complaints fall into one of three categories: 1) regulation is too tough; 2) regulation is damaging; and 3) the regulations are too numerous.

The first assertion is that the regulations are too tough; that the boys in Basel are bonkers. So, let's start with a few facts about the Basel regulatory framework - as it has been and will be.

Banks take risks. When more risks go right than go wrong, the result is a profit. At other times a bank's equity capital absorbs the loss. If there is not enough capital there is one less bank - or one more call to the taxpayer. Of course, some risks are riskier than others. It follows that one should have more capital to support the riskier activities and less for the less risky. This in a nutshell is the basis for the Basel rules governing global banking. This approach produces a system of “risk weightings” for bank assets. Sounds sensible? Yes. Is this tough? That depends on the amount of capital required. Will it work? That depends on the judgement of those “bullies” in Basel. So just how much capital must banks have to support a given level of risk - under the old rules and the new?

Well, let's take government bonds. You will have noticed that some sovereigns are safer than others. Germany is less risky than Greece nicht var? The Basel Committee of the day did not think so. No capital was required for what was deemed to be a risk free asset. Bad call: the write-down on Greek government bonds was 74%.

Next, let's consider mortgage lending. Do housing prices always go up? No. Might they sometimes go down? Yes. How much might they decline?

1. 5%
2. 10%
3. 20%
4. All of the above?

"All of the above" would be a reasonable response - although a citizen of the Spain, Japan or the US of A might raise the ante. So what level of loss did the pre-bust Basel rules implicitly assume? Put more simply, how many pence of loss absorbing equity do you think banks had to have to support a 100% loan-to-value mortgage? 5 pounds per 100? 100 pounds per thousand? Answer: 86 *pence* for every 100 pounds of loan. In other words, the regulations required less than 1% of loss absorbing capacity for mortgages with no money down.

Of course straight mortgage lending is not the sexy stuff for many financial giants. Some investment bankers made millions by originating and distributing an alphabet soup of securitizations. Remember CDOs squared? How much loss absorbing capital do you think the old Basel rules required of banks to carry an investment in a debt obligation backed by a debt obligation backed by a pool of loans made to US sub-prime residential home owners? Yes, you heard correctly. Oh, and assume that these easy-to-understand securities were rated AAA by the world's leading credit agencies. What could go possibly wrong? Well not much in the judgment of the day. Basel required banks to have 40 pence per hundred pounds of such stuff. I understand that the ensuing losses proved somewhat in excess of that.

Of course that was then and this is now. We have all learned from our mistakes, right? Yet for your info, the new rules (that is the new improved version of Basel II which was the new improved version of Basel I) demand 135 pence of equity in support of every 100 pounds of similarly rated CDOs squared - a loss absorbing capability of less than 1.4% for a risk that most rating agencies, regulators, bankers and investors misjudged. Oh, and by the way, sovereign bonds may still register as zero risk.

Fortunately Basel III introduces a backstop. A bank's total leverage will be capped – at ahem, 33 times. Thirty three times leveraged! Many bankers believe this cap to be too strict. (Most hedge funds by the way, operate at less than 3 times.) One thing bankers *don't* complain about is that many of these new rules won't take effect until 2019.

Now I don't know about you, but I find it hard to describe the incoming Basel rules as "onerous" or "severe."

Which takes us then to the banking lobby's second lament which is that "regulations are damaging – damaging to the economy and damaging to shareholder value." The story line here is that higher capital requirements force banks to cut back on lending which then cripples our economy. Well you are all mathematicians so let's do the math. Bank A has a trillion pound balance sheet supported by

50 billion pounds of equity. Now let's double the equity required to 100 billion and retire 50 of debt. Has the balance sheet shrunk? No. Has the bank had to cut credit? No. Does more capital necessarily lead to less lending? No. So does society have to choose between safety and growth? No. Many bankers would have you believe otherwise. It is what I call myth number one.

Ah, but "how dumb can you be?" will be the bankers' retort. "Equity is expensive. Make us double our equity and you will lower our Return on Equity (RoE), damage shareholder value and discourage the supply of bank capital."

This is myth number two. Let's take it two parts. First, RoE may well be an appropriate measure of *long* term bank profitability, but as a short term target it is flawed and dangerous. Ask yourself: has the investment bankers' fixation on double digit RoE achieved it over time? No. Has the annual emphasis on RoE produced attractive and sustainable shareholder returns? No. So does a short term focus on RoE equate to shareholder value? No. Why? Because it does not adjust for risk. The returns (and coincidentally the EPS-related bonuses) may come short term, but the risks come later. Later came recently.

Second, the successful investor is not interested in promises of short-term RoE; he is interested in achieving attractive risk-adjusted returns. The higher the perceived risk, the higher the return required. The lower the perceived risk, the lower the return expected. Capital will flow with either combination but its price will be different. Banks with little equity and lots of leverage are more risky than those with less leverage and more equity. Investors in both bank equity and bank debt will charge accordingly. That "charge" is the bank's cost of capital. And given that markets reward more predictable earnings with higher multiples, even lower earnings need not lower the market cap, dividends or shareholder returns. Not convinced? Look at bank share prices. The market is attaching relatively higher valuations to the relatively less leveraged. In short, higher capital requirements *are* compatible with economic growth and *are* compatible with shareholder value – they just are not compatible with non-risk adjusted banker pay.

Let us now move to the last category of complaints - that regulations are simply too numerous with which to cope. Needless to say that the growth in regulation is the predictable consequence of the near death experience we have all suffered and suffer still. "Never again!" demand our citizenry and quite right too. True, not all banks were guilty of greed, reckless risk-taking and monumental stupidity. But would the debacle have happened in its absence?

And yes, when it comes to culpability the regulatory establishment is not exempt. I have not heard many bankers accept blame for the crisis but quite a few within the regulatory ranks have acknowledged their failings. But for avoidance of doubt, let me say it here and now: the regulatory establishment blew it! We messed up in two ways: first we misjudged the breadth and depth of the risks that many banks were running. Second, we misjudged bankers' ability to judge and manage those risks. The latter is the more damning.

How could we have been so dumb as to believe that bankers were so smart? Both groups belong to the human race and the human race is hubris hungry and error prone.

Nevertheless, I do acknowledge that the cascade of consultations with which banks must now cope is challenging. So let me suggest a deal - one which I stress is not in my gift and which I propose in my private capacity only. How about a moratorium on all new regulation followed by a review and rollback of the rule book. In exchange, all banks everywhere would be required to raise their tangible equity capital to 20 percent of assets. The logic?

- We all agree that too many bankers got it wrong in the past and will get it wrong in the future.

- We acknowledge that too many *regulators* got it wrong in the past and will get it wrong in the future.

- We agree that the taxpayer should never again be stuck with the tab for our collective failures.

- And you now know that higher capital requirements need harm neither the economy nor bank shareholder.

Right? So, the best solution is to set the minimum for loss absorbing capital at a level which discourages recklessness and protects the public purse when it happens. Many leading academics and economists, place the optimum level for such equity at 20 percent. In return we can pare back the rule book - drastically.

So let's go back to where we started. Is banking regulation too tough? No. Is the demand for higher capital damaging? No. And are regulations too numerous? Maybe - but there is a potential solution, should the industry and body politic wish to pursue it.

Oh, and I forgot to mention: that opening quote about "remorseless rise in regulation" being a threat - it was taken from a major industry report published in 2005.

Thank you.