BANK OF ENGLAND

Speech

Prudential regulation: challenges for the future

Speech given by

Andrew Bailey, Executive Director and Member of the Financial Policy Committee,

Bank of England; Managing Director of the Prudential Business Unit, FSA

At the University of Edinburgh Business School

4 October 2012

It is a great pleasure to be in Edinburgh again and to have the opportunity to set out progress on the reform of financial regulation as we approach the formal introduction of the new arrangements. Scotland is home to a very important financial services industry for the UK and Europe and although it may at times seem like the changes taking place in regulation appear through London and Whitehall bubbles, they are clearly as relevant to you as they are to your counterparts in the City of London and Canary Wharf. All of us witnessed the costs associated with the failures of banks. We have learnt the lessons of that experience and that is why the reforms we are making to the way we regulate will affect us all and will create a system that is safer and stronger for every part of the UK.

One thing I should emphasise is that this is a reform of the whole of financial regulation. I say that because it is easy to conclude from observation of the issues we face as regulators, and the public debate, that we are just dealing with reforming the regulation of banks. That is not the case, and what we are doing is not about dragging the rest of the financial services industry into reform to solve a problem that is in essence only about the banks. We have to design a system that works effectively for all sectors of the industry.

On that theme, I would like to start by reflecting for a few moments on the lessons of history. My main theme is that I think integrated regulation – by which I mean regulation which combines Prudential and Conduct of Business in one regulatory body with single teams of supervisors covering both – has not worked as effectively as it would need to do, for reasons that are deep-seated in the structure.

I think there are a number of closely related reasons for this. First, on a rather practical point, I think it is hard for a single organisation to balance, particularly during a period of crisis, a wide range of very demanding issues which are individually rightly of great concern to the public and can come from anywhere in a landscape of around 25,000 authorised firms.

Second, I think the evidence suggests that, over the last 15 years, there have been periods when either conduct or prudential supervision has been more in the ascendancy to the detriment of the other. In the years leading up to the start of the crisis there was a dearth of prudential supervision, but I am quite prepared to acknowledge that there have been periods where the opposite has been true. My point here is that I don't think the system of integrated regulation demonstrated the ability to deliver a stable equilibrium of conduct and prudential supervision.

Third, there is something of an inbuilt tendency within integrated regulation to play down the active debate of issues where conduct and prudential regulators find themselves with potentially conflicting objectives. Of course, it can be said that the 'twin peaks' approach that we are introducing could lead to endless debate and no outcomes. My own view is that that is not correct, and that the benefits of clarity in defining the objectives of the PRA and the new Conduct Authority, the FCA, will dominate any other consequences.

There are several important reasons why reform of financial regulation will, in my view, be an important step forward, starting with establishing very clear public policy objectives for financial regulation to which we, as the regulators, are fully committed.

For both banks and insurance companies, the PRA will have the objective of promoting the safety and soundness of firms. Consistent with this objective, it will focus on the potential harm that firms can cause to the stability of the financial system in the UK. We define a stable financial system as one that is resilient in providing the critical financial services that the economy needs. And this supply of services is a necessary condition for a healthy and successful economy, as demonstrated by the costs imposed by the financial crisis on the public and society at large.

For insurance companies, the PRA will have the second objective of contributing to securing an appropriate degree of protection for those policyholders. Why do we need a second objective for insurance? For me, it rightly emphasises that in taking out some forms of insurance policies, the public can become locked into very long-term contracts, much longer often than is the case in banking with deposit contracts. Bearing this in mind, the public interest I think justifies a second objective for insurance, which is more directly targeted at the situation of individual policyholders.

In contrast as bank deposits are redeemable on demand at par value, and as banks lend the deposits at longer maturities, so they are inherently fragile and vulnerable to contagion, so protecting the system protects depositors.

There are a number of important points in this description of the PRA's objectives. First, the emphasis on economic well-being as an ultimate goal aligns the supervision of banks and insurers more closely to the field of macroeconomic policy. This is in line with the definition of 'financial stability' as the continuity of supply of critical financial services which are important to the functioning of the economy. Three services stand out here: the provision of payment services including access to funds; credit extension; and, risk transfer.

This definition is critical to clarifying the public interest-objective in a stable financial system, and that this public interest can diverge from the private interest of a firm in profit maximisation without reference to the public interest. One of the biggest lessons I take from the financial crisis is the need to ensure that the boards and management of firms appreciate and act consistent with the public interest. To achieve this end, we need a much better definition of the 'public interest', which will come from the legislation.

The second important point regarding the meaning of the PRA's objectives is that it will not be the PRA's role to ensure that no firm fails. Rather, the PRA will seek to ensure that any firm it regulates that does fail should do so in a way that avoids significant disruption to the supply of critical financial services.

Nevertheless, failure is not without cost and there is inherent uncertainty about whether a firm can fail without damaging the financial system and the supply of critical services. Consequently, the PRA will expect a given level of resilience to failure from all firms. Now, I recognise that we have a lot to do still on resolution planning to be comfortable about our objective of avoiding a 'no failure' regime. For large banks, we are making progress on resolution planning, and this world is different to five years ago, but we are not there yet by any means. I have a background in resolving banks, and I regard having the capacity to resolve failed large banks – including the largest – as the Holy Grail of resolution.

Unlike the legendary Holy Grail, I think there is a good reason to believe that the objective of being able to resolve large banks that fail can be within our grasp.

But the challenge of resolving PRA-regulated firms goes beyond banks. Insurers raise exactly the same issue of continuity of provision of critical financial services. Moreover, in a line of business such as with-profits life, the business model involves pooling many vintages of long-term contracts in a single fund for the benefit of policyholders. A typical resolution involves run-off over a long period, which remains a sensible approach. But the public policy interest is reasonably directed towards ensuring a process of resolution, which is fair to those various vintages and more broadly which allows more rapid payout to policyholders, since the current arrangements can involve long delays and pressure for policyholders to accept lower payouts in return for greater speed. This is a different, but nonetheless important, public policy interest in orderly resolution.

I am very clear that when firms mess up, they should be allowed to fail, and by doing so they are putting at risk the money of their shareholders and if necessary after that, those who provide debt funding according to levels of seniority. But I am also very clear that really achieving the objective of avoiding a no failure regime requires a fundamental change of mindset both inside the PRA and in society more broadly. Fear of failure is an important conditioner of behaviour in a financial regulator, and achieving a change on this front depends on establishing a wide acceptance of our approach that orderly failure that does not compromise our public policy objectives is an acceptable outcome. To be clear, we should be criticised where failure compromises those objectives and we could have taken steps to avoid it, and we will be required to report on such failures. But if failure is orderly, and does not compromise our public policy objectives, the responsibility should rest with the board and management for failing to serve the private interest of their shareholders and creditors.

Last on the theme of failure, having firms that are either too big or too important to fail is bad for competition in the industries that we regulate. An industry where exit is too difficult is one where entry is likewise inhibited. Put simply, if we don't know how to deal with a failed firm, we will inevitably set a higher barrier to entry. This is what we see in the banking industry.

Embedding resolution into the public policy objectives of financial regulation matters for two reasons relevant to competition: first, because, to repeat, exit enables entry; and, second, because if, as we will, we require new entrants to satisfy us on their resolvability in order to be authorised, we can lower the barriers and costs of opening for business. We have already started to put this new approach into operation.

Resolution of failed firms consistent with the public policy objectives is one key plank of the new approach to financial regulation. Another key plank concerns the macro-prudential approach to regulation. The legislation will establish the Financial Policy Committee (FPC), charged with the primary objective of 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. In June, the Chancellor announced that the government would amend the Bill to give the FPC a secondary objective so that subject to being content on the first objective, it should support the economic policy of the government, including its objectives for growth and employment. Currently, the FPC is acting in an interim capacity to undertake, as far as possible, the future statutory FPC's macro-prudential role.

Macro-prudential regulation is focused on protecting the financial system as a whole. In a very 'big picture' sense, there is nothing new about this activity. The problems of the last five years have emphasised the close links between the health and behaviour of banks and the condition of the economy. This is a lesson of history, and one that should not have been forgotten. But, forgotten it was.

At present the FPC is pursuing two important objectives: seeking to increase the resilience of the UK banking system, including to the threats emanating from the euro areas; and, subject to being content with the path towards greater resilience, supporting the creation of credit in the UK economy.

I am in no doubt that if banks take reasonable steps to enhance their resilience, they will be better placed to sustain the availability of credit to the economy by lowering their cost of funding and reducing their vulnerability to unanticipated events.

Macro-prudential regulation takes a system-wide view of the risks we face and the buffers of capital and liquidity that banks should hold against possible stress events. This is very clearly the resilience objective for the system, to which the FPC attaches great weight. Banks in the UK have made substantial progress over the last four years in building that resilience, from of course a very low base. We believe that there is further to go on capital, and the FPC has set this position out, but in doing so we should not forget the distance that has been travelled. We should also remember that more capital cannot be conjured from thin air, particularly as there are at present quite severe constraints around the rate of return earned by banks due to low interest margins and redress for past misdeeds on conduct issues.

Credit growth in the UK economy continues to be weak. The latest Bank of England credit conditions survey indicates early signs of an increase in the amount of mortgage lending available to households, though much less evidence of a change in credit conditions for businesses. But it is very early days for the recently announced policy measures – in particular the Funding for Lending Scheme – which are intended to have a positive impact on domestic credit conditions.

So, we can see a picture of gradually improving resilience in the banking system but with further to go, but also credit growth which remains weak. In that context, and recognising the balance of objectives within macro-prudential policy, the FSA has taken a number of steps. We have allowed banks to reduce the capital buffers they hold over the minimum requirements in line with new lending to the UK economy. Our view here is that a reduction in the risk arising from this new lending caused by an improvement in credit conditions should offset the risk from lowering capital buffers. If such extra lending boosts economic growth, it will enhance resilience in the financial system. Likewise, we have altered our guidance to banks on the liquid asset buffers that they need to maintain. This reflects the Bank of England's stance on the potential access of banks to liquidity from the Bank, and a wider desire to reduce the incentives for banks to hold excessive liquid asset buffers for precautionary reasons. This, too, we hope will support credit availability.

It is too soon to assess the impact of all these changes on the resilience of the financial system and on credit creation. We will monitor the results of these actions very carefully, and we will be prepared to amend our judgements in the light of experience. The key point here is that we are applying judgement to our decisions on regulation and within a framework that quite explicitly defines and seeks to balance our objectives of resilience, the primary objective, and, subject to that primary objective, supporting credit conditions and economic activity.

To be clear, in this world of judgement-based regulation, we will not get all the calls correct, not least because the future is uncertain. But, I am a lot more comfortable that we have a framework in which we can apply judgement more consistently and be held to account for those judgements in a more open way.

There is one further element to the package of reforms, namely the measures proposed by the Commission chaired by Sir John Vickers, which the government intends to place into legislation in the near future. I fully support the Vickers proposals. The key plank of this is to ring-fence commercial from investment banking and, in doing so, define the scope of commercial banking that can be inside the ring-fence. This will be a major structural change for the banking system, and will have important implications for us as regulators. There are two key points for me in the Vickers reforms. First, in the last ten years or more, the nature of investment banking has changed to include a much larger element of proprietary position taking. The incentives and risks of this activity are quite different from commercial banking, and I do not believe that the two should be mixed in the same legal entity. Regulators around the world have struggled to regulate this mixture, and will continue to do so even though we have raised the cost of doing investment banking business through changes to the regulatory regime.

Second, in a world where we will not accept banks being too big or complicated to fail, it is sensible to be able to resolve commercial and investment banks separately, and to achieve this we need the ring-fence approach. This will support the continuity of provision of financial services.

In conclusion, we have a very big programme of reforms under way, with the central objective that we must not let a financial crisis of this scale happen again. The reform programme is founded on very clear public policy objectives. We are absolutely committed to the reform programme and knitting together the various parts. We expect financial institutions to abide by the spirit of it too. There are big changes in what we are doing, and it is an exciting time to be putting these changes into effect. We will get a much clearer focus from splitting prudential and conduct regulation for banks and insurers, from introducing macro-prudential regulation to help to protect the financial system as a whole, and from focusing our regulation on applying judgement in a transparent way. Firms that mess up should, and will, be allowed to fail, but it must not be at the cost of damaging the financial system and economy. Ringfencing commercial and investment banking will help to achieve that objective. And, out of these reforms I hope we can encourage a banking system that is more open to competition and serves the public more effectively and, more broadly, a financial system that delivers the public policy objective of financial stability.

Thank you.