

## Andrew Bailey: Regulating international banks

Speech by Mr Andrew Bailey, Deputy Governor of Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority at the Bank of England, at the British Bankers Association Annual International Banking Conference, London, 17 October 2013.

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Today is the BBA's annual international banking conference, and I therefore want to stick to that theme and explain the PRA's thinking on issues concerning the pressures on international banking business and the establishment and supervision of foreign bank branches in London.

Let me start with the luxury of a wider reflection. Before I joined the Bank of England over 28 years ago, I was an economic historian, with a specialism in nineteenth century economic history. All a bit esoteric you might say. Well, it is the case that the late nineteenth century world economy was more open – and, to use a phrase I don't much like, "more globalised" – than at any time in at least the first fifty years of the twentieth century. Moreover, the rate of openness in the world economy probably only truly approached late nineteenth century levels in the last twenty or thirty years. The backlash to greater openness that came in the first half of the twentieth century is quite often attributed to the actual or perceived distributional effects of greater cross-border trade, flows of capital and flows of people. The world economy in many ways went backwards in the first half of the last century.

Why does this historical detour matter? The five or six years since the outbreak of the financial crisis have seen signs of a reversal of some aspects of the greater openness we had seen in the 1980s and 1990s. And probably none more so than the decline in cross-border bank lending. Moreover, the UK experience in terms of lending has been amongst the more pronounced. But again, does this matter? My answer is yes. First, because many of us do believe in the economic benefits of free trade and capital flows, as well as the contribution of migration to balancing supply and demand in the economy. Second, and closer to home, the City of London and its financial markets benefit hugely from, and are at the hub of, the open world economy. For example, whatever you think about the more troublesome recent innovations of banking, basic trade finance remains a core, simple and essential service provided by banks, and the City has for a very long time been a leading centre for providing this finance to support world trade.

International wholesale banking is therefore an important part of maintaining and developing the world economy, just as it was in the nineteenth century. Yet, we have to recognise that in the last five or six years of the crisis we have gone backwards. Cross-border bank lending has declined more sharply than overall lending – home preference has set in. And, the banking system has become more fragmented or "balkanised", with a preference for banks to subsidiarise in countries beyond their home state, and for regulators to wish for – and achieve – the location of more capital and larger pools of liquid assets in their jurisdictions. We should not be surprised by this, but nor should we accept that it is inevitably with us as a permanent feature. The reasons why we have seen these changes are not hard to explain. Major concerns about sovereign creditworthiness undermine stable banking activity across borders, another important lesson of history. Combined with that, as authorities we have had bad experiences in trying to deal with and resolve failed banks headquartered in other countries. It is not surprising that the natural reaction is to make sure in future we have "got the money".

Moreover, no one country is particularly responsible for this trend – the honest thing is to say that many of us have contributed to it because the alternative available at the time looked worse. And, writing rules to say that such actions should not be taken, irrespective of the underlying reasons for them, is not likely to be a success. This amounts to contradicting basic human nature.

But, and this is the important point, we should not design the world as if fragmentation and balkanisation are inevitably always likely to be with us. That is a counsel of despair, and it contradicts everything I said earlier about the benefits of free trade. How, therefore, should we think about, and act upon, this design challenge? A key issue here is bank resolution. Indeed, arguably it is the cornerstone of making progress. The reason is that without confidence in how we would in future resolve banks operating across borders – typically therefore the larger banks – we are unlikely to break down the trend towards fragmentation. This is because some of the most difficult legal and structural issues in bank resolution concern enabling cross-border solutions to take effect, and this is true whether the resolution plan involves holding the firm together – Single Point of Entry unitary resolution – or breaking it up under a Multiple Point of Entry resolution. For instance, either way it will be important to effect a stay on triggering default clauses in contracts.

For me, the big point here is to achieve resolution planning which creates sufficient confidence among national authorities that there is greater trust, and therefore a greater willingness to assume, for instance, that capital and liquid assets are moveable and can be employed across countries when needed. It is an essential pre-condition for confidence in cross-border bank activity and likewise it provides an important counterweight to policies that trap capital and liquid assets in host jurisdictions. In turn this allows a more neutral stance on the subsidiarisation versus branching issue.

Resolution is the toughest nut to crack in the financial reform package, but it is also the one that I think does more to unlock other issues, including the appropriate steady-state end-point for the bank capital regime. Put simply, the answer in my view is different in a world of effective resolution that ends too big to fail. But in the alternative outcome, where too big to fail remains with us and there are doubts around the effectiveness of resolution, it is hard to avoid the conclusion that higher capital requirements will follow, and cross-border establishment will be through subsidiaries.

Let me also say that we have made more progress on resolution in the last few years than many people expected. To say that we are not there yet should not conceal the real progress made. And, an important credit on this goes to Paul Tucker who has led much of the international policy thinking on resolution. Paul leaves us at the end of the week for the calmer environment of Harvard – we shall miss him in many ways, and I hope that when we get to an outcome on bank resolution that meets our wish to reject the permanence of fragmentation, we will remember how much Paul did to get us there.

The real progress that we have made on resolution issues makes it reasonable to start to take steps towards planning for a safe resumption of the growth of cross-border banking in ways that had been in some senses discouraged, and sometimes with a history of discouragement going back before the onset of the crisis. A good example of this is our approach towards branches from outside the European Economic Area (remember that EEA branches are governed by the Single Market legislation). Earlier this week, it was announced that the PRA will be prepared to see Chinese banks open branches here (recognising that the Bank of China already has a branch in London).

I want to describe how this change can come about, and in doing so it should be clear that this is not a special arrangement for China – rather it is part of a broader policy.

Branches of foreign banks (both non-EEA and EEA) have a large presence here in the UK. Currently, they account for around one third of total UK resident banking assets. Supervision of branches has therefore always been an important issue for the UK authorities. In the run-up to the launch of the PRA, in April, we set out our approach to supervising subsidiaries and branches from overseas, and in this context the announcement on China is not a surprise.

Let me read to you the relevant three paragraphs from our Approach document published in April:

“For UK branches of non-EEA firms, the PRA’s authorisation applies to the whole firm. At the point at which a non-EEA branch seeks initial authorisation in the United Kingdom, the PRA, will, as a first step, form a judgement on the adequacy of the home regulator, including its ability and willingness to share confidential information. Where it considers the home supervisor not to have a regime broadly equivalent to that of the United Kingdom, the PRA will refuse authorisation of the branch. It may instead decide to authorise a stand-alone subsidiary, in which case it may limit the interlinkages with the rest of the group or ring-fence the subsidiary (for example if it considers the home supervisor not to deliver effective consolidated supervision). In assessing a non-EEA firm against the Threshold Conditions, the PRA may also have regard to the opinion of an overseas regulator in a country in which the firm carries on regulated activities. In considering how much weight to attach to such opinions, the PRA must have regard to the nature and scope of the supervision exercised by the overseas regulator.”

“For existing UK branches of non-EEA firms where the home regime is not considered to be equivalent, the PRA’s supervisory work is aimed at mitigating the risks of non-equivalence in the relevant areas. Its supervision focuses on issues such as the financial strength of the whole firm, including the adequacy of its liquidity and the resolution plan for the firm (collaborating with the Special Resolution Unit and home authorities to develop such plans in colleges or Crisis Management Groups as applicable), taking into account the importance of the firm to the PRA’s objective.”

“For UK branches of non-EEA firms where the PRA is satisfied that the home regulatory regime is equivalent, and where the PRA has assured itself over resolution plans and the home regulator’s supervisory approach, the PRA relies where possible on the home regulator’s prudential supervision. In these cases, the PRA focuses on collaboration with home regulators (including via supervisory colleges) and on resolution plans. In addition, the PRA takes a close interest in liquidity and ensures that there are senior individuals in the United Kingdom that are clearly responsible for management of both the UK operations and business booked in the United Kingdom. The PRA discusses and agrees with the home regulator the areas in which it will seek to rely on the home regulator’s supervision”.

This Approach document concluded that the PRA would in due course publish a fuller statement on our approach to the supervision of overseas firms operating in the UK. To take that forward, over the summer the PRA Board, acting in its new statutory capacity considered our policy further. It endorsed the account I have read from the Approach Document, but added one important further condition, namely that we do not wish to see non-EEA branches undertaking critical retail banking functions (like taking deposits) beyond de minimis levels unless there is some good reason and importantly there is a very high level of assurance on resolution. In particular, we think that new non-EEA branches should stick to straightforward wholesale banking, of the type that supports world trade and capital flows.

Resolution will be a key deciding factor in the PRA’s judgements, and it is thus where we will place emphasis when forming a view on our risk appetite towards branches operating in the UK. We will therefore expect assurance from the home state regulator over the recovery and resolution plans and assess if the plans adequately cover the UK branch’s activities. For banks with small UK activities we will expect to gain a level of assurance that is relative to the scale of the UK activities.

The PRA’s policy towards branches is part of our general approach set out in the light of the experience of the crisis. It places emphasis on recovery and resolution, and we will expect very clear and credible assurances from the parents of banks wishing to operate as branches and from the home state authorities. It limits the range of activities that branches can undertake, but not I think in ways that undermine the ability of such branches to undertake safer forms of wholesale banking, which is the preference of most banks in that position. We

have a clear policy framework for taking these decisions and our approach to all branches will be consistent with our objectives of safety and soundness. Our stance is sensibly cautious, but not I think restrictive. And, let me reiterate that it is a general policy, not a China policy, and it is consistent with promoting the benefits of an open world economy.