BANK OF ENGLAND

# Speech

## Banking in the tundra

Speech given by

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For their help in preparing these remarks I am indebted to many colleagues at the Bank of England, especially David Aikman, Martin Brooke, Will Dison, Ruth Hendon and Rhys Phillips. Responsibility for all errors and misjudgements, however, rests entirely with me.

It is a great pleasure to speak at an event organised by OMFIF. David Marsh is an old colleague and friend, whom I have known and admired for an implausibly long time. And OMFIF itself one hears spoken of with awe, especially by people who are not quite sure what it is. I like to think of it as a private-sector rival to the IMF, but without the inconvenience of a large balance sheet.

OMFIF takes central banks and their problems very seriously, for which we are grateful. As a member of the Bank of England's Financial Policy Committee, charged primarily with protecting and enhancing financial stability, I am required to take commercial banks and their problems equally seriously. Periods of anaemia among banks can cause damage to the economy as a whole just as surely, if less dramatically, than periods of mania. I want to talk today about two kinds of difficulties facing banks at the moment. One concerns the struggle for financial returns, the other – perhaps in the end more chronic – relates to the structural problems banks face in rebuilding a relationship of trust with their customers.

When pressed to find a title for this talk, I came up with 'Banking in the tundra': it's quite cold out there, the landscape is very flat, and trees do not even pretend to grow to the sky. Luckily the bankers are wrapped up warm, in highly resilient anoraks with contingent-convertible hoods, but the huskies have not been fed for a while, and are getting tired and rebellious. We are in Siberia, where many people feel bankers belong, so perhaps there is hidden treasure under the permafrost.

Before coming to my main points I'd like to address in passing a troubling peculiarity of the financial policymaking landscape over the last year or so. Many observers somehow formed an impression that the authorities, including the FPC, had abandoned a regime of what had been characterised – in my view quite wrongly – as stringent, even oppressive policies towards the banking sector and had begun to march off in a much more accommodative direction. This has been so widely reported as to be considered pretty much a matter of fact. It sometimes feels as though we on the FPC are being door-stepped and challenged: 'Admit it – have you stopped bashing your banks?'

Students of logic and rhetoric will know that there is no good answer to this question. But I want to put on record that these atmospherics have not affected the FPC's discussions or decision-making. In our work on bank capital requirements we feel to have been trudging for some years, in a more or less straight line, towards the proposals that are now in the public domain. The emerging settlement on bank capital is intended to correct the chronic undercapitalisation of the banking sector at the time of the financial crisis and achieve resilience without imposing unreasonable transitional costs at a time of weak global growth. In forming our views, we made a number of assumptions about risk weights, and about the effectiveness of resolution, and we have undertaken to keep these under review.

It has been strange for me as an FPC member to have our work judged according to criteria that I do not recognise. And it is uncomfortable to be tempted, viewing decisions in the light of how they may be judged under such criteria, to tweak them accordingly. I believe so far we've avoided this temptation. It is possible, too, that some of the concerns raised about  recent FPC proposals, most prominently by Sir John Vickers, with whom I served on the Independent Commission on Banking that he chaired a few years ago, may have been influenced by the persistent drip of allegations of institutional wimpishness.  For what it's worth, I believe that the difference between Sir John's ICB version and the FPC on the construction of the capital stack is more or less invisible to the naked eye.  If these judgements on the capital that banks require turn out to be too low, it will not be because they're a tiny bit too low.

One particularly bizarre instance of what I have called these atmospherics was the breathless proclamation some months back in a newspaper story that the Bank of England had caved in to pressure to the extent of allowing ring-fenced banks to pay dividends.  Now at no time in the previous four years, as far as I am aware, had there ever been a suggestion that ring-fenced banks might not be allowed to pay dividends: indeed, it's hard to construct a model in which such a proscription could be made to work.  The story was complete tripe, but like many other such stories, it has been re-tweeted and reheated until anyone consuming it risks poisoning by internet salmonella.

I said a moment ago that the banking landscape was flat, and it was of course of the yield curve that I was thinking.  To mix metaphors, it looks like the heartbeat of a deep-frozen mammoth.  That crucial banking standby, maturity transformation, doesn't work well under these circumstances; if they persist, the banks will be obliged to widen spreads in order to get some oxygen back into their business (there are tentative signs that this is happening).  But this isn't the element that worries me the most.

When our colleagues on the Monetary Policy Committee, rather over seven years ago, reduced  official interest rates to their present stunted level, and when their counterparts in other jurisdictions did the same, one may suppose they were not only out to influence the cost of debt.  They must surely have hoped and expected that as the risk-free interest rate came down, the cost of equity would follow in step.

Those of us who remember the great inflationary wars of the 1970s and 1980s may recall the British conviction that the big problem ailing our economy was a combination of high and volatile inflation and high interest rates, which led to very high discount rates for investment proposals.  Payback periods were necessarily short, and business people looked with envy at companies in Germany or Japan with low inflation, low interest rates and a low cost of capital.  In Switzerland, an all-in cost of capital around 6% was even before the crisis a standard objective for corporations.  Get UK inflation and interest rates down, we thought, and an investment bonanza in Britain was sure to follow.

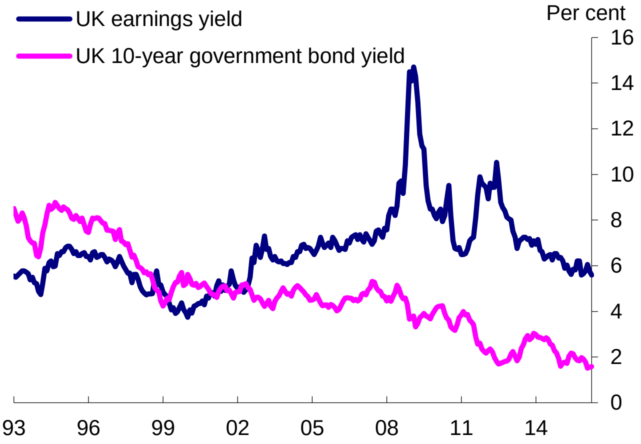
Well, the first bit has happened.  Yet the post-crisis fall in interest rates has not been accompanied by anything like the same reduction, it appears, in the cost of equity.  The Bank's calculations show that the equity risk premium (ERP) may have roughly doubled from its perhaps unsustainably low level at the turn of the century during the dot-com boom.  This rise in the ERP has been working vigorously against the fall in the risk-free rate.

Measuring equity risk premia and thus the cost of equity capital is a slippery business. But here are four ways you might think of coming at it.

First, you could measure the average return above the risk-free rate that equity-holders have actually received in the past. They may not always have got what they hoped for, but there are real numbers here, even if they are hugely sensitive to the investment time periods selected.

Second, you could generate instant readings by taking current share prices and current analysts' forecasts of future dividends, and solving – using the dividend discount model – for the implied discount rate and thus, because the risk-free rate is known, the equity risk premium. Since published dividend forecasts are much less volatile than share prices, you get a very jumpy series for the residual ERP (which precisely because it is the residual picks up all the 'noise'), suggesting that short-run changes in the level of equity prices reflect changes in the ERP rather than changes in expected cash flows. Further evidence that the cost of equity has not fallen alongside interest rates is given by the widening gap between government bond yields and the earnings yield on equities (the reciprocal of the price/earnings ratio) [see Chart 1]. The results derived from these methods correspond rather well with the twitchy risk-on/risk-off markets we have seen in recent years; not so well, perhaps, with earlier equity markets dominated by long-only investors who prided themselves on taking a steadier view of the world.

**Chart 1: Gap between earnings yield on UK equities and 10-year government bond yield**[(a)]




(a) Earnings yield is the reciprocal of the price-earnings ratio.
Source: Datastream, Bloomberg and Bank calculations

Third, you could ask those long-only investors, if you can still find any, what returns they demand.

And fourth, you could ask companies what returns they feel they need to generate, and thus feed into their budgeting and their investment proposals.

Taking these together by means of heroic anecdotal sampling gives answers that are consistently higher than one might expect, and this gives rise to much difficulty.

The ERP and the cost of equity are slippery because they appear to occupy a space that is part-objective, part-emotional. (The financial markets are on one level a place where emotion is objectified). A number of observations may be made about the recent rise in the ERP, and thus the failure of the cost of equity to come down by anything like the same extent as interest rates have fallen (these observations are by no means confined to the UK):

1. Although it is commonplace to say that quantitative easing and loose monetary policy in general have supercharged the prices of financial assets, it may not be entirely true. Equity markets would be very much higher if the ERP had fallen back to previous average levels.

2. It is curious, to put it no more strongly, that investors should be content to hold sovereign bonds on near-zero or indeed negative yields while demanding in some cases double-figure percentage returns on equities.

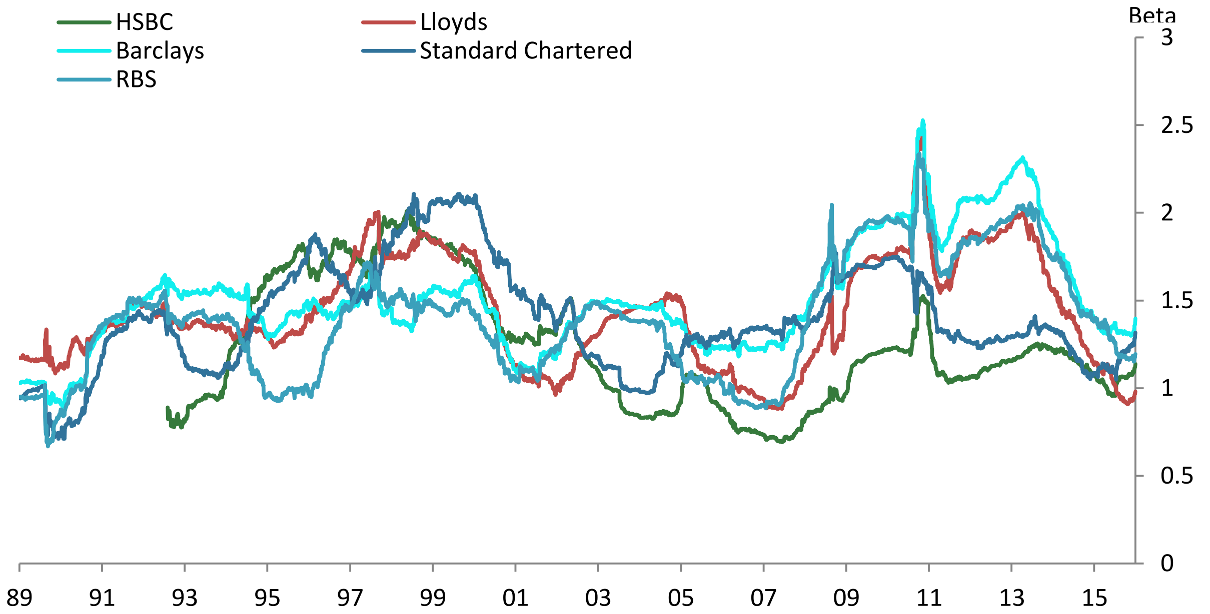
3. It is not surprising that corporate investment intentions lack vitality when so much pressure is on to sustain very high returns. Marginal investments in a successful company characteristically earn more than the cost of capital but less than the core business is earning. If the cost of capital is too high, they will not be undertaken and long-term growth will suffer. Andrew Smithers has written powerfully about the perverse role played by management incentives in reinforcing reluctance to invest.[1]

4. If this situation is difficult for companies, it is deadly for banks. If banks seek unsustainably high returns, whether as a result of a genuine market constraint or an imagined hurdle, they can do a lot of damage to the rest of us. And late last year the major UK banks were mostly publishing medium-term targets for return on equity of between 10 and 13 per cent, with some target ranges stretching as high as 15 per cent.

Banks do generally have a higher cost of equity than the market as a whole, because their beta is higher – they are, that is to say, because of their leverage and lack of transparency, more volatile than the market average. That leverage, though still elevated, has come down a lot since the crisis, and bank betas have come down a fair bit too [see Chart 2].

[1] See for example Smithers (2016).

**Chart 2: Historical bank betas from 1989 to 2016[(a)]**




Source: Datastream and Bank calculations

(a) Betas are estimated from a rolling least-squares regression of daily returns of each bank's equity price against daily returns of the FTSE All-Share index, using the prior 2 years of data.

Within a bank, different activities have different levels of risk and volatility and it is reasonable to suppose that the cost of equity varies by activity. This can directly affect the cost of capital: one would expect a diversified bank to have a lower cost of equity overall than the arithmetic mean of its constituents. Against this, I can tell you from personal experience that there are diseconomies of scale involved in running a large diverse group, and at some stage the financial markets might conclude that management was unable to handle the complexity inherent in diversification: that would push the cost of equity back up again. And banks have a lot more equity to service than they had before the crisis; each unit of equity is cheaper than it was, but dearer than it might be.

All that said, if the banking system has a very high real cost of capital, a number of dire consequences are likely to follow:

1. The banks will tend to under-invest in infrastructure and development, like the non-bank corporates discussed above.

2. They will look to increase the risk at the margin of their book, like the investors discussed above.

3. They will fail to provide credit to the economy on terms that would make perfect sense if the cost of equity were a little lower.

4. They will be unable to perform intermediation services profitably with the increasing number of clients who enjoy a lower cost of capital than they do.

5. Since as a result of all this they are unlikely to exceed the high hurdles they have set themselves, they will come under pressure to shrink. Insofar as this reflects a reduction in low margin business which has little to do with real economy lending, this may not do much harm, but shrinkage often turns out to be merely a short-term palliative. At a time when everyone wants to see the banking system supporting economic recovery, this is quite unhelpful. By demanding too much, we risk ending up with too little.

The brief panic in bank share prices earlier this year, when many institutions found their stock trading at half book value or even less, displayed the problem nakedly. At half book, investors are positively instructing management to withdraw capital from a business. And capital ratios do not look healthy if you recalculate them with numerators at market value.

What is behind the strange rise in the ERP? Does it result from investor pessimism about productivity trends? Is it a symptom of investor exasperation, a belated recognition, in the case of the banks at least, that these institutions are riskier than was previously understood – perversely, perhaps, given all the work that is going on to stabilise them and reduce their chance of failure? Is it a tendency to look through the present monetary policy stance as something artificial, and to demand compensation elsewhere? Is the attrition among long-only money managers, as defined benefit pension schemes shrink and insurance companies bow the knee to Solvency 2, part of the problem? Or have we misdiagnosed as a rise in the ERP an expectation, perhaps not yet fully captured in forecasts, of much lower future profitability in the trek across the tundra? Members of the Bank's Monetary Policy Committee have argued that interest rates are as low as they are not because of coordinated central bank whim but because there is so much caution in the system.[2] People seem to think some catastrophic outcome is possible, and this in turn pushes up the ERP. Whatever is going on, it hangs over the economy as well as the banks, and it should not be underestimated.

The banks are at last – nearly nine years since the financial crisis began in the summer of 2007 – showing signs of recognising that their business models need fundamental redesign. The length of time it has taken for this penny to drop has proved very costly.

Cultural questions are now coming vividly into play too, questions of concern both to supervisors and to macroprudential policy makers. I am not just considering how to stamp out evidently unacceptable behaviour (for which 'culture' has become a curious euphemism) but of the broader issue which the industry

[2] See for example Broadbent (2014) or Vlieghe (2016).

is now beginning to address of rebuilding customer trust – indeed, trust across society as a whole. Recent initiatives such as the BankingFutures report suggest a promising desire to get to grips with all this.[3]

These efforts are more likely to be successful if the industry confronts some of the structural questions which make trust so elusive now, and did so even before the horrors of the financial crisis and its aftermath. Banks were never supposed to be popular; we know from reading Theodore Zeldin that in 19th century France the financial institutions founded after a particularly bloody slump avoided using the word 'Banque' in their title, preferring Crédit or Caisse. Some of the new challengers in Britain today show a similar aversion to the B-word.

Yet bankers are human – I know, I used to be one – and generally do not relish being detested. Advertising campaigns going back to the Midland's 'listening bank' slogan provide eloquent evidence of a profound desire among banks and their retail customers for a different kind of relationship.

That this has proved so difficult to achieve, however, is neither accidental nor mysterious. The customers of a bank do not stand in quite the same relation to it as the customers of a retailer or a car manufacturer do to those firms. For a start, in the credit business, the golden rule of 20th century capitalism, 'the customer is always right', just does not apply. A customer nearing or in default cannot be said to be right in any sense. More generally, borrowers and depositors are more like counterparties of the bank than clients in the true sense.

In the corporate world this is perhaps more easily understood. The CEO of Amalgamated Assets may genuinely be a client of the Gigabank mergers and acquisitions team, who will do everything for him devotedly. But that same CEO's treasurer deals with Gigabank as a pure counterparty. The bank does not owe the treasurer a duty of care. He and they are fellow professionals facing off, and ten basis points more to one is ten basis points less to the other. No doubt the proprieties and courtesies will be observed, as among the Aleppo merchants described by the historian Philip Mansel, who followed the rule: 'If you do business with a dog, call him "Sir".'

Slowly and silently retail banking has gone the same way. The relationship with the customer is highly instrumental, behind that improbably glossy surface. Buyer beware, backed up with 200 pages of small print, makes an unlikely foundation for trust. (In saying this I do not in the least mean to criticise the conduct regulator, which has worked hard and thanklessly to order and codify the thorny underbrush of the financial jungle).

Things used to be different, perhaps, in mutual organisations such as building societies where the intermediation margin never changed and the same customer went from being depositor to borrower to

[3] See BankingFutures Working Group (2016).

depositor again over the course of a lifetime. They were certainly different in the pre-Big Bang Stock Exchange, for which it is unfashionable to feel nostalgia, where the broker had a duty of care to the customer and the jobber (or market-maker) traded on a counterparty basis. You knew who was on your side, and you knew who never pretended to be on your side. Now we have grown lazy about this distinction, and we probably get the results we deserve. Sermons won't fix it, and nor will advertising.

At the BankingFutures launch, the chairman of one major firm talked of his bank's desire to offer customers 'a fair proposition'. That may not be a slogan to have people dancing in the streets, but it is perhaps the best we can hope for at present. For many, it would be a big improvement.

The banking industry has a tendency, driven perhaps by its combination of oligopoly, leverage and cyclicality, to get itself into ghastly collective jams from which extrication is very difficult. Four examples – none of them original – come to mind at once:

1. The free-in-credit current account. In the 1970s, bank customers (much fewer in number than today) paid for transactions unless they kept a minimum of £100 on average in their account – say £1,000 in today's money. As interest rates rose, and unremunerated liabilities became very valuable to the banks, this fell to £50, and then the Midland (even before it had started listening) dropped the requirement altogether. The whole industry followed suit. Bank rate was 17% at the time; had you suggested then that three and a half decades later bank rate would be 0.5% – would have stood at 0.5% for seven years, indeed – and current accounts would still be free, you would have been catapulted into early retirement. The contortions the industry has put itself through to maintain this over-riding of the price mechanism have been very damaging, not only to the most vulnerable consumers who through penalty charges subsidise the better-off (they used to be known, revealingly, as 'delinquents'), but also, I believe, to banking in general. Perceived necessity has been the mother of mis-selling.

2. Teaser rates. In the mid-1990s the idea emerged – a novel idea to those of us raised in more conventional industries – that you should treat people who were not your customers better than those who were. These were not the familiar special offers used in consumer goods industries to persuade someone to try a new kind of shampoo, since the product in question was not a new kind of anything – it was usually an old kind of mortgage. The habit of giving what are effectively disloyalty discounts has turned into a cynical and corrosive negative-sum game. Many recipients of pre-crisis teaser mortgage rates are now marooned on the standard variable rate and unable to refinance.[4]

[4] See Bank of England (2014) for the analysis that supported the FPC's June 2014 Recommendation on mortgage affordability tests.

3. Over-paying investment bankers. City pay was always high relative to professional pay in general, but it really took off in the late 1990s, accompanied and facilitated by sharply increasing leverage in the industry. Numbers are hard to get hold of, but I suspect pay rose even faster than leverage and has come down a good deal more slowly. Keynes' dictum that wages are 'sticky downwards' seems to apply to salary-plus-bonus too. It appears to be easier to fire people than to pay them less; it may even be easier to go out of business altogether.

4. Regulatory arbitrage. The practice of 'optimising' returns on risk-weighted capital by exploiting the gap between regulatory risk weights and underlying risk has become more difficult now that banks have rules for both risk weighted capital and gross leverage to contend with: the noughts-and-crosses game has become three-dimensional. (The banks' first impulse seems to be to combine very low risk-weighted assets on the one hand with very much riskier ones on the other – the kind of barbell portfolio construction eerily reminiscent of investors' response to the higher ERP. Barbell portfolios do not have a glorious history). The habit of arbitrage has encouraged forms of balance sheet construction that overlay financial engineering on whatever mix of assets and liabilities naturally arises – and the word 'naturally' feels almost unnatural in this context – from the banks' day-to-day business operations. The firm might almost as well be run by an algorithm.

All four practices have two things in common. First, however uncomfortable the distortions they produce, bankers fear to abandon them, since first-mover disadvantage can be severe; collusion, meanwhile, is forbidden. Secondly, in different and sometimes subtle ways, they are all mechanisms that promote customer alienation. I have no easy solutions to offer, but feel that until issues like these are confronted, customer trust will continue to elude the industry.

I referred earlier to the improbably glossy façade that retail banks present to the public. FinTech solutions increasingly permit the illusion of real customer intimacy, in stark contrast with the early use of computing in mass market banking, which permitted a step-change in operating scale but was widely felt to be de-humanising. Some applications of FinTech will threaten the big banks; others may enable them to entrench their positions. Much may turn on whether the intimacy produced is genuine or specious; whether it serves a collaborative or exploitative relationship with customers.

Bob Jenkins, an engaged and trenchant member of our predecessor committee, the Interim FPC, called in a Financial Times article earlier this year for what he referred to as 'statesmanlike' bankers. He then had fun measuring some of the industry's more prominent individuals against the yardstick he had designed (they didn't, as it happened, come off all that badly).

'Statesmanlike' is a high bar, and one that even statesmen have been known to undershoot. I'd settle for having public-spirited bankers. They used to exist: think of Jeremy Morse and Tim Bevan, both sadly lost to us recently. Or David Rockefeller, who used to tell every recruit at Chase Manhattan that banking was all about character.  And it is.  The rot set in, I suppose, when people decided it was about what they curiously called talent.  A banker with character but moderate talent can go a long way; a talented banker without character is a public menace.

There are encouraging signs here and there that the good guys are getting back in charge.   But it's cold out there on the tundra.

Thank you for your kind attention.

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