

Jon Cunliffe: Regulatory reform and returns in banking

Speech by Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England, at Chatham House, London, 20 October 2014.

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On 13 October 2008 – just over 6 years ago – the UK government injected nearly £40bn of public funds to stabilise Royal Bank Scotland and Lloyds Banking Group. Parts of both banking groups had started the year in a precarious position, with swollen, highly levered balance sheets and a reliance on short-term wholesale funding. By October, losses had left them dangerously undercapitalised. Absent a resolution regime for dealing with failing banks, and given the importance of these two banks to domestic lending, the government was left with no choice but to inject public funds, bailing out the banks' creditors.

In the intervening 6 years the landscape of banking has changed beyond recognition. Some of this is due to a very different approach to regulation and supervision. Some is due to a very different commercial environment. And most important, there has been a sea change in public attitudes towards banking and bankers.

Bankers should not expect to be popular. But the outburst of public anger that accompanied the crisis and its very painful and protracted impact on the real economy – families and jobs – has not abated much. The latest polls put public trust in bankers at nearly the bottom of the class – only marginally above politicians. It is a hard truth, but I fear a truth nonetheless, that it will be some time yet before trust between banking and society is established. That societal anger has motivated much of the reform effort that has been the story of the past 5 years.

The message to politicians, policy makers, regulators and supervisors has been loud and clear: a repeat of the events of the crisis and recession will not be tolerated.

Against that background, I want to look at the key new approaches that define the new landscape from the regulatory perspective.

I do not want to list in detail the reforms that have been implemented and that are in prospect. It is an impressive list, especially when one looks at the amount of international agreement that has been reached on new international standards.

- Globally there is already more than \$500bn loss absorbing equity capital in the system and,
- for the first time, an international standard for the liquidity banks should hold.
- UK banks have £150bn more capital than before the crisis and their holdings of liquid assets have trebled.
- International standards are in prospect on leverage and on the amount of debt banks must hold that can be “bailed in” if a bank fails.

Rather, I want to look at three fundamental changes in approach that have driven and will continue to drive these reforms. – macro-prudential policy, international governance and intensive supervision.

And I want to look not just at the regulatory landscape but at the commercial one too. What business models work in this new landscape? Banks, particularly those engaged in investment banking, are currently wrestling with this question.

Macro-prudential policy

The crisis and the determination not to allow a repeat has led to a much more intense focus worldwide on the stability of the financial system *as a whole*. This has led to the development

of what, rather inelegantly, is called “macro-prudential policy” to protect that stability. Put simply, whereas “micro-prudential” regulation and supervision address the safety and soundness of individual firms, macro-prudential tries to address the safety and soundness of the system as a whole; to monitor whether risks are building up in the system and to take action to prevent those risks jeopardising financial stability.

Monetary policy, of course, provides a powerful instrument for preventing risks building up in the financial system. But monetary policy also has a very powerful impact on the economy as a whole and there is a broader cost to directing it to address financial stability risks. So it is very much a last line of defense for managing financial stability risks, after macro-prudential policy.

Many jurisdictions have put or are putting in place macro-prudential “machinery” responsible for assessing macro-prudential risks. In some cases, that has meant new macro-prudential authorities with both the responsibility to assess risk and the powers to address them. This, of course, is the case in the UK with the establishment of the Financial Policy Committee of the Bank of England.

Macro-prudential policy is still in its infancy. But the new macro-prudential machinery will, I think, play an increasing role in determining the future landscape for the financial sector as a whole, and banking in particular. Macro-prudential policy will be motivated by two rather different impulses.

The first impulse is the need to establish and preserve resilience in the financial system as a whole. The crisis was what statisticians call a “tail event”; a highly improbable event statistically, that had not occurred for 80 odd years. But while such an event seemed in advance very improbable, very much in what statisticians call the “tail of the probability distribution”, *it happened*. And because the system did not have the resilience to weather it, the system failed.

For macro-prudential policy makers, like the members of the Bank’s Financial Policy Committee, the FPC, systemic resilience in the face of improbable and incalculable risks is an ever present concern.

Their colleagues on the Bank’s Monetary Policy Committee focus on charting the best short to medium term path for supply and demand in the economy that is consistent with the inflation objective. But the members of the FPC focus much more on the robustness and resilience of the financial system to events in the tail of the distribution, and to events that are difficult to place in any measured probability distribution – the so called “unknown unknowns”. And that of course, is why, unlike monetary policy, it is so difficult to define financial stability with a numerical target.

This motivation has been the starting point for the new international standards for bank capital and liquidity which have been set at levels calculated relative to the extreme levels of losses and liquidity stresses observed through the crisis.

It is also the motivation behind the concurrent stress testing of the banking system that is becoming the norm in advanced economies. The current Bank of England stress test, which will report in December, subjects the banking system to a tail event – an improbable but plausible set of circumstances. The objective is to ensure not only that individual banks can weather such an event but also that when we aggregate the actions that individual banks take in such a stress, the system as a whole does not fail.

The second impulse of the macroprudential policy maker is much closer to monetary policy. It is to act counter-cyclically against the upward spiral of exuberance which can easily set in to the financial system as rising asset values provide additional collateral for more and more lending and weaken lending standards. In the old days, central bankers simply called all of this “leaning against the wind”. Nowadays, when done to restrain risk in the financial sector, we call it “counter-cyclical macro-prudential policy”. But however called, we can expect such action by macro-prudential authorities to be a feature of the banking landscape for the future.

When leaning against the wind of the credit cycle, macro-prudential authorities do, like their monetary policy colleagues, still need to find the optimal path. To use the words of the UK Chancellor, their objective is not to ensure “the stability of the graveyard”. How they balance cost and risk, where they set the trade-offs, will depend in large part on how confident they are about the underlying resilience of the system – in other words how well they have done on the first impulse.

International governance

The second big change I want, therefore, to highlight is the development since the crisis of much stronger international governance. This stems from the creation, at the April 2009 G20 London summit, of the Financial Stability Board (FSB). And, equally important, from the decision at the Summit that the FSB should report directly to the G20 Leaders and Finance Ministers to give it the necessary “clout”.

Working with the standard setting organisations like the Basel Committee, the FSB has provided the drive and coordination to reform and develop global standards for bank capital, liquidity, and resolution. If one remembers the best part of a decade that it took to develop and reach agreement on the Basel 2 capital standard, the progress made and international agreement reached over the past 5 years has been extraordinary.

The G20 summit in Brisbane will, I hope, mark the end of a major phase in this work with proposals to help end “too big to fail”, including ensuring that banks hold debt that can absorb losses – i.e. be “bailed in” – if the bank fails, and a private sector agreement to provide for stays on derivative contracts during resolutions of failed banks.

This stronger international framework has not been an accident. The crisis brutally underlined the degree to which countries were connected to each other through the operation of a global capital market and banking system – and the dangers of regulatory arbitrage between jurisdictions.

The FSB and the international standards that have been developed are, it is true, only “soft law”. They are not legally binding. They constrain neither the powers of national regulators to set the rules for their jurisdictions nor the accountability of national regulators to national legislatures. But this soft law is powerful because it is grounded in the recognition by the major jurisdictions that we can only have a globally integrated capital market – and the benefits that brings – if we can agree and implement key common minimum standards.

That impulse to work together, internationally, to provide stronger governance of the global financial sector will inevitably wane somewhat the further in time we get from the crisis in which this was born.

I don’t think the more powerful, more comprehensive international machinery that has been built since the crisis will disappear. But the challenges will change. It will need increasingly to pivot from design of new international standards to ensuring consistent implementation across jurisdictions. It will need to be prepared to speak out loudly when standards are not being met. Where standards have been met, it will need to encourage national authorities in one jurisdiction to recognise and defer to equivalent regulation and supervision in another. And it will need to monitor and address risk throughout the system.

Of course, while I think and hope we can continue and indeed reinforce the international governance that has been developed, it is not a given that we will succeed. It is very much in everyone’s interest to ensure that we do. If we cannot ensure consistent application of international standards, the result is very unlikely to be more unconstrained global financial activity of the sort we saw before the crisis. Rather it is likely to be the further rolling back of financial globalisation to the detriment of the global economy as national regulators feel compelled take local action to protect their own jurisdictions.

Intensive supervision

It is not all about new approaches to regulation – to how you set the rules. It is also about new approaches to supervision – to how you apply those rules, day to day. From the outset, a key element of the international reform agenda has been more intense and more internationally co-ordinated supervision of systemically important firms.

Unlike macro-prudential policy, micro-prudential supervision – the supervision of individual financial firms – is not at all new. But it has changed materially. I recall quite clearly from my time at the Treasury, in charge of financial regulation in the early years of this century, the underlying belief among the regulatory and supervisory authorities that the management and boards of firms had an even stronger reason than the supervisor to control risk and the safety and soundness of their firm – and *that they had the capacity and capability to do so*.

The crisis revealed a very different picture in many institutions worldwide. We have learned from this experience.

In the UK, the Prudential Regulation Authority's new and more intensive supervisory approach reflects this. There is also a much more intensive focus on the firms that pose the greatest risks to financial stability than was the case before the crisis.

This more intensive approach involves a higher reliance on judgment based supervision and a more forward looking and proactive stance. Supervisors are empowered to use their judgment. They no longer need to wait for a problem to occur to take action. An example is the UK stress test I referred to earlier which is carried out jointly by the FPC and PRA: firms who do not meet the standard will be required to take action.

A crucial part of this more intensive supervision is not just to look at the activities of the firm, but also much greater scrutiny of the quality of its governance and management. This includes a very thorough and careful assessment of the suitability of those who run regulated firms, as well as time spent looking at the Board as a whole to ensure that it has sufficient experience and character. For the largest firms, the PRA Board is involved in these judgments and in approving the appointments of the most senior staff.

And, in marked contrast to the pre-crisis period, there is a much greater focus on a firm's business model and the firm's understanding of their vulnerabilities. This enables the supervisors to assess if there are risks posed to financial stability by the way that the firm chooses to conduct its business, or if indeed it is not viable.

The aim is not that the supervisors should run firms. But they should not be shy to question if executives and boards have the right capabilities, if they understand the business model and the particular risks to which it is exposed and, overall, whether that business model can be operated successfully while managing the risks it entails.

These three changes in the official landscape – macroprudential policy, more powerful international governance and more intensive supervision have shaped, and will continue to shape the world in which banks operate. But it is less clear what the changes on the other side will be: how banks will respond to the new regulatory and economic environment. There is much soul searching in the industry about what the future looks like.

The reform programme and returns in banking

The most marked change in this new landscape is the much greater amounts of capital in banks and as a consequence the much reduced level of leverage. Headline levels of required capital have increased. And the risk associated with many types of assets and business activities has been fundamentally re-appraised. For the largest firms, the equity levels required will be around 7 times higher than before the crisis on a risk weighted asset basis.

Moreover, international standards will determine not just the leverage firms can carry on a risk weighted basis but also, when an international leverage ratio is agreed in 2019, the absolute amount of assets they can carry for any given level of capital. A number of major jurisdictions such as the US have implemented leverage ratio rules in advance of that; the FPC will shortly issue proposals to do so in the UK.

Lower leverage will reduce the returns that banks' shareholders make, relative to pre-crisis. But it also means that banks will be safer investments which should also reduce the returns that investors require.

The second big change for the industry is the reduction and I hope removal of the implicit taxpayer subsidy that came from the perception – and as it proved, the reality – that the largest banks were too big to be allowed to fail. New powers to bail-in banks' creditors, living wills, international standards on the debt that can be bailed in – all of these mean that we are getting closer to be able to say “no bank is too big to fail”.

This will change banks' costs. Being too big to fail, the implicit taxpayer subsidy, reduced large banks' borrowing costs in relation to their smaller brethren. As we make it more and more possible for a big bank to fail – like any other company – without having to be bailed out by the taxpayer, creditors are realising that they bear more risks than before. The cost of insuring £100 UK banks' senior debt against default was just 8 pence before the crisis. Today that cost has increased by almost a factor of 10, driving up banks' cost of funds.

This is part of the reason why the spread over the risk-free rate on banks' lending is higher now than before the crisis and is likely to remain so.

Put simply, credit was mispriced before the crisis, in part due to the implicit insurance of taxpayer bailouts.

Taken together, lower levels of leverage, higher liquidity and the removal of the implicit taxpayer subsidy will mean changes to banks' business models. It has started to happen, particularly in the US, but there is a long way to go. As the IMF noted a fortnight ago, global banks accounting for 80% of the total assets of the largest institutions are still earning profits below their cost of capital.

Prior to the crisis, global banks' return on equity averaged 15%. In those years, global banks' actual returns on the assets they held were pretty much flat in that period. Indeed, in the UK, banks in the years immediately before the crisis, return on assets actually fell. The high returns were not fuelled by a better return on the underlying assets banks were holding. In the UK, for example, banks' assets grew from 20 times equity to more than 30 times equity. Put simply, banks maintained and increased shareholder returns by dangerously increasing leverage and thinning their capital cushions.

Of course, shareholder returns collapsed when the crisis struck and risk across the system was re-priced. In the depths of the crisis, global banks' earned negative returns for shareholders. UK banks' return on equity plunged to –10%.

Today, returns on underlying assets remain lower than they were before the crisis. In 2013, global banks' average return on assets was 0.3%. For the largest UK banks, return on assets was just 0.01%. Return on equity in the UK, the shareholders' return, was just 0.3%.

Today's low returns both on assets and on equity reflect a number of factors. One driver of low return on assets for many banks has been the continued effect of low levels of long-term interest rates, which can drag on net interest margins. For this reason, when long-term yields fell on renewed fears about the strength of the global recovery last week, bank stocks fell disproportionately. The return to strong global economic growth that we all hope to see, and to more normal monetary policy settings should support banks' earnings.

There have also been, unfortunately, a series of “one-off” effects – the necessary redress of previous episodes of misconduct. These have reduced UK banks' pre-tax profits from around

£20 billion, to less than £10 billion during 2013. One hopes this will also be a temporary effect.

But some of the effect of the new landscape will be more permanent. This is particularly true of leverage; it will not in future be possible to drive up shareholder returns by levering up on ever thinner capital cushions. For the large UK banks, average levels of leverage have broadly halved and seem unlikely to increase materially.

And that is not all of the story. Another driver of low returns on assets and equity is the fact that banks' paybill has not adjusted to the smaller returns banks are now earning.

It was not just the shareholders who enjoyed high returns pre-crisis. Bank employees did too, or at least some of them did. In the decade before 2007, bank paybills, broadly defined, grew at broadly the same rate as shareholders' profits. In the 10 years before the crisis, for the global banks, profits attributable to shareholders averaged 60% of the paybill. For the big UK banks, profits were about 75% of the paybill.

Since the crisis that picture has changed markedly. In 2013, profits attributable to shareholders were down from 60% to around 25% of the large global banks' paybills in 2013. Put simply, shareholders have gone from getting 60 cents for every dollar in pay for staff to getting 25 cents per dollar. Across the big UK banks in 2013, the fraction had fallen to just 2% – ie to 2 pence per pound paid to staff.

Averages, of course, mask some very different performances by individual institutions. But it is noticeable that, since the crisis, for the industry as a whole, employees have received a larger share of a smaller pie relative to shareholders. And in the UK, due in no small part to one-off factors, this effect has been particularly pronounced. UK banks' returns on equity would have been nearly 6 percentage points higher in 2013 if the ratio of staff costs to the sum of staff costs and shareholders' profit had been at its 2000–07 average.

The sluggish adjustment in pay may well reflect the expectation that returns in banking are set to increase in the future. There are good reasons why they may do so. But, given lower levels of leverage, it is unlikely that we will see, or want to see again, the returns on equity that we saw before the crisis. In the new world, paybills may well have further to adjust.

A major element of the rethinking of business models in global banks has concerned their Fixed Income, Commodities and Currency business – charmingly known as FICC. A consequence of higher risk aversion and tougher capital and liquidity requirements have been a step reduction in FICC-related activity, especially proprietary trading and market-making. Inventory levels held in banks' FICC areas have nearly halved since the boom years. A consequence has been falling income from FICC trading over the past five years.

It is not yet clear how this very material element of banks' business models will evolve. Many banks, reacting to both low profitability and regulatory pressure, are continuing to shrink these operations. And as the data suggest the average pay bill in banking is skewed very heavily towards the top earners, such as principal risk takers in investment banking and trading, this should both restore return-on-equity and reduce the pay bill.

To sum up. The landscape has changed with key changes to the way the official sector approaches regulation and supervision. Those changes have generated changes in rules and in supervisory practice that have changed the world for banks. Banks are now wrestling with the changes they need to make to thrive both in the new economic environment and in this new landscape.

It is important, in seeking to restore returns, that banks and investors do not think in terms of "back to the future". With less leverage and more liquidity in banks, required returns ought generally to be lower than prior to the crisis.

Trying to offset that by taking excessive risk or evading regulation will not, I think, be tolerated in the new world.