BANK OF ENGLAND

Speech

The future of UK banking – challenges ahead for promoting a stable sector

Speech given by

Andrew Bailey, Executive Director, Bank of England

At the Westminster Business Forum, London

24 May 2012

Thank you for inviting me to speak today on what is a very important subject. I will speak from the perspective of the prudential regulation of banks in this country, but in doing so I will seek to link our objectives as regulators to other areas of public interest.

I will begin by setting the scene in which retail banks operate today from a prudential perspective. I want to start with the macroeconomic backdrop as it affects retail banks. The current period of difficult economic conditions is not like many of its predecessors, in that it is characterised by very low interest rates and, by comparison, lower inflation. This means that, whereas in past periods, banks tended to see more of the impact of difficult conditions through loan losses, today the impact is felt more through highly compressed interest margins. Competition for retail deposits is very stiff, so that even though in normal terms, rates paid to savers are at historical lows, the gap between the Bank of England Base Rate and retail term rates is historically high. This is a reflection of the pressure on banks to close their customer funding gaps in order to reduce their dependence on less stable forms of outside funding. On the other side of balance sheets, although we are seeing loan rates re-priced upwards, it has on average not been as rapid, and is dependent on contractual terms as to how much a loan can be re-priced in terms of the rate charged. So, interest margins and income for banks are squeezed. But, we are on the whole better placed seeing the cost come through in bank margins than in more re-possessed homes and the dislocation of households that goes with that. In terms of the broader public interest, this strikes me as much the lesser problem.

Alongside squeezed interest margins, there is no doubt that we are seeing a reduction in the private sector debt to GDP ratio which for banks means the deleveraging of their balance sheets. Private sector debt to GDP is on the whole a good measure of whether the stock of credit creation in the economy has gone too far. But the turnaround of extended debt to GDP ratios is not quick – depending on the scale of adjustment it can take up to 5 to 10 years based on historical examples. Interestingly, evidence suggests that the UK has seen a larger decline in its private sector debt to GDP ratio than most other developed economies during this crisis. But, insofar as this deleveraging has further to go – and there is reason to believe this is the case – it will tend to prolong the period of squeezed interest margins for banks. I offer no view at all on monetary policy, but I do expect risk managers at banks to take a cautious view and assume continuing low interest rates for the foreseeable future, and thus a continuing squeeze on interest margins.

A further factor weighing on banks is the risks from the euro area. Last November I made myself notorious in some circles by saying that banks should prepare and plan for the contingency of counties leaving the euro area. I did not predict such an event; rather, it struck me as sensible contingency planning. That work has now been under way among banks for some time. Whatever happens in the euro area, there is a cost of adjustment, and that too will act as a drag on the returns earned by banks, and in the worst scenario presents a clear threat to financial stability. This is the biggest risk to stability that we face today.

Next, and as if the macroeconomic backdrop wasn't enough, we are in the midst of a major transition to a new and stronger regulatory regime for banks. That is a very logical and appropriate response to the crisis. Capital and liquidity buffers were clearly inadequate in the past, exacerbated by the culture of loose regulation and arbitrage of regulation by banks in the run-up to the crisis. So, this is rightly changing, and this transition is another drag on the banking system in terms of returns. Important questions for the authorities are how fast should this adjustment happen, and what signals should the authorities give to banks on the need to build up buffers of capital and liquidity? There is a tension between a gradual transition to the new standards, which smoothes the effects on banks, and a fast transition which arguably builds credibility more rapidly, but at the expense of a more negative impact on the performance of banks. Also relevant here, is the need <u>not</u> to create more uncertainty by asking banks to raise capital without conveying a clear sense of the pace and end point. We must not forget that uncertainty cannot be measured or easily priced. This is an important message for the authorities – we must not let our actions create unnecessary uncertainty over the framework and end-points of our objectives. The recent IMF statement on the UK put this well in my view when it stated that as authorities we should be clear as to our expectations on the transition path to the new Basel III capital requirements since an accelerated pace can have adverse implications for the economy, and on liquidity requirements we should take account of the state of the economy and the Bank of England's role in providing liquidity insurance.

Let me now turn to other challenges I see for retail banks. There is a very strong, and desirable, push to make all banks, including the largest, resolvable in the event of them approaching failure. Although I don't want to count chickens at this stage, I am cautiously optimistic that we are beginning to see the making of solutions for the resolution of major banks, most likely with the bail-in of creditors as the way to end the dependence on public money. There are two aspects of this work which I want to highlight for retail banks. First, it is of course a reality in transferring the responsibility from the public purse to private creditors that we would improve the pricing of the risk of banks failing – it would be charitable to say that in the past governments have not properly priced the cost of Too Big To Fail. Private creditors of banks will do this, as they should. I raise this because it is another important transitional element in the cost of banking.

The second aspect of this transition from public support to resolution at the expense of private liability holders in banks – which by the way would move the banks into the same place as other companies – is the issue of the public interest in the continuity of the supply of financial services. Increasingly – and in my view correctly – the objective of bank resolution is to ensure the maintenance of the supply of critical financial services to the economy, and thus to all of us as users and consumers. The test in my view is whether we need to ensure continuous supply of a service, or whether we can as users experience a break at acceptable cost. In retail financial services, I would say that for all of us access to our transactional money balance – our current account – and the associated ability to make and receive payments is crucial. But, on the whole, we don't need continuous access to the same financial adviser. We could look for a new one. But where we need continuous supply, the resolution objective must match that desire. Here we come to the Independent Commission on Banking led by Sir John Vickers. The Government will publish a White Paper on this before long, and it is not for me to pre-judge what that should say. So, I will limit myself to one comment. For me, the logic of a ring fence – which would be focused on retail banking – lies in the desire to be able to resolve a major bank and provide continuous access to critical services to customers. But I see the case for being able to do this without having to deal with the whole bank as a going concern. It should not be necessary, for instance, to treat the trading books of banks in the same way – there my resolution objective would be orderly run-down at much lower cost than we saw with the chaos of Lehman. So, for me, the logic of the ring fence lies in providing different resolution options consistent with the public interest in continuous access to critical financial services. But, to be clear, we do need to have a full debate and assessment of what are critical services – the White Paper should deliver this, and it is an important issue for Parliament.

Let me end with one more big issue. The Commission has made a major contribution on both protecting the supply of banking services and on competition. I want to end on the latter. In the same speech last November, I managed to attract some notoriety also for stating that free in-credit banking in this country is a dangerous myth. It is a myth because nothing in life is free; rather, it means that we pay for our banking services in ways that are hard to link to the costs of the products we receive. This can distort the supply of banking services. The dangers include that the pricing of banking to consumers varies too much depending on the services they use. I also worry that the banks may not properly understand the costs of products and services they supply. And I worry also that this unclear picture may have encouraged the mis-selling of products that is now causing so much trouble. In short, I think that the reform of retail banking in this country cannot move ahead unless we tackle the issue of free in-credit banking, and have a much better sense of what we are paying for and how we are paying. But in truth this is not something that will happen spontaneously. It is hard for a single bank to break out of the existing situation without appearing to raise the price of its service to customers (even though it may not actually be raising the price as a whole). And, it is hard for the industry as a whole to break out without appearing to collude. So, it may require intervention in the public interest, not least because it is a way to encourage greater competition. To be frank, I know from last time I raised the subject that the reaction is mixed. But, even if I am like a dog with a bone on this one, I don't think we will have a retail banking industry that is properly serving the interests of the public until we tackle the dangerous myth of free in-credit banking.

Thank you.