



BANK OF ENGLAND

Speech

Geofinance

Speech given by

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Lord Mayor, Ladies and Gentlemen

The Prudential Regulation Authority had a bracing return from the summer break. There was no time for supervisors to compare sun-tans, which was just as well given the deathly pallor I acquired from a summer spent in London and Ireland. The only person with an even worse sun-tan than mine was a colleague who, in what I'm assured was not a political statement, took his summer holiday in Brussels. In fact, I was so desperate to boost my Vitamin D levels in September that (like a few others in this room) I headed south to Frankfurt, where I regret to inform you all that it was very sunny indeed. Yes, even the weather – a traditional safe harbour topic for financial regulators – seems to have acquired a Brexit-y tinge this autumn.

It was therefore a relief to get stuck into some domestic topics when we returned from the summer. First up, how the new accounting standard interacts with the bank capital framework here in the UK – a most enjoyable discussion, because you can never have too much of accounting standards. Next on the menu: consumer credit, of which you definitely can have too much.

Some of the most difficult issues greeting our return, however, were not so domestic in nature. Would cross-border reinsurance contracts function properly in the wake of Hurricane Irma? How might a bad outcome on the Korean peninsula affect British banks and financial markets?

Supervisors of the world's leading international financial centre have always had to juggle domestic and global risks. In between them, however, is a dynamic which is fundamental to retail and wholesale finance in the modern economy. It is a dynamic at play in the cliff-edge risks from Brexit and the differences of view between countries over Basel 3 finalisation.

I am thinking of the impact of borders, location and distance on the shape of banks, insurers and financial regulation. Put simply: the impact of geography on the geometry of finance, a dynamic we might call *geofinance*¹.

With the revolution in regulation following the financial crisis coming to its end, and with changes to the geopolitical landscape looming large, I think that geofinance is likely to be the defining challenge of the next few years.

The domestication of retail banking

Soon after the crisis I worked with the Independent Commission on Banking (ICB). Part of our challenge was to reconcile the UK's position as an international financial centre with stable banking in the UK.

¹ To be clear, I am not referring to any company with a similar name.

We concluded that domestic retail banking should be structurally separated from global wholesale and investment banking.

The distinction was *not* between a safe utility bank which would never fail and a racy casino bank which would never be saved. We have had plenty of experience of retail banks getting into trouble. Both sides of the ring-fence would undertake economically valuable activity, both would take risks, but each would need to be resilient to these risks without relying on the other.

I will not rehearse the full arguments here, but let me highlight one which has had less attention, which is about time-consistency. It is a plain fact that prudential regulators tend to ring-fence retail banking operations in a crisis – I have done it myself. Retail is predominantly domestic by nature and its troubles are best managed by those who know it best. So it makes more sense to recognise that reality and get the structures right *ex ante*, than to try and do so in a tearing hurry just as a crisis hits.

Ring-fencing retail banking is geofinance in action – in a good way. It goes with the grain of how banks are resolved, reinforcing the continuity of services which are critical to the real economy. It is predictable, with a clear framework of rules. It is proportionate, applying only above a clear size threshold. And it is efficient, allowing wholesale and investment business to prosper at a safe distance from retail and SME customers.

Ring-fencing is a very substantial undertaking for the PRA, the FCA and the affected banks – but we are on track for implementation by 1 January 2019.

Stability begins at home

Once these reforms are up and running, the core deposit-taking and payments services that must be continuously supplied to UK households and small firms will be protected in ring-fenced banks (RFBs). Groups operating across borders will also include non-ring-fenced banks (NRFBs) and will need to be resilient according to their global footprint.

Resilience requires systemic capital buffers both at the domestic and global level. The domestic buffer applies to the RFB whereas any global buffer applies to the whole group. The RFB and NRFB shares of capital should provide sufficient resilience for each. So if the size of the domestic buffer risks leaving the rest of the group with too small a share to be resilient against shocks, we will increase the group's buffer to prevent this from happening².

These complexities do not just flow from ring-fencing but from the international reach of many UK banking groups. We set their consolidated requirements as home supervisor. Overseas regulators (as host

² See *The PRA's approach to the implementation of the systemic risk buffer*: [Statement of Policy](#); 5 December 2016.

authorities) use their own rules to set requirements for the subsidiaries in their territories. They might consider these businesses to be systemic on a local basis. They might measure financial transactions under different accounting rules, apply different prudential approaches to assessing risks, or restrict capital transfer to the UK parent.

Therefore, a UK bank's overseas subsidiary might be required to have an outside portion of its group's capital. Back at home, the parent might fund the subsidiary's higher capital requirement by raising debt externally. This is known as 'double leverage' and firms use it because debt is generally cheaper than equity.

But servicing double leverage relies on flows of dividend income which are uncertain and at the discretion of local boards and supervisors across the group. Or the parent might be incentivised to under-allocate resources to unregulated but risk-taking entities within the group.

We need to be mindful of the risks this can create, and so today we are announcing a new approach, to ensure that UK banking groups are at least as strong as their parts³. Subject to our consultation:

- We will expect firms to demonstrate to us that they can manage the cash-flow and other risks associated with double leverage. And we will reserve the right to set double leverage limits or apply capital add-ons for group risk if we are not satisfied⁴.
- We will expand capital and liquidity reporting requirements to assess whether firms are allocating financial resources appropriately in relation to risks across jurisdictions and currencies.
- And we will use the Senior Managers Regime to ensure somebody is responsible for making sure submissions are up to scratch.

In doing this, we are getting to grips with an important geofinancial issue, and showing how we as a home supervisor can ensure that cross-border banks do not present excessive risks to financial stability.

The host with the most

The PRA is also responsible for the host supervision of around 170 international banks from over 50 jurisdictions. This includes every single foreign Global Systemically Important Bank and is more than any other EU country. International banks' UK banking sector assets amount to more than twice UK annual GDP

³ This does not mean we favour a 'sum of the parts' approach to setting group capital requirements. For our proposals, see [CP 19/17: Groups policy and double leverage](#) and [CP 20/17: Changes to the PRA's large exposures framework](#).

⁴ Market discipline already imposes some constraints on the amount of double leverage a holding company can use. Credit rating agencies, for example, take double leverage into account when determining the credit-worthiness of holding companies.

– a greater proportion than the entire US banking sector in comparison to US annual GDP⁵. On almost any measure we are the host with the most.

From the business model to the franchise, from the booking model to the operations, the UK entities of wholesale banks will usually be closely weaved together with other parts of the group. The broader the reach of an international bank, the greater its vulnerability to cyclical trends in the global economy. The more that banks are concentrated in certain overseas markets, the greater the UK entities' potential vulnerability to stress on distant shores.

A foreign bank can operate in the UK either as a subsidiary or a branch. Being a separate legal entity from its parent, a subsidiary is supervised and can be resolved in the UK. It will have financial resources and governance in the UK. In contrast, a branch is part of the same legal entity as its head office and it does not have a standalone balance sheet of its own in the way a subsidiary does. The home state usually leads its prudential supervision.

Why does this geofinancial distinction matter? Branches allow a more fluid movement of resources and diversification of risks within a group. But they also put the greatest reliance on the home supervisor and on cross-border co-operation.

Extending the logic of domestication

Retail deposit-taking is a critical economic function and local supervisors have more levers over subsidiaries than branches.

Therefore – consistent with the ICB's logic – we have preferred for several years that international banks from outside the EEA (known as 'third countries') with more than £100m of retail and SME FSCS-covered transactional or instant access account balances put them in a subsidiary⁶. There are not many of these: most international banks in retail focus on small expatriate or diaspora communities, or on particular niches in private banking.

We expect each of these firms to have a viable and sustainable UK business model which accretes a portion of its own capital, rather than being reliant on its parent, with high standards of risk management and governance.

⁵ See the [PRA Annual Report and Accounts](#); July 2017 and [U.S. Department of the Treasury: A Financial System That Creates Economic Opportunities](#); June 2017.

⁶ See [SS10/14](#): *Supervising international banks: the PRA's approach to branch supervision*; September 2014.

These retail subsidiaries are not as insulated as the financial and operational separation required by the ICB. But with a much lower threshold than the £25 billion of core deposits at which ring-fencing kicks in, our policy follows the same logic, proportionately applied.

Under passporting, currently we cannot apply our preference for retail subsidiaries to banks from elsewhere in the EEA. It would be odd to continue with this if the UK and EU27 become third countries following Brexit. Subject to the negotiations, our current planning assumption is therefore that all international banks will need to put material retail business in a subsidiary. This should be no surprise given our existing policy – we are engaged on this with the handful of relevant branches and will continue to promote a smooth transition⁷.

How far does this logic go?

Overseas there are moves afoot to apply elements of this logic to other parts of financial services, in particular to wholesale banking. Why does this matter to us?

The UK provides unrivalled access to global capital markets. Over three-quarters of foreign exchange and OTC interest rate derivatives trading in the EU takes place here. International banks from Asia to the Americas use their UK presence to raise finance on behalf of their home group. Since the first Eurobond in 1963, which financed the Italian motorways, international banking in London has driven growth in real economies around the world. And custody banks operating here safeguard and administer assets on behalf of institutional investors from east to west.

Wholesale capital markets and the banks which serve them are deeply interconnected and contribute to the efficient allocation of capital. International banks match savers and borrowers across the globe, reducing funding costs, facilitating cross-border investment and financing trade⁸.

This is why some wholesale banking activity lends itself more naturally to the branch structure which allows funds to flow more freely across borders. This requires regulators to work together to manage cross-border challenges to financial stability – implementing common minimum standards, sharing information and building confidence in how each other will behave when things go wrong⁹.

There has been a complementary effort to make it easier to resolve international banks via a ‘single point of entry’ (SPE). Overseen in its home jurisdiction, a SPE resolution would sweep up a group’s losses from around the world and bail in its creditors at the top. The group is recapitalised and does not go into disorderly failure.

⁷ See Woods, Sam: [Contingency planning for the UK’s withdrawal from the European Union](#); 7 April 2017: “...the PRA will expect those EEA bank branches which have significant retail/SME transactional deposits to discuss with it whether they need to establish a subsidiary, if they plan to continue that activity in the UK after its withdrawal from the EU”.

⁸ See Bailey, Andrew; [Free Trade in Financial Services matters](#); 29 September 2017.

⁹ See Carney, Mark; [The high road to a responsible, open financial system](#); 7 April 2017.

Against this grain, recently the European Commission proposed that non-EU groups above a certain size or systemic importance must establish a common 'intermediate parent undertaking'. Some see this as a response to US rules that require large foreign banking organisations to establish an 'intermediate holding company' to hold the ownership interest of all their US subsidiaries.

We are not persuaded that these developments are a good idea. Unlike retail banking, wholesale banking is international by nature. We risk kidding ourselves if we think it can be neatly chopped up into geographic units in which international banks can be supervised and resolved separately. If the real objective of the reform is to bring large investment firms within the scope of SSM oversight, that could be much more efficiently achieved by designating such firms, as we have done in the UK. Those eight firms which – by reference to published thresholds – have the potential to present systemic risk to the stability of the UK financial system are supervised by the PRA as well as the FCA¹⁰. The expectations on designated investment firms are in effect the same as on other subsidiaries of international banks. This system helps facilitate what is proving to be a highly effective and co-ordinated supervisory relationship with the US.

It is best to deepen co-operation so that between us we can properly supervise wholesale banking through branches as well as subsidiaries. This will be challenging, but progress since the crisis shows it can be done. Governments and regulators came together through the Financial Stability Board in a spirit of co-operative resolve and enlightened self-interest to build a framework of global standards. Through supervisory colleges and crisis management groups, insights and expertise are exchanged across borders.

We must finish the job of implementing the post-crisis reforms, hold the line and stick together. Because geofinance will always complicate the supervision of international banks, the high road will never be an easy ride. But we have already seen its benefits in a financial system that can ride out shocks and surprises.

Planning for the worst, hoping for the best

Going by recent debates, you could be forgiven for thinking that international banks and insurers have never had to operate across different currencies, legal systems and regulatory frameworks.

They have *always* had to navigate the contours of geofinance. They were perfectly capable of dealing with the introduction of the euro – and the years of uncertainty about whether or not the UK would join.

Following the referendum, international banks and insurers have done what they always do with risks they don't want to carry – they have hedged. The 'outbounds' using London as a base for continental operations are planning to beef up their existing EU operations or considering where to establish a new entity.

¹⁰ Eight firms as at 31 December 2016 – see <http://www.bankofengland.co.uk/prs/Pages/authorisations/designatedfirmslist.aspx>.

The impact of this first phase of contingency planning on jobs will be relatively modest. Contingency planning is a sliding scale of increased commitment, investment and momentum through time. It is much more prudent and prosaic than hovering over the relocate button or rushing to the exit door. But re-structuring by firms will in general increase their complexity. I struggle to see an outcome in which banks and insurers do not get harder to supervise and harder to resolve for all involved.

While the outbounds are a little further advanced in their planning than the 'inbounds' based in the EEA, I expect that – depending on any developments in the Brexit negotiations – we will see a large number of the latter apply to us for authorisation on the assumption that access akin to their current passporting rights to operate in the UK will fall away. Time and negotiations will tell whether that assumption will prove correct. If it is, authorisations are going to be a significant operational challenge for the PRA.

Brexit poses some material risks to our objectives but we are well on the case in dealing with them. In April I wrote to the CEO of every affected firm about their Brexit contingency plans and received over 400 responses. Supervisors have carefully scrutinised each one and provided feedback where plans needed more work.

We particularly want assurance that firms have considered 'cliff-edge' scenarios where there is no negotiated agreement for financial services in place when we exit, and the two sides do not reach agreement on issues such as transition, mutual recognition of standards, and co-operation in financial regulation or supervision.

Such scenarios are where contingency planning and evidence-led preparation will be most valuable. It's not our job to assess point estimates of their likelihood – it's to assess the risks to safety and soundness, and consider how to mitigate them. This is second nature for forward-looking supervisors who are in the business of precautions. The Treasury Committee is also quite rightly taking a close interest in these issues.

We are also engaging with financial institutions, trade bodies, the FCA and the government to unpick cross-sectoral problems. The two uppermost in our mind are the need to ensure that existing insurance and derivatives contracts can continue post-Brexit, and that data can be shared within groups across the UK/EU27 border. It would be messy and difficult for all firms to try to self-solve for these risks and I hope that we can find suitable fixes as the Brexit negotiations progress.

Most important is some form of transition or implementation period. This will not only help mitigate the Day 1 risks, but will also enable firms to adjust to the new relationship in an orderly way. While it is highly welcome that the UK government is clearly committed to this, the EU's position on transition is not yet clear – despite some obvious risks to EU financial stability in its absence. If we get to Christmas and the negotiations have not reached any agreement on this topic, diminishing marginal returns will kick in. Firms would start discounting the likelihood of a transition in the central case of their planning.

Further ahead, we hope for a strong, co-operative relationship in which wholesale banks can continue to operate across the UK and EU27 in branches. The fact this happens today is not just thanks to the passport. It is because we have shared in the long road of post-crisis reform, developing and implementing the same high standards. And it is because we have embedded a sophisticated framework of supervisory co-operation, toward the same objectives of safety and soundness. With common interests and a concerted effort, there is every reason to think these will continue into the future. But we must plan, in a proportionate way, for alternative outcomes.

Planning for the worst, hoping for the best.

Conclusion

In my speech here a year ago, I said that the post-crisis reforms will be treated to revisionist history and the calls of counter-revolution. So it has proved, most obviously in the US. Some still argue that capital requirements are too high, and others that they are too low. Broadly I think we have landed in the right place and I take some comfort from being flanked on both sides of the argument.

The next challenge will be striking the right balance of geofinance. How much is enough?

Learning the lessons of the past decade, we are embracing geofinance in the domestication of retail banking. The structural reform of major UK banks and a small number of international banks will help anchor their safety and soundness. And by guarding against the risks of double leverage, we are ensuring that UK banking groups operating around the world are robust.

But signals from overseas suggest that geofinance could go too far, too fast. Bringing up the borders in wholesale finance would be regrettable for all sides, be they the home or host of international groups. To finish where I started:

- Although it makes our job more challenging, it is a good thing that investors putting capital at risk in London provide insurance cover for properties hit by hurricanes in Florida.
- It is a good thing that banks are able to provide some services across borders, whether between the UK and our fellow nations in Europe or further afield.
- And it is a good thing that we have, to date, been able to agree global capital standards for banks.

Doing all of these things efficiently and effectively relies on a strong degree of trust and co-operation between public authorities across borders. We hope we can secure that in the years ahead.