Paul Tucker: A new regulatory relationship – the Bank, the financial system and the wider economy

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the Institute for Government, London, 28 May 2013.

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Thank you very much for inviting me here today. For someone who has spent pretty much the whole of my professional life in public service, it comes as something of a relief that the UK has an independent institute dedicated to analysing, monitoring and assessing the workings of government. And, as a central banker during a period in which the role of central banks around the world is once again being reshaped in the wake of the financial crisis, I am very glad to be part of your series on the changing relationship between the State and business. Frankly, it has been impossible not to reflect on precisely that issue as the reforms of the Bank of England have proceeded.

I shall confine what I say this evening to brief remarks under three headings:

- The supervision of the safety and soundness of banks, and the place of rules and discretion in that
- Expectations of what the central bank can and should achieve as a macro policymaker, and how society can monitor that role
- How the central bank's relationship with the business community plays out in a wider international, indeed global, setting.

Before getting to the substance, I should say first that the Bank is releasing a text comprising a few bullet points around which I shall frame my remarks; and second, that I am speaking for myself this evening and not for any of the policy committees, domestic or international, of which I am a member.

Speaking notes

Part 1: Prudential regulation of financial firms: rules versus discretion

- Bank of England is once again the prudential supervisor of banks. And this time of building societies and insurance companies too.
- Prominence given in public debate to the Bank absolutely not adopting a 'tick box' approach, but instead a 'judgment-based' approach. This has been widely applauded.
- In fact, market practitioners tend to be schizophrenic about it. For a couple of decades at least, they have called for 'certainty' whenever any specific, isolated policy area is being reformed; ie clear and complete rules. But taking the resulting monstrous rule books as a whole, senior practitioners rightly condemn the 'tick box' regulation that almost inevitably results.
- And leaders of firms have hardly stopped their staff from making a living finding ways around rules: endemic regulatory arbitrage was at the heart of so-called 'shadow banking' in the run up to the crisis.
- Step back to consider the public policy purpose. Contrast prudential supervision with securities regulation as traditionally conceived. Latter works on basis of: write rules; check compliance with those rules; punish breaches. If the rules proved to be flawed, they should still be enforced, for credibility's sake; but later changes should be made to the rules.

- Animating spirit of 'prudential supervision' is completely different. Impossible to write down a complete (or even adequate) set of binding rules on the financial health of a bank (or on the substance of the professional competence of bankers). Instead, things like capital ratios or liquidity ratios are really ***indicators*** of financial health.
- This is reminiscent of an old debate in monetary policy. Thirty-odd years ago, policy was meant more or less mechanically to follow targets for broad or narrow monetary aggregates. It didn't work: the economic world was not sufficiently stable. Since we adopted inflation targeting, central banks have had an eclectic approach to indicators. We are constrained by a clear medium-term objective (2% CPI target), but do ***not*** use a set of supposedly fool-proof core intermediate indicators.
- No more can we write down hard and fast rules on bank balance sheets.
- Nor, consistent with Parliament's wishes, is the Prudential Regulation Authority seeking to achieve a zero failure regime. The failure of individual firms has to be an acceptable outcome so long as they can be wound down in an orderly way.
- So the PRA's approach to prudential supervision entails making judgments of the kind:
- Your bank isn't as strong as you think it is
- Cut back on the risk in your book
- I'm afraid you're not fit to run the bank
- your business could not be resolved in an orderly way if it fails.
- This shift from rules to judgment changes the relationship between the regulator and business, and is an important example of what this series of talks is about.
- Challenge is how to make a judgment-based approach acceptable when we use it in earnest. Is our society really ready again for judgments from the Old Lady?
- Part of the solution is public law. The Bank ***must*** follow due process when it deploys its statutory powers, and that is subject to judicial review in the courts and appeal tribunals.
- But there is also a wider question about how society as a whole will keep us accountable or, more simply, just see what is going on during the periods, sometimes years, in which banks do not fail and the financial waters are – or at least seem to be – calm. Which brings me to our monetary and macroprudential roles, which indirectly touch every business, and household, in the country.

Part 2: The central bank's relationship with businesses in the wider economy

- Central bank charged with achieving and preserving stability – stability in the (internal) value of the currency and stability in the financial system. ***Medium-term*** goals, requiring a medium-term perspective.
- But what we do affects the path of the economy in the short run. On the one hand, that is why these tasks are entrusted to unelected officials in central banks: to solve the time-consistency problem. On the other hand, society is rightly hugely interested in
- How unelected central bankers manage any short-term trade-offs
- How to satisfy itself that we are not deviating from the medium-term goals we have been given.
- In monetary sphere, the solution has been a quantified, well-defined medium-term objective for inflation combined with transparency. Everyone is now used to this, but

remember that transparency in monetary policy is a relatively new phenomenon. Less than 20 years ago, the US FOMC did not even announce its policy rate.

- Transparency works well for monetary policy because almost everything can be published.
- And even there it is always possible to make improvements. Latest *Inflation Report* package contains new charts, richer indicators. And following a new Remit from HMG, MPC is being clearer about how we assess short-term trade-offs between growth and inflation in a way that is faithful to our medium-term inflation objective.
- That doesn't tackle biggest issue of all. Central banks can, to a degree, smooth the necessary adjustment of economies and so create time for households, firms, governments to strengthen their balance sheets where necessary and adjust to shifts in the relative pattern of demand for goods and services. That is what is going on in the West now. But obviously central banks cannot force others to act. And our actions can make delay seductive.
- Given central banks' responsibility to explain, we can nudge but we must stay within our remit.
- In the present crisis, part of the real-side adjustment is needed within the banking system. For that the Bank of England does have a special role. Through the new Financial Policy Committee (FPC), we have been pressing the banking industry to adjust given the external threats, as sound banks are needed for sustainable recovery.
- This represents the first intervention of so-called macro-prudential policy. Can view the role of the FPC as being to ensure that the need for stability in the financial system is not overlooked. Looking ahead, this will mean keeping the regulatory regime up-to-date as the financial system evolves and, when the time comes, 'taking away the punchbowl' before the next party gets as dangerously out of control as the last one did.
- The case for operational independence here is just as strong as for monetary policy. Taking Away The Punchbowl is something that requires a medium-term orientation. Parliament can tie us to the mast and rely on us not to seek to wriggle free.
- But, as with monetary policy, this makes it vital that Parliament frames the objective and that we are sufficiently transparent to enable ex ante public accountability.
- ***Objective***: The legislation governing the FPC is clear that resilience of the system as a whole is the primary goal but that we must not aim for the stability of the graveyard. Resilience is not quantified, however.
- ***Transparency***: While respecting the confidentiality of data on individual firms, FPC is required by Parliament to be as transparent as possible – via the published Record of our policy meetings and the twice-yearly *Financial Stability Report.*
- This is the background to the FPC calling on the Bank to develop a regime for stress testing to be used for both micro and macro prudential supervision. (Part of a much bigger project that is needed for policymakers to gauge just how much stress our economy can take at any time without serious adverse consequences, and what to do about it.)
- One possibility is for FPC to use stress tests to define the degree of resilience the system needs. Maybe that could become to financial stability what forecasting is to monetary policy. In the USA and elsewhere the results of such stress tests have been published.

- That represents quite a change in regime for regulated firms. But neither the markets nor the public was comfortable with the degree of secrecy on these matters in the past.
- It does, though, pose the question of what happens when a firm 'fails' a stress test. And at this point, I need to broaden these remarks to the international scene and how that is affecting our relationships with business.

Part 3: Policy in a global setting

- This country believes in free trade and open financial markets. Our financial system is highly integrated with the global system.
- That means that some firms domiciled or operating in the UK are global, and many are international. Creates a huge need for a level playing-field internationally. That is a common interest of business and the authorities:
- ***Business***: want to be able to compete more or less anywhere on equal terms with local, indigenous firms and with international firms from other countries.
- ***Authorities***: want ***good*** standards on top of that. Not only because we need them at home. The UK/London needs good standards abroad too: problems in the international financial system almost anywhere in the world will blow through London and the UK to a greater or lesser extent. And vice versa. Financially, we're the opposite of an island.
- Up to a point we can mitigate that by measures such as HMG's planned 'ring fencing' of retail banks, which has the effect of separating domestic intermediation from the entrepôt. But the non-ring-fenced banks matter for stability too! So we can't just leave it there.
- That gives UK a massive incentive to achieve good outcomes in international standards for financial regulation.
- So far in this argument, so good – business and the authorities together pointing in the same direction. Ie business will happily live with what I'm calling 'good' standards provided they are applied evenly everywhere that matters.
- But two issues remain. First, business is frustrated by the time it takes to reach such international agreements. They want speed. They make the compelling point that they can't determine their business models and plan their strategies until they know the regime under which they will function.
- The international community finds that hard. Contrast yesterday's world of a small handful of central bank governors deciding bank-capital standards on their own: a world of G5 or at most G10. Today's world is G20 plus. And, as capital markets have become more important, securities regulators are rightly also at the table – and finance ministries too given the social and political issues. The result is a big table. (FSB Plenary – c.70).
- By prioritising an international playing-field that is as level as possible and as sound as possible, speed is sacrificed.
- Second issue – some key policy discussions end up being away from home, away from the Westminster Parliament. Mainly global in fact.
- That global process is pretty transparent – consultative papers, speeches and so on. But perhaps not covered in any national media, including here in the UK, as much as one might expect.

- But there is a deeper question here about the compatibility of domestic and global objectives. In the monetary sphere, it is well known that one cannot combine capital mobility, monetary policy focused on domestic price stability, and fixed exchange rates. Solution in post-Bretton Woods world has been floating exchange rates. This does not mean there are no spillovers. Hence information sharing in Basel meetings etc.
- There is a financial trilemma too. Cannot combine cross-border banking, and an integrated international financial system more generally; financial stability; and national policies focused solely on *domestic* stability.
- Came home to roost in the crisis: global banks were, as Mervyn King put it, "international in life but national in death". Financial autarky is not the answer.
- Solution: co-ordination and co-operation on the resolution of global banks. G20 Financial Stability Board has led the way here. Real progress.
- Means foreign countries have a stake in our banks, and vice versa. Means the key policies are unavoidably international, global. As a trading nation we should welcome that.

I hope these brief remarks provide the basis for a good discussion. In short, the traditional roles of central banks – for the first time ever reflected in UK legislation – touch every household and business in this country and, in truth, more widely. We need to be clear about what we can do and what we cannot do; we need to operate consistently within our remit; and above all we must be sufficiently transparent to make proper accountability realistic. That is what trust requires, and we are in the business of trust – trust in the value of money.