Andrew Bailey: Progress on prudential regulation and three areas to complete

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, Mansion House, London, 22 October 2015.

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My Lord Mayor, Ladies and Gentlemen – it is a great pleasure to be here again at the regulators dinner, and it is very good of you to entice so many people here tonight with the prospect of an evening with regulators. I won't speculate on how this ranks on the scale of evenings spent in our cosmopolitan capital city. It is also a great pleasure to be speaking here tonight with Tracey.

This evening I want to describe the progress we have made on prudential regulation and then examine a number of topical issues for the PRA and the Financial Services industry: the Senior Managers and Certification Regime; structural reform and ring fencing; and what the PRA is doing to pursue its secondary objective on competition. A common theme here is getting the incentives right to support good outcomes in relation to both prudential and conduct objectives.

Progress

It is over eight years now since the financial crisis began in this country. And to continue Tracey's theme for a moment, it is possibly salutary to recall that amidst the many bad events of Autumn 2007, England reached the Final of the Rugby World Cup. I didn't expect to say "those were the days" about 2007. It was natural that the first response to the financial crisis in terms of reforms was focused on the bedrock prudential issues of capital and liquidity in banks. This has been supplemented by the drive both internationally and domestically to solve the too big to fail problem through a combination of resolution measures at the centre of which is agreement on total loss absorbing capacity for those banks which require such a bulwark to ensure orderly resolution in the event of failure. This is crucial to break the dependence of failing banks on injections of public money and likewise to break the impact of solvency problems in banks on the public finances.

This is an international as well as domestic agenda of reforms aimed at fixing the fault lines that caused the financial crisis, building a more resilient and open global financial system, and deepening and building trust across jurisdictions. I have said before, but I think it justifies repeating, that we are unwavering supporters of an open global financial system which finances the investment and trade necessary to support strong, sustainable and balanced growth. As we see and seek to deal with new risks to the world economy and to global financial stability it is always important to remember that free trade and free capital flows are the foundation of a successful world economy with all the benefits that brings for the welfare of people.

So, it should be no surprise that our focus is on three things: first, full, consistent and prompt implementation of the already agreed reforms across the financial system, and here I would note that the largest single activity for the PRA this year is to complete the implementation of Solvency 2 for insurers for the end of this year, something I believe we are on course to do; secondly, finalising the design of the remaining post-crisis reforms and thus providing the much needed clarity around the future regulatory system; and thirdly, scanning the horizon for new risks and vulnerabilities that appear on our landscape, ones such as the risk of cyber disruption.

I think there is solid evidence of progress in all of these three areas. Internationally, there is plenty of evidence of shared objectives and effective co-operation among national authorities to solve common problems and "own" and thus implement the resulting reforms. An example over the last year has been the building of strong working relations between the PRA and our colleagues at the Single Supervisory Mechanism of the ECB. This can only be for the good, and represents the much needed close working of people who are on the front line supervising the system.

We also want to encourage sound market-based finance and we are, for example, strong supporters of the EU initiative on simple, transparent and standardised securitisation.

Finalising design

When I look at the remaining agenda of post-crisis reforms to be agreed, it is striking that they are not about capital levels in the same way that we saw immediately post-crisis. True, there is work in Basel but that is much more about refining the framework than a step change in capital requirements. As part of this there is work to agree and implement the leverage ratio internationally, and to improve the use of models to estimate capital requirements so that they are used only for asset classes that lend themselves to modelling of this sort and we have an acceptable degree of consistency across banks.

There are two important points I want to draw out which are by no means uncontroversial. First, it is sometimes said that the banking system still needs markedly more capital, and that a focus on other issues is a distraction from tackling a system that is still over-leveraged. The second, closely-related, point is that we should focus much more exclusively on non-risk based measures of capital requirements.

I don't agree with either of these positions, and nor would I say do most supervisors I know. I have been and remain a strong supporter of the reforms to date and the higher levels of capital put in place, and I am a strong supporter of having the leverage ratio in our toolkit and that for some assets it is the "biting" approach and therefore it is not just a backstop. But I disagree with those who want to go much further, for reasons which are at the heart of what we are doing.

First, because to argue for much higher capital on top of what has been done since the crisis is to argue that what is being done on resolution and loss absorbency is of little use. This misses the point that resolution is about being able to stabilise and then where necessary close or restructure failing banks. In other words, resolution is a much more extensive approach, and in my view very necessary. The design of international policy measures to end too big to fail is now largely complete for banks, but substantial work remains to put these into effect in terms of resolution plans.

Second, understanding how banks take and manage risk, the controls they have and the quality of risk management, is at the heart of the job of a prudential supervisor. That's what we do every day, and the standards of this work have been raised extensively since the crisis, which was very necessary. Now, it is possible I suppose to argue that a focus on oversight of risk management should be pursued alongside a sole focus on a non-risk based capital measure like the leverage ratio. But in my view that is a flawed argument because the prevailing capital regime has a strong influence on how firms take and manage risk, in other words it creates the incentives. And, if we only used a non-risk based system, we would incentivise firms to disregard the amount of risk per unit of assets on their balance sheet. The leverage ratio is firmly in the camp of necessary but not sufficient, as is the risk-based approach.

The third reason why I disagree with the much more capital school of thought is because there are more important things for us to do, which revolve around getting the incentives for behaviour right in firms. This is why as supervisors, both prudential and conduct, we spend so much time on governance in firms and on getting the incentives aligned for individuals through our approach to remuneration and to the responsibility of individuals.

We have achieved much progress towards strengthening the resilience of the global banking system, with stronger capital ratios, and this has demonstrated in my view the important principle that appropriately strong capital positions support rather than deter lending by banks.

Jobs still to finish: three topical issues

The Senior Managers Regime

The Senior Managers and Certification regime for banks is a product of the Parliamentary Commission on Banking Standards chaired by Andrew Tyrie, put into legislation and to be implemented by the PRA and FCA by next March, so not long to go now. The current approved persons regime has not delivered effective incentives and thus behaviour.

As part of last week's announcement on the Bank of England and Financial Services Bill, the Government put forward an important change to the senior managers regime for banks, by removing the "presumption of responsibility" and replacing it with a "duty of responsibility". I can tell you from my postbox in all its many forms, that the "presumption" is the most controversial element of the new regime. On its own that is not a good reason for change. I want therefore to explain why the change does make sense, and why the new regime should create the right incentives.

In the current Approved Persons regime, the PRA and FCA can take formal action for misconduct against an approved person either if that person has failed to comply with the statements of principle (which will become in the new regime common rules of professional conduct) or they have been knowingly concerned in a breach of a regulatory requirement by the firm. The burden of proof in an enforcement action falls on the regulator.

The Banking Reform Act adds a third reason to take enforcement action against senior managers (not others) in these firms if: the firm (and I emphasise here the firm – going beyond the individual) has breached regulatory requirements; and the senior manager is responsible for the area of the firm in which the breach occurred. The Act goes on to say that the person would not be guilty of misconduct if they satisfy the Regulator that they have taken such steps a person in that position could reasonably be expected to take to prevent the breach. For the first two limbs the burden of proof would fall on the Regulator in the same way as the continuing provisions I mentioned earlier. But, crucially, it would be for the senior manager to satisfy the Regulator on the question of reasonableness – thus the presumption is created until it is rebutted. The change that the Government has announced to create "the duty of responsibility" will, if Parliament approves it, replace the presumption with a statutory duty on senior managers to take reasonable steps to prevent breaches of regulatory requirements by their firms from occurring. Thus it will be for the Regulator to show that the senior manager did not take such steps as it was reasonable for a person in that position to take to prevent the breach of regulatory requirements.

In my view this does not represent a watering down of the requirement. Why? Well the "duty of responsibility" creates a positive duty on senior managers to take reasonable steps to prevent regulatory breaches occurring. This will be on a statutory footing, which hardwires the concept in the very fabric of the regulatory regime, rightly reflecting the importance which society places on this issue.

Let me be very clear, substituting "duty" for "presumption" changes the mechanism of enforcement not the substance of the requirement on senior managers, and I would not support changing the latter. There has been a lot of noise around the new regime in recent months, and I have asked people involved whether their problem was with the "presumption", or with the regime more broadly. The universal answer has been that the difficulty was with the "presumption" not the regime which appears to have broad support.

So, if Parliament is in agreement, and I do not presume to take that for granted, I expect that the new regime will be put into effect in the spirit with which it is intended, and that the focus will shift to that spirit and away from finding ways to circumvent the "presumption". To be blunt, I hope that those within firms and their advisors will respect the will of Parliament on this crucial point.

The new regime matters hugely for getting the right incentives for people running firms. The important word is not "presumption" or "duty but rather "responsibility", it's about holding people more personally to account. If there are people who wish to argue that they should not take on the responsibilities of the job they do, then I believe they have no place in the industry, it's that simple. We all want well-run firms where senior people lead and take responsibility. And I know that this is how the vast majority of people do behave, because I observe it.

The senior managers and certified persons regime is also not purely, or in my view even primarily, a tool of enforcement. Our job is always to apply forward-looking judgement to prevent problems occurring; and the new regime will ensure that the incentives on senior managers in the roles that they perform align with that approach. But, just as Parliament has recognised that it is not the PRA's role to ensure that no firm fails, likewise we should not expect the Regulators to prevent all failures, or misconduct, by individuals. The PRA's enforcement powers are a necessary part of its toolkit, and we will use those tools when the circumstances warrant it. But they are not our primary mode of operating. Also, the Government announced last week that – subject to agreement by Parliament – it plans to extend the Senior Managers regime to other firms across the industry. This is a further step in the right direction. There is no doubt that one regime will be better than many.

Lastly on the senior managers regime, there is one other very important broad reason for putting it into place. On and off I have been involved in regulation for over twenty five years. During that time a few regimes have come and gone, and there have been debates about self-regulation versus a regime more purely in the hands of public authorities. This debate strikes me as a gross over-simplification. Self-regulation doesn't work if there is no clear and consistent allocation of responsibility for the public interest objectives of financial regulation to public bodies that are answerable to the government and to parliament. But likewise, public bodies cannot seek to take on the responsibility of managing within firms, something that has to be the responsibility of boards and management. The senior managers and certification regime is vital here because it creates the framework to establish effective responsibility within firms, while maintaining the role of the public authorities, the PRA and FCA, for supervising and enforcing the public interest. A very good example of how this should work can be seen in the recommendations of the Fair and Effective Markets Review, which provide a means to establish and maintain high conduct standards in financial markets.

Structural reform

I want now to turn to structural reform and ring fencing. This is a subject in its own right, but I can assure you that I intend to be brief on this one tonight. We are now well into implementation. Last week we issued our second consultation paper on implementing the regime, and we plan one more such paper which will be more in the form of a wrap up of points raised and a few outstanding actions.

Any structural reform measure involves complex implementation, the devil is always in the detail, and we need to get that right. I read from time to time that we are apparently watering the regime down via the implementation. I can assure you that we are not doing so, and we should not because that would go against the will of Parliament. But, sensibly, the regime sensibly allows for a degree of flexibility in how the requirements are implemented, recognising the differences in business models, legal structure and strategy of various firms. That was essential and sensible because a rigid definition of the fence would not work well for all firms.

To ensure balance, I should say that I also get the opposite commentary, that the implementation is too rigid. One particular form of this commentary is that our rules on the governance of the ring fenced bank within a group mean that it will be independent in all respects, and that, proverbially, it will be able to stick two fingers up at its parent. No. The ring fenced bank will have to observe the law in respect of the requirements of ring fencing, not more than that. This is not really different from the position for banks that have subsidiaries operating in other countries, they have to respect the laws of the country in which they operate. But, let me be clear what it does not mean: it does not mean that the ring fenced bank can set its own strategy and thereby ignore the group to which it belongs; it does not mean that it can set its risk appetite in isolation of the group to which is belongs; it does not mean that it can refuse to pay a dividend to its parent if it is adequately capitalised both now and looking forwards using stress tests (in other words, it does not have a reason to trap excess capital); and it does not mean that its CEO can ignore the Group CEO. But, and this is crucial, the group cannot require the ring fenced bank to break the rules of ring fencing. I hope this is clear. If you think we have watered down the regime, please let me know.

Competition

I want to finish on an equally important subject, namely competition in the banking industry, which is of course topical today in view of the CMA's report. The PRA has been given by Parliament a so-called secondary objective which I think is best described as requiring us to act in respect of the competitive implications of our own actions and inactions but only to the extent that we are not undermining our primary objective for banks of safety and soundness. We have been working to embed the secondary objective in the PRA, and to date our most publicised actions have been in the area of new bank authorisations. The PRA has authorised ten banks in the last two years, and currently we have a substantial pipeline of interested parties.

We are thinking about competition in our domestic work, but also about how we approach international policy issues. For instance, this week our response to the European Commission's consultation on the impact of the new capital regime has been published. It is quite often said that aspects of the capital regime discriminate against smaller banks and building societies that use the so-called standardised capital approach versus larger banks that use their own models. The consequence of this is that smaller banks and building societies cannot compete effectively in lower risk asset markets such as prime mortgages because the capital requirements are too far apart and in favour of large banks. This forces them into riskier assets and undermines their position.

This is an area where the leverage ratio acts to counterbalance the difference, a point that is not well enough understood. But in our response to the European Commission we said that while the financial stability benefits from regulation of large, internationally-active banks mean these firms should meet global standards, a differentiated approach for smaller firms would recognise the high costs and smaller benefits of applying global standards to them, and should enable us to find ways to create a regime which is more simple and which reduces their reporting burden. This would help to foster competition and would be good for the European Single Market. This is an important issue, and one that matters if we are to have growing challenger banks. We want to put such a regime into effect, and thus demonstrate that at the PRA we are very serious about our competition objective. I hope the European authorities will likewise pursue this important change.

We will also be arguing in Basel and in the EU to narrow the gap between standardised and internally modelled capital requirements for prime mortgages including by having more risk sensitivity in the standardised approach. And, we have also tightened the standard for models. I also want to be clear that we welcome internal model applications by smaller banks and we will do what we can to help them meet the required prudential standards, which are largely set out in the EU legislation.

Lord Mayor, a year in your office is never dull, and likewise our world is certainly full of interest. I have ranged quite widely this evening to give a report on a number of our key areas of activity. There are however some very important core principles at the heart of our work, getting the incentives right for firms and individuals, and establishing the importance of personal responsibility within an appropriate setting. I have been blunt on one or two points and this may provoke debate. This is a good thing, and we will have the opportunity to return to the debate on these issues at The Open Forum being organised at the Guildhall on November 11th. I know you will be there, as will Tracey and I. Please, will everyone participate, and to find out more consult the Bank of England website. Thank you.