Andrew Bailey: Financial stability – objective and resolution

Speech by Mr Andrew Bailey, Executive Director of the Bank of England, at the Pro Manchester Business and Professional Services Conference, Manchester, 17 March 2011.

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Thank you for inviting me to speak at Pro-Manchester. It is a pleasure to be here.

Today, I will talk about the financial crisis that is now in its fourth year, and particularly about the new regime of financial regulation that is being put in place.

There is, I am afraid, nothing new about financial crises. On one count there have been sixty different crises since the early seventeenth century, and the first record of a bank panic dates back to at least Rome in AD33[1]. A common theme of the antecedents of financial crises is that they begin with a wave of optimism and borrowing among consumers, companies, investors and governments.

One of the best modern descriptions of this sequence can be found in a book by the economists Carmen Reinhart and Kenneth Rogoff. They summarise the sequence as one where: "excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom. Most of these booms end badly".[2] Reinhart and Rogoff's book goes under the title "This Time is Different: Eight Centuries of Financial Folly". Their response to the cry of this time is different is to assert that "it almost never is."

Why, then, is it so hard to understand the true picture of financial crises? I think that the issue here lies clearly in the characteristics of banks. One of the conclusions of work on the history of financial crises is that they have worse outcomes when they involve banks. As an example, if you remember the stock market crash of 1987, which seemed very bad at the time, it did not threaten the banking system, and its effects were contained. It was not a major financial crisis in its own right.

The reasons for this difference when banks are involved have to do with the nature of banks. At the heart of banking is a technical term called maturity transformation, or more simply, banks borrow at a shorter term and lend at a longer term in respect of the duration of their deposits and loans. This is the essence of banking. Banks transform savings that may be required by their owners at short notice into longer-term loans. This is a benefit to the economy and society because it allows longer-term borrowing by companies and by all of us to buy houses. But it makes banks inherently illiquid. If all depositors decided to ask for their money back at the same time the bank would struggle to pay-out and survive. This is because the bank will generally find it difficult to realise its assets in time. Northern Rock represented the most extreme case of this, the bank run, starting with wholesale creditors and then on to a full-scale retail creditor run. And it follows from this assessment that banks depend upon maintaining the confidence of their depositors that they will over time be able to meet claims on them. A very important part of maintaining confidence in banks is that the value of their assets – the loans they make, to simplify – has not fallen below their sustainable value in the accounts of the bank. In order to prevent this happening, banks maintain buffers of their own funds – capital – which can be used to maintain the claims of depositors.

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1 Liaquat Ahamed: "Lords of Finance" (Windmill Books, 2009), p14.

2 Carmen Reinhart and Kenneth Rogoff: "This Time it is Different: Eight Centuries of Financial Folly". Princeton University Press, 2009.

Here then we have the two fundamental elements of the safety and soundness of banks, liquidity and capital. Banks are often said to fail either because they are insolvent (lack of capital) or because they are illiquid (lack of funds to meet the claims of depositors to be repaid). My own experience of dealing with banks that get into trouble suggests that the reality is somewhat different – it isn't a case of either one or the other. On the whole, banks lose deposits for a reason – depositors worry that there is something going on that they do not like. The film "It's a Wonderful Life" illustrates this point well. Rumours spread fast, depositors queue to get their money out while the bank still has funds available. In the film of course James Stewart came to the rescue, and he did that by convincing the queuing depositors that they should have faith in his bank.

Loss of deposits is a symptom of a wider problem – in other words, typically a bank becomes illiquid because its depositors fear a problem which is more often than not to do with the expected future solvency of the bank. I want to put the emphasis here on the word "expected". Very few banks fail because they are insolvent today. They don't get that far. Typically, they fail because of a rising probability that they are expected to be insolvent at some point(s) in the future. This is important because regulating banks has to be forward looking, and in my view has not been adequately so in the past.

It also means that a problem in a bank can spread to create a problem in the wider financial system, so called systemic risk. Maintaining the stability of the financial system – financial stability – is therefore at the heart of the efforts of the authorities to prevent problems in banks spreading out of control. The financial crisis of the last three and a half years has illustrated starkly what can happen when financial stability is not maintained. So, establishing and maintaining financial stability should be high up everyone's agenda, and we should embed financial stability as the objective of public policy towards regulating the financial system.

You can reasonably ask, why is this difficult to achieve? Financial stability is difficult to define quantitatively and precisely. Some people say that you know it when you have it, but it might be better to say that you know when you don't have it.

What is being done to tackle the issue? A month ago, the Government issued a consultation paper which seeks to define the financial stability objective that will be given to the new Financial Policy Committee of the Bank of England under its plans. The objective is defined at the high level as protecting and enhancing the stability of the financial system of the UK. More precisely, the Bank's objective "relates primary to the identification of, monitoring of, and taking of action to remove or reduce" risk to the stability of the UK financial system as a whole or to a significant part of the system, "with a view to protecting and enhancing the resilience of the UK financial system". But the paper goes on to include in the objective the statement that: this does not require or authorise the Bank "to exercise its function in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term". Here then we have the recognition of the need to have regard to the impact of financial regulation on the long-run growth of the economy. To back this up, the Government intends to include in the legislation a power for it to provide the Bank with guidance in the form of a remit which would provide greater clarity on the overall approach the Bank should take to pursue its objective. That remit is likely to be more a matter of words than a single number like the inflation target, but it is the right approach to seek to set this out as explicitly as possible.

There are at least three things that need to accompany such an approach, none of which by the way is unusual to this area of public policy. The first is transparency, namely the clarity of explanation of the objective and how it is pursued. Transparency is an important part of the monetary policy framework – the same approach can be used for financial stability.

The second necessary tool is accountability to Parliament. Again, this is a well-established feature of monetary policy and is already well embedded for financial stability.

A third necessary element of financial stability policy is to have an approach which recognises the importance of the spirit as well as the letter of the law. I believe lawyers call this a purposive approach to interpreting legislation and regulations – in other words interpreting meaning in the context of regulations rather than a literal interpretation. This is necessary because history shows us that the financial services industry can be addicted to arbitraging regulations – exploiting the rules to suit short term purposes rather than longer-term stability.

I want to finish by saying something about a further important feature of financial stability. For me, the most unacceptable aspect of the financial crisis is that large banks have required the support of so much public money. This is often called the Too-Big-To-Fail problem, or better the "Too-Important-To-Fail-therefore-public-money-has-to-be-used" problem. Why are large banks in this position? The root of this issue is common to the key features of banks, namely their dependence on the confidence of depositors, the role of banks providing each of us with the facility to manage our money – our savings, and in our everyday lives in terms of payments – and the externality caused by the failure of one bank spreading a loss of confidence to other banks.

The failure of any company should be dealt with, wherever possible, using the standard insolvency or bankruptcy laws of the country. These provide a well-established and predictable framework for dealing with company insolvency. But, the insolvency laws do not operate quickly – resolving a company can take time. For a standard company, this will not matter in the sense that there is an externality in terms of loss of confidence in other like companies. But this is not true for banks. If ordinary depositors get locked into an insolvency process, there can be both hardship and unacceptable loss and the real risk of spillover to other banks. And yet, when a bank fails, decisive action is required to solve the underlying problem. This was the problem with Northern Rock – the only action that could be taken promptly was to use public money, initially in the form of a guarantee by the Government.

For the last three years, we have had a special resolution regime for banks in the UK, initially in the form of emergency legislation, and for the last two years in the form of permanent powers given to the Bank of England. The resolution powers give us the right to speed up the insolvency process, subject to a series of legal safeguards which limit what we can do to affect people's property rights in their money. The central aim of resolution is to enact a solution which ensures that depositors have access to their money and the supply of credit to the economy does not suffer an unacceptable disruption. Resolutions are possibly the most stressful thing you can do as a central banker. Fortunately, we don't do them very often. The aim is to get the failing bank to a weekend and give ourselves that time to effect the resolution. There is one question that has to be answered by 8am on Monday morning – when the depositor asks: "Is my money safe", you have to be able to say yes, no hesitation or qualification.

The reason I have described this is that, while we have a resolution regime, and we are ahead of many other countries in this respect, it is a regime for small and medium-sized banks. We are working very hard to solve the too important to fail problem for big banks. But, until we do so, we haven't solved the big problem that we have seen in the last four years, the dependence on public money. A healthy industry is one in which within an industry that is fundamentally sound, companies can fail, and new companies can enter to replace them without an unacceptable cost to society. That will be the objective of the new Prudential Regulation Authority. From a resolution perspective, we need a regime in which failure is orderly, and the cost of failure is borne by the capital holders and, if necessary creditors of the failed bank. This is a big issue on which a lot of work is currently underway.

Very important changes are under way in financial regulation. These put the stability of the financial system at the heart of the objective of regulation. Financial stability is a necessary condition to allow the pursuit of other good objectives of public policy – avoiding mis-selling, competition in the provision of financial services etc, things that are rightly not done by the

Bank of England but are important to society. Financial stability is not a superior objective to these other goals, but it is in my view a necessary condition to achieve them. And, in reforming regulation we should have in mind that a healthy and competing industry is one that does not rely on the support of public money, either explicitly or implicitly.

Thank you.