Andrew Bailey: City Week 2014

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 City Week 2014: The international financial services forum, London, 31 March 2014.

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It is a great pleasure to be at City Week again. I am most grateful that you have timed it to coincide with our first birthday. It is a good time to reflect on a year that has had some moments.

I have not tired of emphasising that our approach to regulation is necessarily forward-looking. I have been asked quite a few times over the last year what is my objective for the PRA. It is simple to describe but history would suggest less easy to achieve. I have been in the Bank of England for quite a while, and this new system is the fourth approach to financial regulation in the UK in my career. From that, I draw at least one conclusion, namely that we have a strong need to achieve a stable institutional structure of financial regulation in the UK. We are not alone in this challenge, but that does not change the objective, it just means we have company. That is my objective for the PRA, and for the new system of regulation as a whole, and I have been pleased to see the PRA Board and our staff working effectively to pursue that objective.

There is another lesson that I draw from this history, namely that there must be some difficult impediments to achieving the goal of institutional stability in financial regulation. To start with, achieving consistency and clarity in identifying the objective of regulation has been a problem in the past. The new approach anchors the PRA's primary objectives of the safety and soundness of firms and the protection of insurance policyholders in the broader goal of the stability of the financial system. This very clearly ties together micro and macro-prudential regulation, whose objectives are consistent. And, we now have a secondary objective around the competition implications of our actions, which I welcome.

Just under two weeks ago we announced changes to the Bank of England's strategy and structure. In doing so, we adopted a single mission, namely to promote the public good through achieving and maintaining financial and monetary stability. This single mission is much more than just the speak of management, it is a clear change intended to promote the integration of the Bank of England's objectives of monetary and financial stability. This integration of objectives into a single mission represents a very deliberate decision that the Bank of England should not be organised as a series of silos defined by our different statutory objectives and by the structure of policy making committees given to us in legislation. To be clear, this is not going against the wish of Parliament in establishing these structures; rather, it is designed to reinforce that wish by making the pieces work closely together. And, it also emphasises that the Bank of England is a public policy institution with the overarching objective and responsibility of serving the public good. Interestingly, the language that we found to describe this public good comes from the Bank's original Charter of 1694, though I should recognise that the detail of the description of what constituted the public good in 1694 is rather different from the one we have today.

The key thing about a public good is that no individual or group of individuals can be excluded from using or consuming it, and use by one individual does not reduce the availability to others. Fresh air is a public good, and so is the stability of the economy. In our world, history shows that it takes a crisis to provide a decisive impetus to create and maintain the emphasis on the public good. Thus, stable low inflation – monetary stability – received its decisive impetus in many countries, including the UK from the painful experience of high inflation, most notably in the 1970's. Out of that came a broad consensus on a central idea – low inflation is a necessary condition for stable economic growth and its resulting benefits for well-being. And, the central idea came with a coalescing around a view on the institutional structure of monetary policy, that an independent central bank, with a clear objective and target emanating from the public via Parliament was the best way to achieve and sustain the public good. I have absolutely no doubt that in the UK this change has been an outstanding success. Moreover, the benefits of the public good are not challenged – there is a difference between a healthy debate on what the setting of policy should be at any point in time and an unhealthy undermining of the fundamental public good. We have seen the former, and the record of the last nearly twenty years shows that this important distinction has been robustly maintained, all for the good.

It is therefore easy to conclude that another crisis, the financial crisis, has made the same mark. Likewise, it is easy to conclude that a stable financial system is a necessary condition of stable economic growth. So far, so good. But it has been less easy to describe simply what constitutes financial stability. It doesn't reduce to a single measure, like the rate of inflation. It has many heads. There is nothing wrong with this per se, but it may help to explain why it has taken longer to arrive at a stable institutional structure for achieving it. It is also the case, I think, that the success of the innovation in monetary policy obscured the need to develop complementary tools to achieve macro-economic objectives in financial stability, what is today known as macro-prudential policy. That meant too much dependence was placed on monetary policy and too little was done to develop macro-prudential policy.

I say this because you should interpret the changes to the Bank's strategy and structure as very intentionally pushing the other way, to ensure that we are One Bank integrating our public policy objectives for one Public Good.

I want to spend a bit more time on this whole issue, and in doing so reflect on the first year of the PRA, and then what lies ahead. My experience tells me that we have had to work harder, and still have to do so, to embed the idea that a stable financial system is a necessary condition for economic growth and other economic welfare benefits. Let me give some examples. The most obvious one is that if we want a stronger recovery of bank lending, then we need a well capitalised banking system. If we want the banking system to be able to fund that lending, it needs to be well capitalised. I believe that the last year has seen good news on this front for the UK banking system. Yes, we have had one or two very highly publicised revelations on legacy problems – but none of that should take away from the fact that the UK system is stronger today, in my view markedly so. But, I can tell you that achieving such progress on this public good has not been as straightforward or uncontroversial as you might think. And that continues to concern me, because it conveys the message that acceptance of the benefit of the public good is not as entrenched as it needs to be – we have work to do to build the consensus around what constitutes financial stability. I am firmly of the view that last year's actions on capital were correct, and I have no doubt at all that the recovery in bank lending to support economic activity requires a belief and an expectation that the banking system is and will remain well capitalised, and that if we doubt either of these positions, action will be taken. And that is why we, and other countries, are introducing, or have done introduced, regular stress tests. It is about regulation being forward-looking and using judgement.

The second point I would make here is that a stable financial system is a necessary pre-condition of realising other benefits. Let me give a few pertinent examples. The first one comes from the insurance industry, in which I also have a very strong interest. The Government announced some very major reforms in the Budget to the provision of pensions, notably in the annuities market.

There are very clear public policy objectives behind this announcement, which are not about financial stability but are about economic welfare. The key test for me – which I think is passed – is that the industry for which the PRA is the prudential regulator is in a sufficiently robust financial position from the point of view of its prudential standards that meeting and maintaining those standards should not get in the way of achieving the other public policy objective in terms of people's welfare in old age.

A second important example on financial stability at work comes in the housing market in the UK. In the statement issued last week following its Policy Meeting, the Bank's Financial Policy Committee noted the continued evidence of increasing momentum in the UK housing market. Although a number of indicators remain below their long-run average levels, including mortgage approvals, there has been a marked strengthening in activity. House prices are not only rising on the national average, by around 10% in the year to February, but also in the second half of last year there were increases in all regions of the country, though of course the scale of these increases is not even.

The share of mortgages at higher loan to income ratios is greater than at any time since the measurement began in 2005, though the share of high loan to value lending remains low by historical standards. But here, too, there are clear signs of an increase in high LTV mortgage products on offer.

Towards the end of last year, the FPC announced measures to reduce the stimulus previously provided, for instance from the Bank's Funding for Lending Scheme, and outlined further instruments it had available to mitigate potential risks to financial stability from the housing market. Given the increasing momentum, the FPC stated its clear intention to be vigilant to emerging vulnerabilities and to take further proportionate and graduated action if warranted. Also, the FCA has undertaken, from next month, as part of the implementation of the Mortgage Market Review to work to maintain stronger underwriting standards – I say "maintain" deliberately because we observe evidence of a welcome strengthening by the industry of such standards. The FPC, for its part, has recommended that it should in future be able to give guidance on appropriate interest rates to be used by banks in their affordability tests. The FCA is putting this new arrangement into effect.

In its latest statement, the FPC made clear that it had discussed the appropriate scenario for this year's bank stress testing exercise. Like all stress tests, this scenario will not represent the FPC's central expectation of what is likely to happen, but rather act as a coherent representation of risks in the tail of the distribution of possible future outcomes against which the resilience of banks can be tested. A key part of this test will be to examine the resilience of banks to a housing market shock and a snap back in interest rates.

Let me therefore finish by drawing seven important messages for the future from this example of UK housing conditions and how the new system of financial regulation will operate:

- first, an effective macro-economic framework needs the credibility to influence people's expectations of future conditions and how our policy actions will influence them. Our actions, and therefore the expectations of them, have to be credible and therefore consistent over time. The FPC has taken steps to lay out the future actions it would take if it judged the momentum of the housing market to be too strong;
- second, in doing this "laying-out" of future actions, we are signalling that we will act to prevent the pro-cyclical tendencies of the past – whereby lending and underwriting standards weakened in the good times and then suffered a knee-jerk reaction back when conditions deteriorated;
- third, the FPC and PRA are going to be very explicit in their use of forward-looking judgemental tools of prudential supervision, of which stress tests are a prime example;
- fourth, our policy-making tools in the Bank of England will be joined up, consistent with our single-mission directed at the public good. A clear example of this is that our three statutory bodies, the MPC, FPC and PRA Board will work together closely. And likewise, we are working across the institution to maximise our very considerable international engagement;

- fifth, while it is a real strength of the new system that conduct and prudential supervision have their own institutions that can provide the focus that is essential, where we should work together we do, as the example of mortgage underwriting standards illustrates;
- sixth, our approach is to use judgment to set the right incentives for the firms that we regulate to take the actions themselves rather than default to the regulators to do the work. I welcome the action taken by firms on mortgage underwriting standards as an example of that process, and more broadly I welcome the recommendations of the Parliamentary Commission on Banking Standards not least because they put the whole issue of incentivisation of the right behaviour at the front of their recommendations;
- and last, returning to my earlier theme, we want to create and preserve financial stability as a platform to enable choices to be made in other areas of public policy free of concerns that our objective might be put in jeopardy by doing so. A prime example of this is to enable conditions to exist which can enable people to buy homes.

I hope this gives a good sense of what we are about. Thank you.