Andrew Bailey: Challenges of prudential regulation

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 Society of Business Economists Annual Dinner, London, 3 June 2013.

* * *

Thank you for inviting me this evening – it is a great pleasure to have this opportunity and particularly at a time when we are embarking on major reforms to policymaking in the area of financial regulation.

The financial crisis has provided hard lessons on what happens when the stability of the financial system is found wanting. It has reminded us how much we depend upon the supply of critical services from banks, insurers, investment firms, asset managers and other parts of the financial sector. If you take the banks as Exhibit One, there is good reason to curse them, but at the same time recent experiences have only served to emphasise how much we depend upon them, like it or not. The new legislation on financial regulation in the UK emphasises the importance of the continuity of supply of critical financial services. This is a permanent public policy objective, and rightly so. I use the term "permanent" deliberately to distinguish this objective from the support provided by Too Big / Important to Fail, which should not be permanent.

The Financial Policy Committee of the Bank of England, the FPC, has the task of identifying, monitoring and taking action to remove or reduce risks with a view to protecting and enhancing the resilience of the financial system in the UK. These risks at the level of the system can include those arising from structural features of financial markets, from the distribution of risk within the financial system, and from unsustainable levels of leverage, debt or credit growth. The emphasis here is very clearly on ensuring the resilience of the financial system.

But our objective is not to achieve resilience at any cost – our actions must not 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. Moreover, and here you will recognise the symmetry with the objectives of the MPC, the legislation provides that, subject to achieving our primary objective for financial stability – resilience – the FPC must also support "the economic policy of Her Majesty's Government, including its objectives for growth and employment".

The reforms have also created the new Prudential Regulation Authority as part of the Bank of England. Here, the statutory objective of the microprudential regulator is the safety and soundness of the firms which we prudentially regulate – banks, insurers and major investment firms. Moreover, our objective of safety and soundness sits in the context of the stability of the financial system. What does that mean? One clear example is that we are not a no firm failure regulator. Orderly failure which does not disrupt our statutory objectives is part of supporting a functioning market economy.

We have learned the hard way that financial stability is essential for supporting growth and employment. We have seen the effects of damaging financial stability, and the consequences in terms of lost output and the need to use public money to counteract the inability of the tools of the day to deal with the threat of the collapse of the system. We have also seen the long-lasting effects of that loss of financial stability. I remember that in the early stages of the financial crisis, most forecasts suggested a recovery would take hold in a year or so, on the assumption that the policy tools available at the time would be effective. That did not happen.

A crucial lesson from that experience was the importance of policy coordination, which is why it is so much at the heart of the new role of the Bank of England. The remits of the MPC and

FPC require the committees to explain how they have regard to the policies of each other. In the last year, we have seen that coordination at work. Almost a year ago, the Bank and Treasury introduced the Funding for Lending Scheme. The Bank also introduced an extended collateralised term repo facility. At that time, the FSA eased banks liquid asset requirements following a recommendation from the FPC, and also the FSA relaxed capital requirements on eligible net new bank lending as part of a deliberate set of actions to combine the objective of resilience with supporting activity in the economy.

Since then, the focus has been on the capital of the banks more than anything else. The FPC has recommended to the PRA that it should seek to establish a minimum level of capital on the final Basel 3 measure of at least 7% after taking account of three issues, namely uncertainty around asset valuation in more vulnerable portfolios, possible future conduct of business costs, and aggressive use of risk weightings. A further test is to consider whether banks are making acceptable progress towards the Basel 3 minimum leverage ratio (leverage is a simple concept in many respects, but it is confusing in one respect, namely that you might – but Basel doesn't – describe this as a maximum leverage ratio).

The PRA is in discussion with the banks on the issue of capital. I read a lot on this most days of the week. Let me make a few points. Many commentators and journalists have worried publicly that these recommendations will lead to lower bank lending. I want to reassure you, that is not the case. Capital is not money that has to be stashed away for a rainy day. Essentially, it is the shareholders' stake in the company. In non-financial companies, shareholder capital or equity is used to finance the acquisition of assets. The same is true for banks. Equity finances the provision of loans to households and companies. In that sense, additional capital supports lending by banks and does not substitute for it. Higher capital ensures that enough of the finance raised by banks is in a form that is capable of absorbing losses without the banks going bust.

Much of the discussion on capital is couched in terms of a ratio to risk-weighted assets. But another more basic yardstick of a bank's ability to withstand losses is the leverage ratio. This is simply the bank's capital expressed as a proportion of its assets. So a further test that we should consider is whether banks are making acceptable progress towards the Basel 3 minimum leverage ratio. Basel 3 requires that banks have leverage ratios in excess of 3%.

In asking banks to have a larger share of equity on their balance sheet, we are for the most part dealing with legacy issues. The whole point of this exercise is to move more rapidly to put the past and its problems behind us. This emphasis on legacy explains why it is possible to want more capital to back old risks while easing the capital requirements on new lending to the real economy. Frankly, this is about convincingly putting the past behind us.

We have not yet released numbers on the capital requirements for each bank. At the end of March, the FPC – consistent with its remit – announced that UK banks had around a £25 billion capital shortfall against the 7% Basel 3 yardstick. To be clear, that £25 billion referred to the shortfall in banks' balance sheets at the end of 2012. And at the time of the FPC's announcement, I said that firms had already made plans to deal with half of the £25 billion number. The PRA has translated all of that into firm by firm numbers. And, the PRA Board is taking a view on whether for each firm it agrees with the quantum of capital implied by the FPC's figure, and the timing of action it requires from banks. This is entirely consistent with the "comply or explain" nature of FPC recommendations to the PRA. We have not released bank by bank numbers because as a prudential supervisor we want to spend time discussing with each bank our judgement on the need for capital, and their judgement on the actions they can take. I make no apology for doing this quietly. I am much more interested in the outcomes that the running commentary.

Within the past two weeks, you will have read that RBS and Lloyds now have plans to make good their capital shortfall without raising new equity. Some commentators have written that this means RBS and Lloyds have been let off the hook. I have to tell you that is not true, it was always envisaged that both banks would achieve their capital enhancements by

restructuring their balance sheets without reducing their lending to the UK economy. Moreover, both of those institutions have come a long way from their original business plans, and are consequently much safer thanks to FSA and now PRA pressure. These banks have agreed to do what we have asked and we will hold them to that. This is a regulator's promise.

As we near the end of a timely but not rushed process, we will be communicating in the next few weeks the headline results of this work.

Finally, there is also comment that nobody has yet raised new equity capital, or announced an intention to do so. True, but that is not the only way to increase capital relative to assets. What has not gone unnoticed is the reasonably steady stream of disposals by UK banks, both of businesses and assets. At the end of last week, for instance, the last elements of one of the more infamous assets of the crisis, the so-called HBOS Alt-A US mortgage assets were sold. We are happy to see these disposals happen.

I mentioned earlier the steps taken last summer at the time of the introduction of the FLS. The evidence on credit creation in the UK economy is however mixed. Funding costs for banks have fallen, which I think is a necessary pre-condition of stronger lending.

Net lending in the UK was broadly flat in the second half of last year up modestly in the remainder of this year. This compares with an expectation prior to the launch of the Funding for Lending Scheme that net lending would decline over last year and this. I emphasise this point because the record of the first year of FLS needs to be judged against a worse outlook for lending a year ago.

Net lending to large businesses remains weak, but these companies tend to have access to alternative sources of external finance, such as corporate bond markets and such bond issuance has been very strong so far this year, more than double the quarterly average pre-crisis.

Small and medium-sized enterprises are more reliant on banks for external finance. Survey evidence suggests some improvement in the pricing of loans to small firms, but applications for credit have not yet picked up, and net lending to SME's remained negative in the first quarter of this year. Survey evidence suggests that both lenders and borrowers expect an increase in firms' demand for loans. This is the pattern also seen by firms surveyed by the Bank of England's regional Agents. But, the extent of any increase will depend on the macroeconomic outlook, as well as the perceived reliability of bank credit as a source of finance.

There is, I have to say, a sense of déjà vu here, in that twenty years ago, coming out of the recession of the early 1990s there was a concern about SME lending. Then, too, it was hard to untangle lack of supply and lack of demand as causes. A lot work was done then, including by the Bank of England, to seek to understand better the causes of the problem. This time, there remains a need for such work, a point that I will come to in a moment. But, as the central bank, we have this time put our toolkit to work more directly.

It is important here to be clear on the role of a central bank. Our role is to ensure access to credit – to take steps to unblock the supply of lending. Although we can have some influence over the supply of credit generally, as we have with the FLS, it is not for us to judge the credit risks of, and hence the access to and price of credit (in terms of the risk premium above the risk-free rate) for individual borrowers. Coming out of the crisis, we want to see the market economy restored and functioning. We have recently announced an extension to the Funding for Lending Scheme, so that drawings are now possible until early 2015. We expect that this should provide confidence to scheme members to expand their lending to the real economy by virtue of them having greater confidence in their future access to funding. The extension also expands the FLS to cover lending to financial leasing and factoring corporations (which are a source of credit for SMEs).

We have been clear that the design of the extended FLS particularly encourages lending to SME's in determining access to the FLS. Incentives to lend to SME's are therefore in place,

no doubt about that. But we cannot promise that the results will follow almost as night follows day, because there is more to it than that. Let me end, by advertising a piece of work done by your chairman-elect, chairing a group that recently produced a report on SME lending in Northern Ireland. In that report, Kate and her colleagues point to structural market failures affecting the supply of finance to SMEs, which mainly relate to imperfect or asymmetric information, and which tend to be exacerbated in times of heighted economic uncertainty and risk aversion. Likewise, the report points to information failures on the demand side for businesses seeking finance. The report goes on to note that over the last five years there has been a market correction as banks have moved away from a lending approach based on property as security to one that is more based on evidence of a business plan that indicates returns to the firm that will repay borrowing. Linked to this shift, a property debt overhang is leading businesses with such property exposures to experience more constrained access to finance, something that, other things equal, will take time to work through. Our evidence tends to support this dichotomy between the position of companies where commercial property is either the source of their business or the source of their security for borrowing, and those where there is no such dependence. The conclusions I draw from this are that as well as our part in creating the right incentives for credit to be on offer, there is a need to extend the work done by Kate and her colleagues, to consider information flows in terms of particularly of credit assessments, and the issue of whether some types of commercial property are acting as a restraint or access to finance. It is also consistent with comments I hear from businesses and banks that the "distribution" capacity of SME lending lags a long way behind the mortgage market.

In conclusion, we are determined to put behind us the legacy of issues that have called into question the capital position of banks during the crisis. We are approaching the sixth anniversary of the start of the crisis, so this is hardly overly hasty action. The resilience of the financial system is our objective, but this is not just for its own sake but also to support the economy and credit creation. The evidence in credit creation is so far mixed, which is not in my view a mark of the failure of policy since this operates with a lag.

But it does indicate that all of us should go on looking for changes that will help. The distribution and information issues around SME lending identified by Kate and her colleagues are one such area, and in my view more focus needs to be put on the consequences of debt overhangs linked to commercial property in those parts of the market where there are problems.

Thank you