Andrew Bailey: The future of banking regulation in the UK

Speech by Mr Andrew Bailey, Executive Director of the Bank of England, at the British Bankers' Association Annual Banking Conference, London, 17 October 2012.

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It is a great pleasure to be here this morning. I am going to talk about what has become the hot topic of the time, namely the role of bank regulation in macroeconomic policy. But before I do so, just a few words on progress towards creating the new system of regulation in the UK. The Treasury announced on Monday that they expect that the new regime will formally come into existence at the start of April next year. I expect that the PRA's new home, near to the Bank of England in Moorgate, will be occupied by our supervisors shortly before then. On Monday, we published two important documents on the PRA's approach to supervision, covering banks and insurers respectively. Next Monday, we are holding conferences at the QE2 Centre, covering banks in the morning and insurers in the afternoon. Please do come along. You can access the documents now on the Bank of England and FSA websites. I should add that Martin Wheatley and his colleagues in the FCA-to-be have also issued an approach document this week and are holding a number of events too. We are doing our best to keep you entertained!

Let me turn now to the issues around bank regulation and macroeconomic policy. The financial crisis has emphasised the close links between the health and behaviour of banks and the state of the economy. We are remembering a very uncomfortable lesson from history that should not have been forgotten. But, forgotten it was. We have a very big programme of reforms under way, with the central objective that we must not let a financial crisis of this scale happen again. At the heart of this programme we are trying to knit together monetary policy and financial stability in both its macro- and micro-prudential forms, something that has not been done properly for a long time. I say that quite deliberately, because such coherence was not present prior to the reforms of 1997, so this is more than a change to recent arrangements.

The new macro-prudential approach to financial stability will see the establishment of the Financial Policy Committee (FPC), charged with the primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. In June, the Chancellor announced that the government would amend the Bill to give the FPC a secondary objective so that, subject to being content on the first objective, it should support the economic policy of the government, including its objectives for growth and employment. Currently, the FPC is acting in an interim capacity to undertake as far as possible the future statutory FPC's macro-prudential role.

These two objectives contain the same "subject to that" language used in 1997 in the Monetary Policy Committee's objectives. It means that there is a hierarchy of objectives which the FPC must observe. But, two further points are relevant here. First, resilience and economic growth interact, so they are not fully independent. An economy that displays stable growth is more likely to have a stable financial system, and vice versa. Second, policy is necessarily forward-looking, in that we are concerned with stability and growth in the future, since today's outcomes are so to speak, "baked in". This means that, in thinking about the hierarchy of objectives, in my view we have to take a forward-looking assessment of the probability of success, rather than saying we should complete one and then do the other.

Financial stability is more complicated than monetary policy in at least one respect, namely that it does not reduce to a single target expressed as a number. Rather, it comes in the form of recommendations, in the plural, expressed as words. You would think that as central bankers and public officials we should love that, spending our time crafting language in a form that only we really understand. Let's not get carried away here – there is a danger that by doing so we create uncertainty about our intentions. This danger of creating uncertainty exists because we are finding our way in a new and difficult area of policy. I want to try to cast more light on the issues here. But, I would note that, in the history of monetary policy, regime changes have had to deal with the challenge of crafting communication that avoids creating more uncertainty.

We have two, hierarchical, objectives: simply put, the resilience of the financial system, and the objective of encouraging growth (the counter-cyclical objective). These two can point in opposite directions, for instance in terms of banks' ratios of capital to assets. The FPC has recommended that banks should strengthen their buffers of capital.

What is meant by this? Let me tell you what we have concluded, and what we have not yet concluded. We are in a quite extended transitional phase, whereby the capital buffers of the banks are being increased to the Basel III levels. This process has around six years to run on the transition timetable. The FPC has recently said that it thinks banks should take steps to build up those buffers more rapidly than most firms have done recently under the Basel transition policy. (I say "most" because some firms have already made the transition.) But, we are not defining this objective as requiring banks to reach a level such as a 10% Core Tier One ratio in the next year or so on the new Basel III measure. Why not? It would run the big risk of encouraging banks to reduce their loan books – in other words, it would affect the interaction of our two objectives, or incentivise the banks to reduce/"optimise" their risk weights. We are, instead, defining the growth of capital in terms of the increase in the nominal stock of Core Tier One, or equity, capital. This makes it easier to find a transition path that allows more capital and more new lending to co-exist.

But, this begs three big questions: by how much do we want to see the nominal capital bases of banks grow in short order; why do we want this to happen; and what form do we want the capital to take? The first two of these questions, how much and why, are best taken together. Here, in my view, we face uncertainty that we have to find a way to resolve adequately. What we have done so far is to ask the major banks to try to maintain the projected growth of nominal Core Tier One capital over the next 18 months, according to the projections for this growth that they provided to us earlier this year. This is, their Basel III transition path.

In order to go beyond that path, we have to ask why we want to do so? In my view, there could be at least four reasons why new lending by banks might be restrained by lack of capital as represented by low price to book ratios. First, there is a possible shortfall in asset values relative to their book values, which is exacerbated by the accounting standards preventing provisions being taken against expected future losses. Second, there could be inadequate capital to protect against tail risks, most obviously a disorderly break-up of the euro area, which has negative consequences for banks and their valuation. Third, the impact of higher funding costs and the constraints on the ability of banks to re-set rates on longer maturity assets could mean that banks cannot earn the previously expected rate of return on them, which, like the first reason, is amplified by widespread loan forbearance, in both the household and corporate books. And, fourth, there could be a market value adjustment to reflect more structural uncertainty about the future business model of banks, for instance due to uncertainty about the final shape and impact of regulations, for instance the likely cost of implementing the ring-fence.

Any of these four could contribute to the market value of banks' capital being less than the book value of tangible equity capital. This is not currently true for all banks, but among the UK banks, more often than not, they are valued by the market at quite a sizeable discount to book value. If the market value diverges from the tangible book value, we know that investors are likely to be at least unsure that a firm's net assets are valued correctly in the published accounts. Consistent with this, we can see that in their published accounts, banks are placing a fair value on some of their assets which is below the book value.

This evidence, while informative, does not, for me at least, get to a conclusion on the need to add more nominal capital, or more particularly how much capital to add. To do that, we need to know more about the contribution of these various possible causes of market values of banks' capital, and that must be the key next step in the work. On this, I would ask for the insights of banks themselves and analysts, because as I always say, I know one thing for sure, we don't have a monopoly of wisdom, and this is a tough question.

But, it is a key question, because the danger of a very slow resolution of the capital gap is that new lending to the economy is seriously restrained. This is the Japanese threat, based on the recent history of Japan, and the basis of the argument that a more aggressive approach to re-capitalising banks will create more support for new lending. Moreover, it does illustrate why we see a close interaction of the FPC's two objectives, of resilience and growth. I need to see more evidence and analysis of why market values of banks' capital are low before I can determine what and how much needs to be done. This is the immediate task ahead because we need to do all we can to clear up uncertainty here.

Before going on, let me deal with two points that are related to this argument. First, it is said that this stance on capital is unnecessary because banks have stronger capital positions now than they did in the height of the crisis. This statement on the capital position now relative to the past is true but on its own that part does not tell us whether they have enough capital now. UK banks have made substantial progress over the last four years in building their resilience, but from a low base, it has to be said. There is further to go, but we should not forget the distance that has been travelled.

The second point I want to deal with here concerns forbearance, namely the extension by banks of a variance in the terms of loans, which involves forgiveness of various forms. It is easy to imply that forgiveness is a bad thing, turning Japanese in the unfortunate sense of that term. Rather, we should deal with the consequences of forgiveness, not prevent it. The reason for that is because forgiveness has a very good side to it, namely that fewer jobs are lost and fewer homes re-possessed where it takes place. And we can see evidence of both of these in the latest recession relative to previous ones. Let me say something unusual now: I think that the banks deserve a thank you for the way in which they have sought to use forbearance. When I was Chief Cashier of the Bank of England, I was responsible for our work on the so-called London Approach whereby we seek to use our powers of persuasion to facilitate company re-financings which are in difficulty. That brought me into regular contact with the corporate loan restructuring bankers and I was always impressed by their commitment to helping companies in trouble. Sometimes the medicine could be hard, but there are many companies around today that would otherwise not be employing people.

Now, I said earlier that we need to understand more not only about the size and cause of the capital gap but also how best to fill it. The choice of solutions matters because it can influence subsequent lending behaviour. It is often said that raising new capital dilutes existing shareholders. That is not really true in a literal sense if existing shareholders have written down the market value of the capital they own. But is true in the sense that it dilutes their claim on any future upside to the current market value reflecting the inevitable uncertainty about the future. This would be the effect of raising new equity. An alternative could be to raise the capital in the form of contingent equity, or "Co-Cos" for short. The attraction of this is that existing shareholders will retain some of any upside, though they will pay via lower returns for the risk premium on the cost of Co-Cos. I am quite attracted to Co-Cos, but we need to think through whether they will create the necessary incentives to new lending. I should add that, while we are seeking to discourage banks from deleveraging in the form of lending to the real economy, we are not against releasing existing capital to support new lending where that capital is currently tied up in non-core assets, which can either be sold or run off because they are not needed on the balance sheets of banks to support the real economy, such as trading book proprietary assets.

Finally on this subject, let me briefly describe what we have done so far. The government and the Bank of England have introduced the Funding for Lending Scheme (FLS). FLS is in large part a response to developments in financial markets, notably the increase in the cost of bank funding which was, inevitably, being passed on in the form of higher costs of lending. In the twelve months up to the middle of this year, business lending and mortgage rates rose and the evidence we had suggested that there was an accompanying tightening in the terms and conditions of new lending. The Bank of England's Credit Conditions Survey suggested that household secured lending and corporate lending rates were expected to rise further and all of this on the back of two years of flat GDP growth and three years of broadly flat credit growth to households and business in the UK. This was notwithstanding the MPC's action on quantitative easing. FLS is designed to provide banks with medium-term funding at a more reasonable cost, with incentives that reduce the cost if banks lend more. This should improve credit creation in the economy through lowering rates on new lending, but to some degree it may also enable banks to improve their net interest margins and thus build more capital. At the same time the FLS was introduced, the Bank of England signalled its willingness to enhance its provision of liquidity insurance through the activation of the Extended Collateral Term Repo Facility.

For its part, recognising the need to balance macro-prudential objectives in the way that I described earlier, the FSA has taken two steps. We have allowed banks to reduce the capital buffers they hold over the minimum Pillar One requirements in line with new lending that is consistent with the objectives of FLS, though to be clear, we do not require banks to use FLS to get this benefit. Our view here is that we have enabled the use of the additional capital buffers built up since the height of the crisis by anticipating what will be in the future their partial use as the Basel III counter-cyclical buffer. What we have done on capital is consistent with the intent of Basel III. Last year, the major UK banks had total so-called Capital Planning Buffers of just under £100bn, so we could see a change in the course of credit creation by those banks without going far into the buffers.

I want to develop this point a bit more because it has a broader relevance. One of the features of the Basel arrangements which is insufficiently appreciated is that, since the outset of the Basel Capital Accord in the 1980s, there have been three pillars to the framework. Pillar 1 is the rules on capital adequacy. Pillar 2 is where supervisory judgement is applied to overlay the rules. And Pillar 3 is the requirement for transparency in order to enhance market discipline. Since 2008, Pillar 1 capital in the major UK banks has increased from £151bn to £186bn. Pillar 2 capital, in all, increased during the same period from just under £20bn to £150bn, of which the £100bn I mentioned is part. Put simply, in the regime up to 2008, there was no judgmental overlay of capital buffers, now there is such a buffer. There are two very important points on Pillar 2 capital. First, when I read commentaries which go something like: "You wouldn't believe how low Bank X's modelled risk weights on, say, mortgages are". I do note that the commentator can only observe the Pillar 1 capital requirement. They are not observing the judgmental overlay in in Pillar 2 which, as you can tell from the numbers I quoted, has gone up. The trouble is, this tends to suggest that Pillar 3 transparency is not working as it should do. This is all I am going to say today on models and RWAs, I will save that for another day.

The second point on Pillar 2 is that, having built it up, we think that we can allow a relatively small part to be used to support the second objective of the FPC. Now, in terms of how we justify this, given the hierarchy of objectives that I described earlier, I believe that it is important to look at the interaction of resilience and lending as I set out. I think it is reasonable to conclude, and the FPC supported this action, that a reduction in the risk arising from this new lending caused by an improvement in credit conditions should help to offset the risk from lower capital buffers. In other words, if such extra lending boosts economic growth, it will enhance resilience in the financial system. This means that while banks will, where needed, have to hold some capital above the Basel III transaction path for the reason that I set out earlier, the FSA is allowing those banks that increase lending to a lower Pillar 2 capital buffer to recognise the benefits of such lending.

I should add that the FSA has also altered its guidance to banks on the liquid asset buffers they need to maintain. This reflects the Bank of England's stance on the potential access of banks to liquidity from the Bank, and a wider desire to reduce the incentives for banks to hold excessive liquid asset buffers for precautionary reasons. This action, too, has been endorsed by the FPC, and I hope it will support credit availability.

In conclusion, I have tried this morning to set out how we are thinking about and then applying macro-prudential policy, going back to first principles. This is a new field, and as I said earlier, please bear in mind that in the early days of the low inflation monetary policy regime in many countries, it took time to refine the communication. But, beyond that, we also need to fill in what for me is the big gap at present, namely how we explain and calibrate the resilience objective in terms of capital. The FPC will focus on this at its next meeting.

It is therefore too soon to assess the impact of these changes on the resilience of the financial system and on credit creation. We will monitor the results of these actions very carefully, and we will be prepared to amend our judgements in the light of experience. The key point for me is that we are applying judgement to our decisions on regulation and within a framework that quite explicitly defines and seeks to balance the objectives of resilience, the primary objective, and, subject to that primary objective, supporting credit conditions and economic activity. To be clear, in this approach of judgement-based regulation, we will not get all the calls correct, not least because the future is uncertain. But, I am a lot more comfortable that we are building a framework in which we can apply judgement more consistently and be held to account for these judgements in a more open way.

Thank you.