Andrew Bailey: Speech at the Lord Mayor's Banquet

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 City Banquet, London, 16 October 2014.

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Lord Mayor, thank you once again for inviting us round to Dinner. Events at the Mansion House never cease to be special, with an aura that sets them apart. It is a true story from some years ago that a very senior official from another country came to a lunch at the Mansion House, at which he spoke, and after which he came to visit the then Governor of the Bank. He had been impressed by the grandeur of the surroundings, the food and drink, the speeches (in plural), but he had just one question for the Governor. How does anyone make money in the City if that is how they carry on? The Governor was wise and slightly avuncular in his answer, to the point of remarking that it is not a question that anyone in the City would ask. Lunches may have become shorter, but dinners remain a place to take stock over good food and wine and with good company. And, for Martin and me it is a chance to take stock after just over eighteen months of the new arrangements.

The PRA is responsible for the prudential supervision of banks, insurers and major investment firms. We take all of our responsibilities very seriously, as of course we should.

Across the board, there have been developments over the last year that give me a sense of cautious satisfaction – by the way, that is at the happier end of the spectrum of emotions for a central banker

Seriously, I am afraid that we must not get carried away here.

We are in many ways in the second phase of the financial crisis. The first phase was a prudential one, while the second phase has revealed past misconduct. Fixing the financial system requires more than just fixing capital and liquidity standards. Standards of governance, conduct and the right incentives structures are all extremely important.

After commenting on two material development this year I want to use the rest of my time to set out four areas where we are either taking action, or watching very carefully to determine whether action may be required.

Let me start by describing two developments which point to some cautious satisfaction. First, the capital position of UK banks has strengthened. Market conditions have supported actions to raise capital and reduce non-core assets, and banks have taken advantage of those conditions. The targets that were set as a consequence of the FPC and PRA exercise of nearly two years ago have been met ahead of schedule. The banking system is now more able to support lending and the growth of the economy. I will repeat something that I have said often before, namely that a well-capitalised banking system is essential to support the economy. No good comes from having a fragile system. The evidence from the Bank of England's regional agents through their contacts with borrowers among companies is that there is more lending on offer but companies are reluctant and wary about banks, and this picture is consistent with the economy wide figures. Given the evidence of revealed misconduct, we should sadly not be surprised at this wariness, but neither can we be relaxed about it.

My second important development comes in the field of life insurance. Insurance as a whole is a vital industry to all of us, performing the essential function of enabling us to manage our risks. Within the insurance industry, life firms provide access to retirement income and long-term savings as well as financial protection against mortality. Earlier this year the Government made a major announcement on annuities, which are an important part of retirement provisions. Like many people, this struck me as a sensible announcement, pointing to a clear need for change. The big question of course, is what next – or if not that, what else? We heard something on that earlier this week. I am not going to reflect on that tonight, but while the original announcement came as a shock to some business models, the PRA's assessment was that it did not appear to compromise the safety and soundness of firms in way that threatens our objective, and nor did it threaten our insurance objective of policyholder protection. No firm has failed, but bear in mind that orderly failure is very much consistent with our objectives being met. That is what should happen in my view, namely the prudential position should be sufficiently safe and sound to accommodate changes in other areas of public policy. It is not easy in our world to point to indications of when our objectives are met, a point made to us quite rightly by the National Audit Office. I would offer this as one such indicator.

I will spend the rest of my time commenting on a four areas where we are either taking action or watching very carefully to determine whether action may be required.

The first is the capital framework for banks – which is distinct from, but related to, the capital position of banks that I mentioned at the start. There are now three planks to the capital framework: a risk-based assessment which may be based either around firms' internal models or a standardised approach; a measurement of leverage; and stress tests. Together these approaches provide firms and us with the tools to do two things: to add up overall capital requirements; and as diagnostic tools to allow the probing and analysis of strengths and weaknesses of firms' positions. I cannot emphasise enough that good judgemental supervision which is forward-looking employs diagnostic tools. None of these tools will provide the "right" answer, they are not tablets of stone. They enable assessment and challenge, by managements, boards and supervisors. The idea that we could rely on one of these tools alone, which you can read in some books, is, let me be blunt, naïve. Good supervision looks at things from different angles in order to build up pictures. In the same vein, I do not agree with those who say that we should disallow firms' internal models. That amounts to saying we are not interested in how firms' manage their own risks and that somehow we have better models to use. But, we don't rely exclusively on firms' models, and we challenge them hard; and we throw them out when we don't like them, and we have done that. Good prudential supervisors are bold enough to do that. The lesson is look at models, but do it properly, and to do that is not a simple job.

Toward the end of the year, we will publish the results of our first round of simultaneous across major UK banks stress tests, which will follow the publication by the European Banking Authority of its stress tests in just over a week from now. Our stress tests are a real step in the direction towards the full use of such tests as one of the three pillars of the capital framework.

This is a major development compared to the cumbersome and slow process of stress testing one bank after another that we developed during and after the height of the crisis. We will be using these tests to assess whether firms have capital positions and capital plans looking forwards which will provide re-assurance that they will be safe and sound under stressed conditions, as the name suggests. If they don't – and you should take no inference on the results from what I say here – we will ask them to look again at their plans. Stress tests should not be a dramatic event, they should be part of the health check and they should prompt measured responses where necessary, and reflecting the fact that at different speeds banks are heading out of the crisis.

Last on capital is the issue of loss absorbency in going and gone concern states. For the major banks this is the too big to fail problem. The Basel Capital framework was flawed: it didn't provide adequate loss absorbency in going concern; and it failed to consider what would happen in gone concern states of the world. The global framework remains in that position until we can get agreement on, and implementation of, a Total Loss Absorbency framework. This is our single most important objective, at the heart of the global work of the FSB in respect of the largest banks – the globally significant. The huge effort to secure what will be an historic agreement comes to the table in Brisbane next month. I'm not going to tempt fate; but my fingers are crossed, and I should add that this is the nearest I get to insider trading, as I know the impressive quality of the work that has gone on in the FSB.

The second area on which I will comment concerns the insurance industry, namely the introduction of Solvency II. It will happen in 2016. It is a major step forward as a framework for risk assessment. It is not the first time that insurance firms will be using models to assess safety and soundness and policyholder protection. That would be an absurd thing to say for an industry that has modelled from the outset. But, it does represent a step change in the use of models in the prudential process. Very briefly I want to be clear that we will be using these models in an appropriately diagnostic fashion. None of us should be slaves to models. We will challenge robustly, and some of our challenges will be less welcome than others, that is the nature of what we do. As Mark Carney said recently, this rigour has a purpose. The dangers of using poorly designed models were made all too clear in the banking sector. So the PRA won't hesitate to withhold approval of an inadequate or opaque model. But, I want to give a commitment from the PRA, my door will always be open to discuss the challenges, and the same goes for my colleagues.

My third area might at first hearing sound rather odd as it is conduct risk or, sadly, misconduct risk. No, I am not making a bid for the FCA – I like Twin Peaks thank you; and the PRA and the FCA work together, and Martin and I put great emphasis on that happening. But as I said earlier we are in many ways in the second phase of the financial crisis, and this phase has at its root conduct of business, towards customers, in financial markets, and in areas of public policy such as financial sanctions and anti-money laundering. At its most serious, this confluence of conduct risk can threaten the safety and soundness of firms. Let me be clear, as a prudential supervisor I do not condone misconduct, and I support Martin and the FCA in what they are doing.

Society expects higher standards, and the PRA supports the FCA in upholding these standards as part of the global effort to restore trust between financial institutions, regulators and – most importantly – the public. Three things strike me as important as part of this effort and I pick these three because they are close to my role and that of the PRA and the wider Bank of England. First, the Fair and Effective Markets Review under my colleague Minouche Shafik, with Martin and Charles Roxburgh, is vitally important to establish the better standards that society reasonably expects. Second, we need better international coordination among authorities to enable conduct risks to be dealt with effectively, but also in ways that do not threaten safety and soundness. That is a high priority. And third, to support credit and borrowing in the economy, and thus growth, we must all work to ensure that people feel confident to use banks and thus overcome the legacy of mistrust from revealed misconduct.

The fourth issue on which I want to comment concerns incentives. These lie at the heart of good pro-active supervision, getting the incentives right. Unfortunately, we see areas where that has not happened. I want to cover two of those. The first is remuneration. Once again there is a lot being said on this subject. My view has not changed. We need a system where senior people who are responsible for the performance of their firms understand that for a reasonable period of time a meaningful proportion of their remuneration is at risk of being taken away. There is nothing new about this; after all, it is how the traditional partnership system worked. So let me be blunt, the bonus cap is the wrong policy, the debate around it is misguided, and the best thing I can say about allowances is that they are a response to a bad policy. They are not a good solution. I will not win friends in some places for saying this but it dismays me to see a debate which is at times so divorced from the heart of the matter, which is setting appropriate incentives by putting a meaningful amount of pay at risk. Sadly, taking this stance sometimes attracts the criticism of being pro bonuses. This is not true, and I can say from experience that advocating putting bankers' pay at risk does not naturally improve my popularity in some quarters. But if you don't believe it from me, here is what the Parliamentary Commission on Banking Standard had to say: "There are distinct advantages to a significant proportion of banking remuneration being in variable rather than fixed form. It is easier to adjust variable remuneration to reflect the health of an individual bank. The use of variable remuneration also allows for deferral and the recouping of rewards in ways which better align remuneration with the longer term interests of a bank".

The second area where incentives are important is governance of firms. For banks, Parliament has legislated to introduce the Senior Managers regime which implements an important recommendation of the Parliamentary Commission on Banking Standards, and the PRA and FCA are consulting on our proposals for implementation. For insurers, we will consult on implementing the fit and proper requirements of Solvency II, and as the Governor has made clear it is our view that we should align the regimes where that is possible. I have read with considerable interest some of the press reporting of the new regime, which has been at times at odds with the facts. The regime has been portrayed as all about proving criminality under a reverse burden of proof. That is the wrong interpretation. The key principle is a simple one: there should be a presumption of senior management responsibility.

To support that principle, we will set out the meaning of the statutory requirement that senior managers will need to show that they have taken the steps that a person in their position could reasonably be expected to take to prevent breaches of our requirements. We are very clear on the presumption of responsibility, as Mark Carney has said, but I would assert that the test is no different from other areas of corporate responsibility.

In this context senior management means only the very senior executives, and in the PRA's proposals, only non-executives that are either: the chair; chair of a major board committees; or the senior independent director. There are differences between prudential and conduct in this respect, and our consultation poses the question of how substantial those differences should be. But, is it really unreasonable to expect the most senior figures to assume responsibility? Not in my view, and in my experience not in the view of those who take on these roles.

Boards should challenge and this is the role of the NEDS. The executive should view this as a positive help to improving judgements the board is called upon to make and so should provide NEDs with the material to do that, and to do so as concisely as possible. The old saying for students that it is harder to write a good short essay than a long one is relevant here. And, as supervisors we too should follow that principle.

In conclusion, whilst more capital and liquidity was a necessary condition for fixing the financial system, it wasn't sufficient. Getting the incentives and governance right matters a lot. As supervisors our job requires good judgement – not easy but it has to be done – and it also requires a keen eye for structuring incentives to deliver our objectives. Rules alone will not get us there.

Lord Mayor, you are a great example to all of us who want to improve the diversity of our institutions, which makes them better places to work in. You are going on to undertake a role of great importance, one that reminds us that whatever the problems that we deal with, there are unthinkable acts of evil taking place. It reminds us not be become obsessed with our own work to the exclusion of the terrible human suffering that can happen. We wish you all the best in your future role, and please accept our thanks for all that you have done and are doing as Lord Mayor.