Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to Scottish business organisations, Edinburgh, 20 October 2009.

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Two years ago Scotland was home to two of the largest and most respected international banks. Both are now largely state-owned. Sir Walter Scott would have been mortified by these events. Writing in 1826, under the pseudonym of Malachi Malagrowther, he observed that:

> "Not only did the Banks dispersed throughout Scotland afford the means of bringing the country to an unexpected and almost marvellous degree of prosperity, but in no considerable instance, save one [the Ayr Bank], have their own over-speculating undertakings been the means of interrupting that prosperity".

Banking has not been good for the wealth of the Scottish – and, it should be said, almost any other – nation recently. Over the past year, almost six million jobs have been lost in the United States, over 2½ million in the euro area, and over half a million in the United Kingdom. Our national debt is rising rapidly, not least as the consequence of support to the banking system. We shall all be paying for the impact of this crisis on the public finances for a generation.

The United Kingdom faces two fundamental long-run challenges. First, to rebalance the economy, with more resources allocated to business investment and net exports and fewer to consumption. That is consistent with the need – now widely accepted – to eliminate the large structural fiscal deficit and to raise the national saving rate. It is part of a need for a wider rebalancing of domestic demand in the world economy away from those countries that borrowed and ran current account deficits towards those that lent and ran surpluses.

Second, both the structure and regulation of banking in the UK need reform. Banks increased both the size and leverage of their balance sheets to levels that threatened stability of the system as a whole. They remain extraordinarily dependent on the public sector for support. That was necessary in the immediate crisis, but is not sustainable in the medium term.

These two challenges are interrelated. In creating the crisis, imbalances in the world economy led to unusually low real interest rates and large net capital flows from the emerging market economies to the developed world. That provided the fuel which an inadequately designed regulatory system ignited to produce the financial firestorm that engulfed us all. If our response to the crisis focuses only on the symptoms rather than the underlying causes of the crisis, then we shall bequeath to future generations a serious risk of another crisis even worse than the one we have experienced.

Tonight I want to focus on the second of those challenges – reform of the structure and regulation of the banking system. Why were banks willing to take risks that proved so damaging both to themselves and the rest of the economy? One of the key reasons – mentioned by market participants in conversations before the crisis hit – is that the incentives to manage risk and to increase leverage were distorted by the implicit support or guarantee provided by government to creditors of banks that were seen as "too important to fail". Such banks could raise funding more cheaply and expand faster than other institutions. They had less incentive than others to guard against tail risk. Banks and their creditors knew that if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them. And they were right.

The sheer scale of support to the banking sector is breathtaking. In the UK, in the form of direct or guaranteed loans and equity investment, it is not far short of a trillion (that is, one thousand billion) pounds, close to two-thirds of the annual output of the entire economy. To paraphrase a great wartime leader, never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.

It is hard to see how the existence of institutions that are "too important to fail" is consistent with their being in the private sector. Encouraging banks to take risks that result in large dividend and remuneration payouts when things go well, and losses for taxpayers when they don't, distorts the allocation of resources and management of risk.

That is what economists mean by "moral hazard". The massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history. The "too important to fail" problem is too important to ignore.

There are only two ways in which the problem can – in logic – be solved. One is to accept that some institutions are "too important to fail" and try to ensure that the probability of those institutions failing, and hence of the need for taxpayer support, is extremely low. The other is to find a way that institutions can fail without imposing unacceptable costs on the rest of society. Any solution must fall into one of those two categories. What does this mean in practice?

Consider the first approach. To reduce the likelihood of failure, regulators can impose capital requirements on a wide range of financial institutions related to the risks they are taking. This is the current approach underpinned by the Basel regime. In essence, it makes banks build a buffer against adverse events. It has attractions but also problems. First, capital requirements reduce, but not eliminate, the need for taxpayers to provide catastrophe insurance. Second, the "riskiness" of a bank's activities and the liquidity of its funding can change suddenly and radically as market expectations shift. This means that what appeared to be an adequate capital or liquidity cushion one day appears wholly inadequate the next.

Indeed, the Achilles heel of the Basel regime is the assumption that there is a constant capital ratio which delivers the desired degree of stability of the banking system. After the experience of the past two years, and a decade or more in which capital ratios fell and leverage ratios rose to historically unprecedented levels, banks need more capital to persuade investors to fund them. A larger buffer gives new creditors greater comfort that their claims will be met in future, without resort to the public purse. And rather than pay out dividends or generous remuneration, banks should use earnings to build larger capital buffers. But how much larger? We simply don't know. A higher ratio is safer than a lower one, but any fixed ratio is bound to be arbitrary.

One way of dealing with this problem is to require banks to take out insurance in the form of "contingent capital", that is capital in a form that automatically converts to common equity upon the trigger of a threshold that kicks in before a bank becomes insolvent. If a bank's regulatory core tier 1 capital – common equity – remained above the threshold, nothing would happen. But if the regulatory core tier 1 capital fell below the threshold then the contingent capital would automatically be converted to common equity. When bank failures impose costs on the rest of the economy, it is reasonable to insist that banks themselves purchase a sufficient degree of insurance in the form of a large capital cushion available automatically before insolvency.

Such contingent capital instruments are very different from instruments, such as subordinated debt, which banks have been permitted to count as capital under the Basel regime, but which do not provide a reliable capital buffer until too late – after the bank has failed. So at present the taxpayer is providing capital that is exposed to future losses rather than investors in debt-like capital instruments of a troubled bank. Whether investors would be willing to provide contingent capital on the required scale would depend upon the price, but at least the cost would fall where it belongs – on the banks.

So the first approach to the "too important to fail" problem might be made to work with a requirement for contingent capital. It is worth a try. But it has three drawbacks. First, banks still have an incentive to take really big risks because the government would provide some back-stop catastrophe insurance. Second, experience has shown that it is difficult to assess risks of infrequent but high-impact events, and so it is dangerous to allow activities characterised by such risks to contaminate the essential – or utility – services that the banking sector provides to the wider economy. Both of these drawbacks mean that it is almost impossible to calculate how much contingent capital would be appropriate. And a third drawback is that the approach probably requires the extension of detailed regulation, and especially a special resolution regime, to all institutions deemed "too important to fail" – or could become "too important to fail" in the middle of a crisis – in order to prevent a bank failure leading to conventional insolvency procedures. It remains to be seen whether that scope would be easy to define beforehand. Failure to deal with the underlying problem draws regulators deeper into murky waters.

The second approach rejects the idea that some institutions should be allowed to become "too important to fail". Instead of asking who should perform what regulation, it asks why we regulate banks. It draws a clear distinction between different activities that banks undertake. The banking system provides two crucial services to the rest of the economy: providing companies and households a ready means by which they can make payments for goods and services and intermediating flows of savings to finance investment. Those are the utility aspects of banking where we all have a common interest in ensuring continuity of service. And for this reason they are quite different in nature from some of the riskier financial activities that banks undertake, such as proprietary trading.

In other industries we separate those functions that are utility in nature – and are regulated – from those that can safely be left to the discipline of the market. The second approach adapts those insights to the regulation of banking. At one end of the spectrum is the proposal for "narrow banks", recently revived by John Kay, which would separate totally the provision of payments services from the creation of risky assets. In that way deposits are guaranteed. At the other is the proposal in the G30 report by Paul Volcker, former Chairman of the Federal Reserve, to separate proprietary trading from retail banking. The common element is the aim of restricting government guarantees to utility banking.

There are those who claim that such proposals are impractical. It is hard to see why. Existing prudential regulation makes distinctions between different types of banking activities when determining capital requirements. What does seem impractical, however, are the current arrangements. Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly risky and speculative activities, would be thought rather unworldly. But that is where we now are.

It is important that banks in receipt of public support are not encouraged to try to earn their way out of that support by resuming the very activities that got them into trouble in the first place. The sheer creative imagination of the financial sector to think up new ways of taking risk will in the end, I believe, force us to confront the "too important to fail" question. The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion.

Separation of activities does not resolve all misaligned incentives. Where private sector entities outside of the utility banking sector engage in a high degree of maturity transformation on a scale that could have consequences for the rest of the economy, the government would not want to stand aside when such an entity fails. That is the heart of the matter. Maturity transformation reduces the cost of finance to a wide range of risky activities, at least some of which are beneficial, but the implicit government guarantee means that the true cost of that maturity mismatch does not, as it should, fall on those who receive the benefits. The aim of policy should be to minimise or eliminate that subsidy. Separation of activities helps not hinders that objective, not least because it is the mixture of activities that reduces the robustness of the system. Although there are no simple answers, it is in our collective interest to reduce the dependence of so many households and businesses on so few institutions that engage in so many risky activities. The case for a serious review of how the banking industry is structured and regulated is strong.

By international standards UK banking is highly concentrated. There are four large UK banking groups. Of these four, two are largely in state ownership and their assets are a multiple of the assets of the next largest bank. As in the English Premier League, getting into the top four will not be easy for those outside it. But in both cases I hope greater competition will produce less rigidity in the composition of the top four.

Whichever approach to the "too important to fail" problem is adopted, there is growing agreement that such financial institutions should, as I argued at the Mansion House in June, be made to plan for their own orderly wind down – to write their own will. I welcome that, but without separation of the utility from other components of banking it will be necessary to develop detailed resolution procedures for a very wide class of financial institutions. The options may turn out to be separation of activities, on the one hand, or ever increasingly detailed regulatory oversight, with the costs that that entails for innovation in, and the efficiency of, the financial system, on the other.

So far, I have discussed measures to ensure that the financial system can continue to function when individual institutions find themselves in difficulty. But there are broader policy goals relevant to financial stability. The crisis certainly suggests that there is a need for additional policy tools that can (a) moderate the growth of the financial sector and (b) lean against the macroeconomic effects of the credit cycle. The Bank is working with others to explore such macro-prudential instruments, and we will be setting out our thinking in a discussion paper and a speech by Paul Tucker later in the week. Given the difficulty of applying such tools to overseas banks, their use in (a) is likely to be more productive than in (b). The key point though is that parallel to the long-established role which monetary policy plays in taking away the punch bowl just as the party gets going, so there is a role for the central bank to use macro-prudential policy instruments for financial stability purposes by turning down the music just as the dancing gets a little too wild.

As we focus on how to create a sound and stable financial system, we cannot neglect the rest of the economy. Recent months have brought better news here. Around the world, the sharp falls in output that occurred over the winter have largely come to an end, and business and consumer confidence have improved somewhat. It is likely that in the second half of this year, the UK economy will return to positive, if modest, growth. Financial markets have improved, with banks finding it easier and less costly to access wholesale funding markets, and in time this should ease lending conditions to households and businesses.

These developments are encouraging. But they need to be seen in context, and we should be under no illusion that the path to a sustained recovery will be smooth and painless.

Output is still well below and unemployment well above their levels of a year ago, and are likely to remain so for sometime. To keep inflation close to the 2% target, monetary policy tries to keep a balance between overall demand and supply. Judging that balance, given an impaired banking sector and the likelihood of a significant fiscal tightening over the next few years, is particularly difficult.

At the moment, inflation is 1.1%. Many have forgotten that only a year ago it reached 5.2%. It is likely that inflation will remain volatile over the coming year. It will pick up over the next few months reflecting higher petrol prices, recent falls in sterling and the reversal of the cut in VAT. Looking through these short-run factors, however, inflation will be determined by the path of money spending relative to the supply capacity of the economy. Over the past year money spending, which normally expands at around 5% a year, has fallen by 5%. That is already pulling down on inflation and will continue to do so until spending recovers. To put money spending back on a desirable trajectory is likely to require a pick up in the growth rate of broad money in the economy. That is precisely what our asset purchase programme, by injecting more money directly into the economy, aims to achieve.

In deciding when and by how much our present programme of asset purchases should be either expanded or reduced, the Monetary Policy Committee will continue to base its decision each month on a judgement of the action required to meet the 2% target for inflation.

Before the financial crisis, a generation of households and businesses had accepted that the discipline of a market economy was the most promising route to prosperity. Uncomfortable though it seemed, the importance of more flexible labour markets, greater competition in product markets, regulation of privatised utilities and allowing unsuccessful businesses to fail, came to be widely understood. Then, out of what must have appeared to many of you to be a clear blue sky of economic stability, arose a financial firestorm that wreaked substantial damage to the real economy, and we have not yet seen its full consequences. The case for market discipline is no less compelling for banking than for other industries.

So I am sure that we can turn this crisis to our long-run advantage by reviewing and reforming the structure and regulation of banking. As Sir Walter Scott noted, the failure of the Ayr Bank in 1772 "was a terrible [warning], and has been so well attended to in Scotland … forcing a capital on the district could only lead to wild speculation, instead of supporting solid and promising undertakings". Of the bankers themselves, Scott recognised that, while the majority were "good men", "there may have been, among so numerous a body, men of a different character, fishers in troubled waters, capitalists who sought gain not by the encouragement of fair trade and honest industry, but by affording temporary fuel to rashness or avarice".

If unsustainable capital flows provided the fuel and an inadequately designed regulatory system ignited the fuel, the past two years have shown how dangerous it is to let bankers play with fire. This is not a question of blame – as Sir Walter rightly said, the majority in the industry are "good men" and women. It is a matter of the incentives they face. To protect our genuinely successful financial centres – of which Edinburgh is clearly one – reform of banking is essential. With that, I am confident that we will have attended to our terrible warning and our varied and internationally competitive financial services industry will thrive.