BANK OF ENGLAND

Speech

The new approach to financial regulation

Speech given by

Andrew Bailey, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority

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It is a great pleasure to be here this evening for the Chartered Banker Dinner. President, in the description of tonight's dinner you made the important point that the Chartered Institute supports "ordinary" bankers providing a vital service to their customers at a very difficult time. I want to speak tonight about the importance of those vital services.

The fact of the matter is that banks are in the dog house, and for reasons that are very well documented I am afraid. But, in saying that, it would be wrong to believe that this makes banks irrelevant and unwanted. On the contrary, the financial crisis has through adversity reminded us of the importance of banks to the functioning and health of the economy and their role as providers of critical financial services. Going back in history, it was Walter Bagehot in the 1870s who argued that the development of joint stock banks played an important part in the growth of the mid-nineteenth century British economy with its very high degree of openness to world trade. Scotland played a very major part in that period of economic development, and in the first official history of the Bank of England, Sir John Clapham recorded that the Scots loved their banks.

Banks were then important institutions supporting the industrialisation of the British economy and the trading system that fostered this growth. There is no difference today as the purpose of banks remains to support activity in the real economy, most obviously by intermediating between savers and borrowers to enable credit creation. Now an observer could easily intervene and say "yes, but, what I observe is that they have developed funny ways of going about it" – complicated products, likewise impenetrable slicing and dicing and re-packaging, all with the end of supporting bankers' remuneration on a vast scale. There is some truth of course in that observation, but let's not forget that there is a permanent interest of public policy to ensure the continuous provision of critical financial services to the real economy of this country, that is protecting savings, enabling payments, credit creation etc. What goes with this is a very sharp public policy interest in the state of the banking system. This will not change and nor should it – banks are too important to lose sight of them in ways that happened in the past.

The job of prudential regulators is to maintain the safety and soundness of the banking system to ensure the continuity of those critical services to the economy and to the public. The crisis has been a searing experience for banks and regulators, precisely because at times they have both failed to fulfil this central objective of maintaining safety and soundness and hence the continuous supply of critical services to the public.

For what is now not far short of three years we have been working to change the approach to financial regulation in the UK. We are still working to do that of course, but the difference is that for the last four and half weeks we have been doing so within the new regulatory framework of regulation – we are doing it now as the Prudential Regulation Authority and the Financial Conduct Authority. The prompt for this change of approach has been the severity of the financial crisis, a crisis that has been through a searing phase of prudential problems – failing banks – and more recently a conduct phase as the misdeeds and unacceptable behaviours of the past have been revealed.

On a personal note, recently when my appointment was announced, I was described a number of times as a veteran of the Bank of England. It was for me a moment of home truth; 28 years is quite a long time in one place, even if the term veteran sits uncomfortably. But it reminded me that the UK is on its fourth system of financial regulation during that time. The serious message from this is that institutional structures do matter for the success of public policy goals and objectives.

The last major reform of the institutional structure in this field was in 1997, when the then Government reformed monetary policymaking and financial regulation. The results of these changes were very different. The MPC has in my view been a good example of a successful institutional structure. You can argue with what the MPC decides month-by month, you can debate how the framework of policymaking should put into effect the mandate in statute, but the test of a successful institutional structure of policymaking is that these debates can be had without undermining the credibility of that institutional framework. As a close observer, I would say that the MPC has passed this test very well.

I make this point because the same cannot be said over the last fifteen years or so for the institutional structure around financial stability and supervision. In the 1990s in the UK there was a very determined effort to build a lasting structure of monetary policy in the wake of the difficult experiences before that. That institution building effort was about enabling good policy-making, supported by strong accountability to Parliament and the public, a determination to be transparent in making policy, and as part of that a commitment to engage with all the regions of the country. Today, we face the same challenge with financial stability and supervision.

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.

The 1997 reforms created the FSA as an integrated regulator – by which I mean regulation which combined Prudential and Conduct of Business in one regulatory body covering the broad sweep of the financial services industry. The record now shows that this approach did not work as effectively as it needed to do.

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 was something of an inbuilt tendency within integrated regulation to play down the active debate of issues where conduct and prudential regulators found themselves with potentially conflicting objectives.

There are several important reasons why reform of financial regulation will in my view be an important step forward. It starts 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 policyholders. Why do we need a second objective for insurance? One reason is 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.

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 in terms of the continuity of supply of critical financial services which are important to the functioning of the economy. Four services stand out here: the protection of savings; 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 I believe we now have in the new legislation.

The second important point in terms of 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 costless 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.

There is another major public interest in the banking system, namely that by becoming too big to fail, the largest banks have developed an implicit, and in some cases explicit, dependence on public money. This is unwelcome, for the public, and for the banks, the former because of the unwanted cost, and the latter because of the intense scrutiny and oversight of the banks, which must be more intense as long as this state of affairs lasts.

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 and thus solving the Too Big To Fail problem.

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.

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 firms, the authorities 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 which 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. 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. 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 will lower the barriers and costs of opening for business.

Put simply, if we don't know how to deal with a failed firm, we will inevitably set a higher barrier to entry. 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 has formally established 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.

The FPC also has a secondary objective, to support the economic policy of the Government, including its objectives for growth and employment.

The root of the introduction of macro-prudential regulation sounds quite obvious, which is to take into account the impact of financial regulation on the functioning of the real economy. Obvious you might say – yes, but it wasn't done in the past.

Macro-prudential regulation is focused on protecting the financial system as a whole. It is quite simply about ensuring that financial regulation is conducted with an eye on the state of the economy. 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.

A clear objective of macro-prudential policy is to act in a countercyclical fashion – to restrain booms by acting to tighten regulation, and to seek to dampen the impact of busts. Unfortunately, the record of the past shows that the behaviour of regulators has not been consistent with these objectives.

The crisis illustrates the dangers of not applying restraint in what appeared to be good times. But it requires a very strong culture to allow this type of restraining to happen. The record of the past indicates that the temptation to "let the good times roll" is deeply embedded in the political economy of regulation.

Macro-prudential regulation can also lean against the tendency otherwise of micro-prudential regulators to toughen up their regime in the teeth of the storm. At the heart of this new approach to making policy is a very simple observation, namely that changes in regulatory intensity in this area can have an impact on credit availability and thus the performance of the economy. There are two legs to this argument, and it is important to understand both.

The first leg involves the simple proposition that a well capitalised banking system is more likely to support credit creation in the economy. We see evidence today of better capitalised banks tending to see more rapid growth in lending.

It is with this objective in mind that the Bank of England's Financial Policy Committee has recommended that the major UK banks as a group should increase their equity capital resources. The whole point of this action is to enable forward-looking judgemental regulation to take effect in a system where balance sheet strength is a necessary pre-condition of stronger lending to the economy as a whole. In the same vein, last summer the Bank of England and the FSA took steps to implement a clearly counter cyclical response to a situation which was a problem to for the economy as a whole.

It was an occasion on which responsibilities were well-defined and thus the accountability for the actions was clear; for the Bank, to introduce the FLS to support lending by bank and likewise to introduce the extended repo operations for the FSA, to loosen liquidity requirements and adjust capital buffers to incentivise net new lending.

The key message here is that if the banking system is sufficiently capitalised against future losses, it can play a full role in counter-cyclical policy which seeks to respond to and lean against the conditions of the day. That is the essential use of forward-looking judgement, done with the explicit objective in mind of using financial regulation as a counter-cyclical tool.

At present the Bank of England is pursuing two important objectives: seeking to increase the resilience of the UK banking system, and, supporting the creation of credit in the UK economy.

Let me say a few words therefore about the announcement last week to extend the Funding for Lending Scheme and modify its terms. It is almost a year since we designed and began the implementation of the current FLS.

That was done against the backdrop of a much more febrile environment in the euro area in terms of sentiment and a real concern that the risks arising from the euro area situation were affecting the costs of funding for UK banks and therefore their lending and the economy more broadly.

Alongside that evidence, we could see that the sum of the projections for lending in the two years ahead for the UK banks was substantially negative. The case for acting was therefore strong, but the challenge was also that in its first year, success for the FLS was in some ways to prevent the most negative outcome for lending, which in an absolute sense would not look great.

What we have seen over the last year is quite a substantial change in the funding costs of banks which has fed through into lower lending costs, but more so in terms of the amount of lending in the mortgage market than for small firms. Funding for the major banks have also become less disposed, which has probably increased the willingness of banks to compete on lending. But the uneven pattern of lending meant that we thought it was sensible to increase the incentives for banks to lend to small firms.

We cannot say that this will conclusively deal with the question of whether the problem is a lack of loan supply or demand, but we can say that we have used our toolkit to create a big incentive for banks to lend to small firms.

In summary, there is a strong public interest in the banks, which has been sharpened by the crisis. One element of that public interest is permanent – the role of banks in supporting the real economy. Another is permanent, and like the first should be in the category of a given – namely, good conduct by banks. But the third – the dependence on public money – should not survive, hence the strong focus on developing bank resolution and ending too big to fail.

President, we all have our work cut-out. You can take pride in the role of the Institute in supporting the establishment of the Professional Standards Board and their work on the Code of Professional Conduct and the Professional Standards initiative. As a start, I understand that at least 70,000 bank staff will go through the Foundation Standard by the beginning of July this year. This is a big achievement, for which those involved should be proud. There is a lot more to do I know, but let me congratulate Susan Rice, who has led the work, and everyone else involved. Thank you