Andrew Bailey: The outlook for financial regulation in the UK

Speech by Mr Andrew Bailey, Executive Director for Banking Services and Chief Cashier of the Bank of England, on a regional visit to Edinburgh, Edinburgh, 10 January 2011.

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Andrew Bailey will become the deputy chief executive of the Prudential Regulation Authority (PRA) on its creation.

Thank you to Linda Urquart for inviting me to speak today and Morton Fraser for allowing us to use your venue. I would also like to thank Will Dowson, the Bank's Agent for Scotland for the assistance that he has given me, and for the work that he does to ensure that the Bank is well connected to the UK's most important financial centre after London. Will worked for me when he first joined the Bank as a graduate entrant, and I can assure you, drawing on that experience, Will is an excellent person to ensure that the Bank and you as our contacts in Scotland are well informed and understand the relevant developments that affect each of us, and of course that we in the Bank understand the state of the economy in Scotland and the financial sector here.

It is quite right that first and foremost our Agents support the needs of monetary policy and the MPC. The information that they gather from you, their contacts, makes a real difference to the monetary policy process. There is a parallel in our responsibilities for ensuring financial stability. In an important financial centre like Edinburgh, we need to be well connected, and to understand your assessment of the threats to financial stability and we need to explain what we are doing to tackle these threats. Our market intelligence function under my colleague Paul Fisher plays an important role here, and is in frequent contact with the Scottish financial community.

This contact will be even more important under the new arrangements in which the Bank will be responsible for macroprudential policy and its focus on the stability of the financial system, with a new policy making body, the Financial Policy Committee, or FPC. Alongside and feeding into the Bank's macroprudential role will be our new responsibility for microprudential supervision of deposit takers, insurers and major securities dealers, also in a new body, the Prudential Regulation Authority, or PRA.

It is therefore a period of major change at the Bank, and we are taking very seriously our role in building a system of regulation in the UK that must meet the very reasonable expectations of the public for a safer and sounder financial system. The overarching objective for the Bank is to put the stability of the financial system at the heart of the mission of financial regulation.

We are now in the fourth year since the financial crisis started in the middle of 2007. The Scottish banking system took a pounding during the earlier stages of the crisis. That was not just deeply regrettable for the institutions concerned, but also it damaged a proud and long tradition of sound banking in Scotland. It pained me, in my role as the person responsible for resolving a number of these problems, to see the lack of regard for the basics of a well run bank, the foundations which must be there to be sound and successful. I have spent the last seven years also responsible for the Bank of England's banking operations, and I know from this experience that unless you really understand your balance sheet and its risks, the systems and control environment that supports the balance sheet, and you have the basics needed well covered – the reconciliations work, the right management information available promptly – you aren't doing your job. It isn't sexy or headline grabbing, but it is surely what the good Scottish bankers of the past taught us to do, and what I hope is back with the current generation.

The financial crisis has moved on since those earlier days. Over the last twelve months, concerns with both sovereign states and their banking systems have intensified in other parts of Europe. Recently, the IMF and European authorities have moved to put in place a substantial package of support for Ireland. This intensification of concerns has raised the threat of contagion from these countries, and the consequent financial market developments that have affected several other European countries have added to the risk of a spill-over to the largest European banking systems, including our own.

So far, the threat has been limited. An important reason for this is that banks have done the right things over the last two years, namely to focus on their resilience by refinancing debt at longer maturities and raising their buffers of capital. It is hard work in an environment that is still affected by the crisis, but there is no doubting that it is the right thing to have done and continue to do. Sound banking is about having a strong capital base and a funding profile in terms of maturity that can withstand the sorts of shocks in the world that will happen from time to time. It is not about expanding your bank rapidly and funding the growth in the overnight money market.

This need for adjustment also explains why at the Bank we are sticking firmly to the plan to allow the Special Liquidity Scheme to run-off on time a year from now. Over the last twelve months, banks have taken the necessary steps to move towards that goal. It is all about getting the banking system into a position where it can demonstrate robust capital and liquidity buffers, and to do so by facing up to the discipline of the market rather than the support of the authorities. The Edinburgh fund managers are an important part of that market discipline. In a market economy, you are in the front line of defence and discipline.

Now, I cannot say that the UK is insulated from the risks we observe in other parts of Europe. As our most recent Financial Stability Report, published just before Christmas, made clear, "the United Kingdom is only partially insulated given the interconnectedness of European financial systems and the importance of their stability to global capital markets". As the Report also made clear, there are other, probably more medium-term risks posed by evidence of low bond yields in many advanced countries and signs of an intensifying search for yield as capital flows into alternative assets, including into emerging markets.

Against this backdrop of risks, it is in the collective interest of banks to continue to build up progressively their capital and liquidity resilience so that they support not only themselves, but also the stability of the financial system as a whole. The Basel III agreement, and the reform programme of the G20 and the Financial Stability Board set up under the G20, will provide the supporting framework by which the authorities will back up the discipline of the market to achieve and maintain financial stability.

This brings me back to the reforms in the UK. At their heart lies the objective of putting the stability of the financial system at the centre of the regulatory mission. You may say, "surely that's not new". I would disagree – our overriding objective must be to create a consensus of public opinion which will enable financial stability to be embedded as a public policy objective in the same way that in the wake of the 1970s, low inflation came to be adopted as a necessary condition for stable economic growth.

Too often, I hear people say that achieving financial stability needs somehow to reflect a balance with other objectives, such as competition, consumer protection, and the like. I'm sorry, but while these objectives are of course very important, the best way to achieve them is by establishing a stable financial system. Of course, there are judgements to be made on what constitutes financial stability, but those are not judgements that should be a product of murky compromises with other objectives.

The assessment of the failures of monetary policy in the 1970s should stand as a clear guide as to why we must establish a strong understanding of financial stability as the driving public policy objective for the financial system. The absence of a consensus for low inflation in the 1970s as an objective of public policy led to – and I will tell you the source of this assessment at the end – policy making which lacked the courage and conviction to do what was needed to achieve an objective which in itself was not always accepted as necessary. Policymakers did not persist with actions when criticised (criticism will of course happen), they tended to give too much weight to perceived political constraints and too little weight to the cost of failure to achieve the objective of policy. They talked tough, but didn't match their words with actions, and their actions in response to criticism tended to be of the "do something" variety. And the result was? A policymaking process and institutions with low credibility in the eyes of the public, a very dangerous place to be. Now, I haven't made this up, you can read it in one of the best accounts of the failings of monetary policy in the 1970s, the history of the Federal Reserve by Allan Meltzer.

The reason for drawing this point out is that if the reforms are to work, we must have a clear consensus that financial stability is a goal which will enable other things that improve the welfare of the public to be achieved more easily.

So, what does this mean for important aspects of the regulation of the financial system? For microprudential supervision, the proposal is based on the so-called Twin Peaks model which separates prudential supervision (one peak, to be in the PRA) from conduct of business and consumer and investor protection (the other peak, to be in the Consumer and Markets Authority). One of the very important features of this approach is that it doesn't mean one peak is less important than the other, that is not a consequence of financial stability being a necessary condition for good conduct of business. Rather, it should enable each regulatory body to be focussed on its own objective, because it requires different skills and experience to undertake the two peaks. Of course, great attention needs to be given to ensuring the boundary between the two peaks is robustly defined, and there is effective and efficient cooperation between the two authorities. But, my view is that done properly it will improve the system of regulation.

As far as microprudential supervision is concerned, we are clear that it should not be a regime in which firms cannot fail. A successful industry of any sort needs to have means by which unsuccessful firms can fail without an unacceptable cost to the public, and where appropriate means by which firms can recover from serious problems without having recourse to a formal resolution process. Banking still suffers from the too big, too complicated, too interconnected to fail problems. This has meant that public money has had to be used to prevent disorderly failures. Achieving a regime in which orderly failures can occur without recourse to public money is a vital part of the redesign of regulation. This objective is recognised internationally in the work of the G20, the Financial Stability Board, and in the European Union. One important way in which this work has started is with the development of recovery and resolution plans for major banks. But there is a lot more to do in order to embed a credible approach to ensuring failures can be handled into the framework of prudential regulation. In my view, it is vital that we do this, and thereby introduce greater market discipline into the behaviour of banks by making clear to investors that failure is possible, and can be handled without unacceptable disruption.

Last, but certainly not least, the new framework of regulation needs to be clearly accountable to the public through Parliament and that accountability will depend on a clear understanding of the objectives of supervision. Alongside accountability goes transparency, so that all interested parties can see what we are doing.

There is no doubt the agenda is challenging, but we have very good reasons for sticking at it. I will be part of the new senior management responsible for prudential regulation, and I look forward to having another opportunity to update you as our work moves on. Thank you.