

Paul Tucker: Competition, the pressure for returns, and stability¹

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the British Bankers' Association Annual Banking Conference, London, 17 October 2012.

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Introduction

Propelled by a deep crisis in the financial system, the international authorities are overhauling the “rules of the game” for global finance.

The changes are profound. But it is worth stressing that the goal is not to abolish risk or risk-taking. We need to find broadly the right balance between, on the one hand, safety and, on the other hand, the contribution that sound and honest finance can make to economic prosperity. In striking that balance, international policymakers have maintained three beliefs:

- risk is an intrinsic and unavoidable part of the (monetary) services that banks provide to the economy, just as risk is intrinsic to the businesses that borrow from banks;
- competition in finance is good, although the authorities need to be mindful that the drive for superior headline returns can contribute to excessive risk in the system as a whole;
- a global financial system must be maintained, but the authorities need to contain the way that financial problems can be transmitted easily from one part of the globe to others.

In short, the things society wants from finance come with risks attached. History contains repeated episodes of herd-like chasing of high headline returns during exuberant phases of the credit cycle. It would be too much to promise that that can never recur. Nor can we hope completely to eliminate the linkages within the system that can propagate distress. But this realism is not remotely a counsel of despair. On the contrary, I want to emphasise this morning that the emerging new regime will enable the authorities to lean against stability-threatening exuberance and will make the financial system much more resilient.

The tendency to excessive risk in the system

That excesses occurred in the run-up to the current crisis is not remotely in doubt. As leverage increased, asset prices rose, increasing net worth and so inducing more balance sheet expansion. The buoyancy in markets gave intermediaries the confidence to lend secured on wider classes of securities – temporarily enhancing day-to-day liquidity. Facing depressed returns from their core business of providing liquidity to customers, banks sought to sustain high headline returns by resorting to ever more leverage and maturity transformation. In other words, increasing leverage fed upon itself.

This poses deep but pressing questions about the efficiency and effectiveness of capital markets in monitoring and pricing risk. Why did boards and investors in bank equity expect such high returns? Why didn't the capital markets downgrade the value of bank equity and debt as leverage and other sources of risk increased? Why didn't the markets distinguish more between banks?

¹ These remarks draw on a chapter contributed to a book, edited by Andreas Dombret of the Bundesbank and Professor Otto Lucius, being published next year.

Part of the answer, of course, is that around the world the holders of the largest banks' debt relied on a public safety net. Financial institutions being "Too Big To Fail" is the biggest problem we have to crack. But moral hazard isn't a complete explanation, because equity holders surely realised that they were exposed to risk, as events proved. We need richer explanations.

Agency problems

Another part of the explanation of the tendency to excess has to be layer upon layer of principal-agent problems.

Shareholders of joint-stock companies enjoy the upside, but the downside is capped. When we add in the fragmentation of shareholdings, diversified portfolios and relatively liquid markets in equity shares, few shareholders seem to have had the incentive or wherewithal to monitor individual banks effectively.

By giving management equity and equity options, shareholders put management in a similar position to themselves. And within the management structure of banks, there were problems in how different layers monitor others, with all to a greater or lesser degree incentivised by contracts – and accounting regimes – that rewarded short-term performance.

These problems are compounded by agency issues in the asset-management industry. Why didn't investors act to constrain the excessive risk taking at various banks? Possibly because their individual stakes were too small for any of them to make a difference. Possibly because they believed there were impediments in securities laws or regulation to their acting as a co-ordinated group. Possibly because they held back from selling their holdings because they were reluctant to go underweight a large component of an index they tracked (or were measured against). How to improve the performance of the asset management industry has been relatively neglected. That matters because in a market economy regulators should *not* be the first line of defence.

Myopia

Agency problems and incentives are not, however, the sole source of exuberance. I doubt that, in managing their banks, many bankers deliberately or even consciously drove the system over the cliff. Rather, like others, many were myopic about the risks in the system. Innovations in technology, the opening up of the world economy, new markets for transferring risk, and years of smooth growth, apparently attributable to better macroeconomic policy frameworks – all of this encouraged a sense that the world had become a safer place. High actual returns were extrapolated forward into required future returns.

Add in to the mix, complexity obscuring the risks in the system as a whole. And, although UK policy rates were relatively high for a number of years, accommodative *global* monetary conditions fuelled a search for yield and underpinned confidence in resiliently liquid capital markets.²

Distorted incentives, myopia, complexity, easy global monetary conditions: a heady mix. And a mix which the prevailing regulatory regime was singularly ill equipped to address, and in some respects had done much to create through inadequate capital requirements and an absence of liquidity requirements.

In fact, a toxic mix. When credit markets become overly exuberant, not only do the balance sheets of lenders become stretched, cheap credit leads borrowers to become over indebted,

² See Tucker (2012), "National balance sheets and macro policy: lessons from the past".

raising the probability of default. When defaults eventually pick up, a general awakening occurs, triggering mass deleveraging.

This matters to debates about risk measurement and management. It is not simply that the models employed over recent years – notably Value-At-Risk – make assumptions, such as normally distributed returns, that are manifestly false.³ It is not just a matter of finding better models, useful though that might be. The problem of exuberance is not simply one of lots of Black Swans. It is that the collective behaviour of market participants can generate the tail events that sow the seeds of the system's destruction. It can breed swans.

What the authorities are doing

Given the complex mix of factors behind the crisis, it would be surprising if there were a single policy initiative that could make the system safer in future. The response is multi-dimensional. But you will be relieved to hear that at this point I am not going to summarise the whole of the international agenda.⁴ I'm going to put to one side, for example, the panoply of measures being pursued internationally to simplify capital markets through greater use of central counterparties, and to avoid the systemic risks of banking activity simply relocating to shadow banks. I shall confine myself to a tour of some of the international and domestic reforms of banking itself, highlighting a few questions for debate along the way.

Expose debt holders to losses: resolution regimes

First and foremost, we need holders of bank debt to be exposed to losses when banks fail. This is not some macho thing. If banks' cost of debt finance does not vary with the risks they are taking, what should be an important check on the tendency to excess is badly diluted.

For the financial system to be safe, we need to be able to sort out distressed commercial banking and investment banking operations without massive disturbances to the provision of services and without taxpayer solvency support. That, in a nutshell, is what is meant by making a firm "resolvable". The economy's payments system obviously needs commercial banks that can be resolved in an orderly way. But, in addition, the capital markets need sound intermediaries which, if they become distressed, can expire safely or whose viable parts can be resurrected. I stress that because we need to do more than ensure that the most critical services are preserved come what may. We need also to avoid the massive destruction of value that occurs when, under standard bankruptcy proceedings, a trading portfolio is liquidated in stressed market conditions and without sensitivity to spillovers to the rest of the system. We need resilient capital markets.

That is why around the world countries are introducing resolution regimes that enable them to put losses on to bondholders without all the costs of liquidation. Bail-in – a power for the Resolution Authority to write down and convert debt into equity – is one way of doing this.⁵ It is included in the Financial Stability Board's global standard on resolution, and it is an important feature of the EU Commission's draft directive on recovery and resolution – and so it is set to become part of UK law over the next few years.

Bail-in is only one resolution tool, and no one is claiming that it could be used on its own in every circumstance. For example, group-level recapitalisation via bail-in will not work when the financial condition of every part of the business is so rotten through and through that the

3 See Haldane (2012), "Tails of the unexpected".

4 For a fuller account of the international agenda, see Tucker (2012), "Banking in a market economy – the international agenda", a chapter in *Investing in Change: A book of essays on financial reform in Europe*.

5 See Tucker (2012), "Resolution: a progress report".

group's losses cannot remotely be quantified upfront. In those circumstances, the authorities do have to focus on preserving continuity in the most critical (even elemental) services – payments and deposit taking. The UK government's plans for insulating retail banking are, therefore, a central element of the plans to make the UK's large and complex banks resolvable. The proposals in the recent Liikanen Report on the structure of EU banks are welcome in seeking to achieve the same goal. Both Vickers and Liikanen can be viewed as working with the grain of the broader international agenda on resolution regimes.

But bail-in can be attractive when a distressed group does have viable parts and sufficient uninsured debts covered by the bail-in power. As the UK's resolution authority, the Bank is working closely with the FDIC on how to operationalise this type of resolution strategy. Meanwhile, the FSB will, over the next month or so, be publishing a consultative paper on resolution-strategy planning.

The prospect of taking losses via resolution gives debt holders a strong incentive to monitor banks' risk taking. That will be a first order change for the financial system.

Expose management to tail risk: payment in subordinated debt

Once debt holders are unambiguously exposed to loss, the authorities need to consider whether to require management to be paid to a significant extent in subordinated debt: an idea recently endorsed by the Liikanen Committee.⁶ Having managers exposed to instruments whose value depends on the survival of their firm would give them a healthy incentive to maintain a safe and sound bank.

There should also be a review of the structure of remuneration for desk-level bankers – tying pay to the medium-term success of the firm. Putting it bluntly, that would make it less easy to get rich quick irrespective of the quality of business transacted or the compliance culture in their part of the firm.

This points to revisiting the terms and scope of the existing codes on remuneration of the G20 Financial Stability Board, the European Union and, in the United Kingdom, the Financial Services Authority.

Industry structure and system resilience

Incentives will also be influenced by measures that constrain the structure of banking.

The UK's plans to ring-fence banks' more basic retail banking business will do more than help to make complex banks resolvable. The domestic-intermediation part of banks' activities will effectively be separate from the entrepôt, wholesale business centred in the City of London. This will make it somewhat easier to see what is going on – where profits are coming from; how much capital is allocated to domestic intermediation, etc.

It will also help establish different cultures in different lines of business. Within domestic commercial banking, we need somehow to unwind some of what I think of as the industrialisation of retail and business banking that occurred during the years of plenty. Branch and regional banking came too close to being seen as an exercise in sales and marketing. The role of local branch managers in making loans has been diluted over recent decades, replaced by credit-scoring techniques operated from the centre. Banking is about credit judgments. Boards need to think about how to re-inject that into the role of banks' front line managers.

6 See Tucker (2010), Remarks at an FSB conference entitled "Financial Crisis and G20 Financial Regulatory Reform: An Overview": "part of deferred compensation should be in the form of a debt contract, so that the managers and workers in large firms eventually become creditors of the firm and so they themselves have the same risks as other debt holders". See also Liikanen (2012), "High-level Expert Group on reforming the structure of the EU banking sector".

Competition policy may matter too. Some countries – notably Australia and Canada – are sometimes characterised as shielding their main domestic commercial banks from competition,⁷ in order to dilute the temptations of international wholesale banking. The UK should try, instead, to combine openness with stability. That requires a profitable banking sector: we should not forget that, as the Bank used to say, the first buffer against losses is profits.

Other countries – perhaps most obviously the US – ban acquisitions of banks that would result in control of more than 10% of the country's insured deposits. The approach there is to limit the accumulation of market power.

Questions of industry structure, as well as firm structure, might be relevant to the UK. The operations making up Lloyds Banking Group and the Royal Bank of Scotland accounted for about 40% of the stock of lending to UK businesses in 2007. It was a disaster for domestic credit conditions when they failed. With more competitors around, the wider effects of the failure of an individual bank would in all likelihood be smaller. The stability authorities need to be more alert than in the past to this source of economic vulnerability.

Consistent with that, as we prepare for the transfer of prudential supervision, the Bank of England wants to reduce barriers to entry somewhat, so that the banking system can, over time, become less concentrated.

But for that to be sensible, we need to be confident in the authorities' ability to resolve those banks that get into distress without dramatic spillovers – lowering barriers to entry by removing barriers to exit. For smaller banks, that should already be possible using the Special Resolution Regime introduced in 2009. Prudential supervisors will need, as a priority, to ensure that banks are set up to enable the Financial Services Compensation Scheme to pay out rapidly. To be clear, for banks funded by insured deposits, the costs of failure will fall on their peers. Over time, I suspect that that will increase pressure for a funded deposit-guarantee scheme with risk-based levies. The Bank would welcome that.

Prudential regulation: higher risk-based capital requirements and a cap on leverage

But the reform agenda is not just about handling failure. Banks will be better capitalised, more liquid, and less interconnected.

To take just one of those changes in the global order, higher capital requirements will affect behaviour as well as resilience. For example, as a matter of simple arithmetic, the first round effect of higher capital requirements is probably to depress the headline return on equity. It has seemed to me quite likely that that will prompt shareholders to demand a larger share of the cake, with a smaller share going to managers. There have already been signs of this happening. This might help temper the gains available to managers in buoyant credit conditions, and so reduce the incentive to shield their eyes from the risks.

But, most important of course, higher equity capital requirements provide a bigger buffer against losses – the increase is, perhaps, about an order of magnitude (around 1% of risk-weighted assets to around 10%), all things taken into account.⁸

7 See, for example, Kent and Debelle (1999), "Trends in the Australian Banking System: Implication for Financial Stability and Monetary Policy".

8 Basel 2 in effect required a minimum equity capital ratio of 2 percent. Under Basel 3 almost all regulatory deductions from capital come out of core tier 1 capital (ie equity) rather than being split equally across tier 1 and tier 2 capital or taken from total capital. Also, some risk-weights are increased, for example on counterparty credit risk exposures. Together those changes mean that the old Basel 2 core tier 1 minimum risk-weighted asset ratio is equivalent to around 1% on a Basel 3 basis. Taking into account the capital conservation buffer and the surcharge for systemically important financial institutions, the Basel 3 minimum comes to around 10% for the largest banks.

That is on a risk-weighted basis. Policymakers need to be confident, therefore, that the risk-weights are determined robustly. Leaving banks completely free to choose risk-weights, using internal models, is not safe. It effectively allows banks to determine their own regulatory capital requirements, which hardly fits with society's purpose in regulating banking in the first place. That being so, the introduction of mandated floors on risk-weights should be debated in Basel. They are already being introduced in the US.

That would be one concrete step to contain the risks from complexity in the current Capital Accord. The planned Basel leverage limit should be viewed in the same light.

This is not to say that it would be sensible to rely entirely on a simple regulatory constraint. History teaches us that they do not work on their own – just remember the 1980s' Latin American and East European debt crisis, which left much of the Western banking system perilously close to bankruptcy, notwithstanding the leverage limits applied in the US and elsewhere. On its own, a simple leverage limit incentivises banks to increase the riskiness of asset portfolios. The new Basel package is an attempt to use simple measures to put bounds on the consequences of flaws in more complex measures, which were themselves designed to avoid the perverse incentives to hold only very risky assets created by the previous generation of simple measures.

More will need to be done in the years ahead to simplify and underpin the Basel regime. Market discipline can help, but only if there is much more transparency around the drivers of risk weights – both why they change over time and why they differ, for similar exposures, across institutions. The market needs to be able to understand what is published.

Microprudential supervision under the new UK Twin Peaks system

But the new UK regime will not rely on getting the regulations exactly right. That would be a fool's paradise. Effective supervision is absolutely vital. Whether we like it or not, firms will be able to find their way around any set of rules – complex or simple – if they are determined to do so. This is not good.

But the UK's new Twin Peaks structure will help. In the first place, the reforms will finally give London a dedicated securities regulator a quarter century after the Big Bang that made it so necessary. The Financial Conduct Authority's approach to enforcement will need to preserve – and, where necessary, restore – honesty in a market community for which side-stepping rules and principles has become too close to being part and parcel of commercial life.

More widely, the future Prudential Regulation Authority will work to transform the climate of prudential regulation. The Bank's prudential supervision will avoid ticking boxes, instead being centred on making judgments about big risks to safety and soundness. We want this to be as collaborative, open and honest as possible – a different relationship between banks and their supervisors. One that revolves around penetrating and forensic analysis of the business and, where necessary, frank discussions with senior management and the board. Not a negotiation. And a regime where the Bank's Prudential Regulation Authority has the powers to underpin pursuit of material concerns about safety and soundness, based largely on whether firms meet the broad statutory criteria – the Threshold Conditions – for being authorised.

Macroprudential policy: keeping the regime up to speed, and taking away the punchbowl

No set of static rules, regulations and structures will keep the system safe for ever. As time passes, and the financial system evolves we cannot put an ever increasing burden on microsupervisors of individual firms to compensate for outdated regulatory regimes. The market will eventually take the system to the edges of the box the authorities have tried to put it in. Policymakers therefore need to be able to move the box when circumstances warrant.

This is where macroprudential comes in – keeping the rules of the game up to date, and leaning against exuberance. In the UK, the Financial Policy Committee is charged precisely with those tasks.

Although to date most of the Interim FPC's deliberations have concerned bank capital adequacy, I expect the FPC's longer-term focus to be as much on the capital markets and, thus, the policies of the FCA. In a world where banks have been re-regulated, some risk taking will migrate to other parts of the system. It is, therefore, hugely welcome that the Bill currently before Parliament gives the FCA a statutory objective of helping to preserve stability.⁹ That is going to be important, for example, to contain any systemic risks stemming from shadow banking, such as money market funds, or from fault lines in the trading infrastructure or disclosure regimes.¹⁰

Sometimes a permanent fix will be needed. The FPC will be able to make recommendations to HMT to move the perimeter of microregulation, and to PRA or FCA to change their rules and policies.

But sometimes it will be more a matter of choking off a transient burst of exuberance. Even where market participants become aware of the potential risks, a collective action problem can impede their taking their foot off the accelerator. A telling experience in the run up to the crisis was of Chief Risk Officers on Wall Street talking openly about a dilemma between what they called financial risk and business risk. On the one hand, the Street was taking a lot of financial risk, which could end in tears. On the other hand, they were not certain that it would end in tears and they were worried that if they left the field too early, their customers would cross the street to their competition, destroying their franchise.¹¹

Central banks can help to solve that collective action problem, as Federal Reserve Board Chairman McChesney Martin highlighted more than half a century ago when he explained our role as being to take away the punchbowl when the party is getting going. Chairman Martin was talking about monetary policy, and monetary policymakers do sometimes need to take the long view. But often it will fall instead to the FPC temporarily to adjust capital or liquidity or margin requirements to build system resilience and lean against

the exuberance. When we reach that point, as we shall, turning down the music will be unpopular. That is why the current debates in the UK Parliament about the Bank of England's new Financial Policy Committee are so very important: in a word, legitimacy.

Concluding remarks

When the financial tide goes out, it lays bare problems that had been gathering during the "good" times. Work by the international central banking and regulatory community to make

9 The single strategic objective of the FCA will be to ensure that financial markets and markets for regulated financial services function well. That is supplemented by three operational objectives, including "protecting and enhancing the integrity of the UK financial system" which is in turn defined in the legislation to include "its soundness, stability and resilience". This is in line with Principle 6 of IOSCO's objectives and principles for securities regulation: "the Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate".

10 See Tucker (2011), "Building resilient financial systems: macroprudential regimes and securities market regulation", International Council of Securities Associations.

11 This was highlighted by the Bank of England in 2006 Financial Stability Review p. 8: "Many may have believed that the price of certain assets had become too high and the premium for taking risk too low. But there are business risks associated with acting on that view when others are not; it may not only reduce profitability in the short run, but may also risk losing market share or failing to establish a foothold in a rapidly expanding market. These concerns often seem to have outweighed the risks to balance sheets associated with potentially overpriced assets. As a result, in the early part of this year, there appears to have been an extension of risk-taking activities by financial institutions, including some UK banks. "

the system safe and sound has made real progress in recent years, but it is not complete and absolutely must continue with energy. G20 Leaders and Finance Ministers need to keep our

We may not be able to abolish the occasional waves of optimism that grip humanity and the tendency to excess they set off. But we can and must dampen their effects on the financial system and economy. This must include changing the incentives that bankers face. It will include a simplification of the capital markets; and constraints on the effects of exuberance through policies on leverage, capital and liquidity – applied beyond banking where warranted. And it must include macroprudential regimes that help us to refresh the *micro*regulatory regimes and enable the authorities to take away the punchbowl when the party threatens to get out of control.

Markets will, in time, forget about the risks, but the system will be safer if we succeed in building official institutions that do not forget. Parliament can underpin that by holding us to account in this endeavour, as it does on monetary policy – incentives matter in the official sector too. That will make for a safer and sounder financial system that can meet the abiding needs of the economy as a whole. And, to those of you here today, I would say that the Bank believes what it always believed: that sound and honest finance is not only essential for the economy, it will be good for the City too.