Andrew Bailey: Bank capital – debating again

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 Barclays' 2016 Financial Conference, London, 9 March 2016.

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Bank capital has been in the news again recently, or at least parts of the news – there are some other things going on. There are probably two reasons for this "news": first, because we have entered another phase of highly uncertain conditions in financial markets, which has had a strong impact on the market value of banks; and second, as authorities we are pushing on with implementing the post-crisis reforms to capital standards, and in doing so we have reached a point where some of the important building blocks are now being put into place.

Today, I am going to reflect on and draw some conclusions for what I would call the bigger picture, namely what sort of banking system are we seeking to create, what are we not doing, and why not. I will draw on the detail, and there is no shortage of that, but this is not a talk about the detail of bank capital, you can find that in plenty of other places.

Another objective is to tackle some urban myths of today. Let me start with an important one, the so-called "liquidity narrative[1]" which sets up in order to knock down, and attributes to regulators, the view that the financial crisis (indeed crises more generally) was caused by a lack of liquidity rather than solvency in the banking system, and this blinded people, notably regulators, to the real cause of the problem, namely solvency and capital. Whatever happened in the past, it is most certainly not true today. Loss of liquidity is much more the symptom than the cause of crises, and while symptoms have to be observed, and some actions taken to minimise their effects, I am in no doubt that the cause is usually either an actual solvency problem or critically rising expectations that there will be such a problem in the future. If you spend time in the PRA, you would quickly learn that capital is front and centre in what we do as supervisors.

Why is that so? Banks are different from other financial firms because they provide deposit contracts to their customers. A deposit is a very particular form of debt contract. For all of us the essential feature of a deposit contract is simple – we put our money (our asset) on deposit at a bank, and we expect all of it back, with whatever rate of return is agreed, and we expect to have access to it in line with the terms of the contract.

Let's contrast that with non-deposit debt (bonds) and equity contracts. If you invest in either of these, you are not promised all of your investment back, though of course you expect to make a positive return. Such an investor ordinarily expects the full return of their investment, but this is not assured. Investment in debt and equity can of course be managed on a collective basis, as asset management. You may remember the Woody Allen quote that a stockbroker is someone "who invests your money until it's all gone". Cruel I know, but it illustrates the difference between deposits, other forms of debt and equity.

A distinguishing feature of banks is that by providing deposit contracts, far more of their liabilities take the form of value certain contracts. This alone makes capital and solvency critical for banks. In contrast, for asset managers, the contract does not promise such value certainty. Two particular conditions need to be met in my view to make asset management effective and robust to wider economic conditions. First, that there is no lack of clarity of the nature of the assets held under management. Second, that there is no illusion give to investors about

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1 Anat Admati and Martin Hellwig: "The Bankers New Clothes: What's wrong with Banking and what to do about it". P38–40

liquidity of their assets. It follows therefore that capital and solvency matter much more for bank supervision, and market liquidity conditions matter more for asset management supervision.

So bank capital matters a lot. The next question, rather obviously, is how much of it banks should have as a liability on their balance sheet? This has been the subject of lively recent comment. Most of that comment has focussed on the core issue of how much capital and overall loss absorbency banks should have as part of their balance sheet liabilities to protect the value certainty of deposits. This is a very reasonable debate because there is no monopoly of wisdom on such a subject. I do however discount heavily those commentators who have seamlessly switched from attacking on the grounds that as supervisors we were choking off lending by requiring too much capital (the so-called at the time "Capital Taliban" argument) to arguing now that we are falling down by setting the standard too low.

The main argument of late has been whether our recent proposals on capital buffers for the largest banks operating in UK markets have diverged from previous post-crisis commitments on the level of capital banks should maintain both in going concern, and the overall level of loss absorbency available amongst the liabilities of a bank to enable a resolution to occur if needed. To put it into context, the capital standard we have developed is based on the last quarter century of bank performance – including the financial crisis – such that the probability of bank failure during that period would have been extremely low. In aggregate terms we have not diverged, and if anything our recent proposals put the level a little higher than that suggested, for instance, by the Independent Commission on Banking, but not by enough to make a big point of it. It is true that within that aggregate we have introduced a new element in the form of incentives to protect the stability of the financial system. We have followed through wherever possible on the principle that larger and more complex banks should have higher capital buffers because they pose a greater risk to the stability of the financial system. Consistent with that principle, we have created a tiered system of increasing capital requirements but left the topmost tier unpopulated. This empty tier is not a product of a craven fear of putting a bank there, but rather to create a disincentive to further complexity. So, we don't see this element of the design as contradicting its goal.

We could argue about the merits of small changes in the capital standard, but that is not in my view a worthwhile exercise. What is more notable is the divide between this view of strengthening banks' loss absorbency and the alternative view that the answer lies in a radical restructuring of the banking system to require banks to have loss absorbency which would be a substantial part (say 20% to 30%) of their total balance sheet[2]. It is wrong in my view to conflate an argument about small differences in capital buffers with one that is all about a different financial system.

I want to spend a few minutes on this alternative view, on what it would mean, and why it is advocated. To be clear, I am not commenting as a supporter, but rather to try to cast light on this big issue. The essence of the argument as I see it is that it is asserted by supporters of, let's call it the "big equity" school, that we cannot value large banks adequately because they are too complex and opaque, cannot supervise them effectively and cannot resolve them, we must resort to an approach which requires a sizeable shift in the balance of their funding away from value certain deposits contracts towards loss absorbing equity type contracts. This is on the basis that there is then a large buffer to absorb the losses that will flow from inadequate valuation and supervision, and without recourse to resolution. For me, this begs the question of the appeal of a proposition which states to the public: "will you please provide equity funding to something we can't value or properly oversee". Put like that, the idea does not seem appealing. I cannot see why there would be a desire to provide equity funding for banks on such terms rather than invest in other companies either directly or through a collective asset

[2] To be clear, this is 20–30% of the total balance sheet not 20–30% of risk weighted assets, the latter being a considerably smaller number.

scheme. I recognise that it has been proposed that the equity funding should be built up by retaining dividends, but to accumulate say 20% of a bank's balance sheet by this means requires I think an implausibly long transition period. In fact, based on the current position of the major UK banks, including the average dividend payment rate, the transition period to 20% equity would be around 90 years. That's a little bit longer than the 17 year transition period for Solvency II. I do not therefore see "big equity" as a sustainable solution because this sort of proposal is just not practical.

A more logical alternative to today's approach is the narrow banking model[3]. Again, to be clear, I don't support the approach, but it has the greater logic over the "big" equity approach of creating deposit funded banks which can only hold highly liquid and low risk government bonds. Loans would be made by other financial intermediaries. I think that the ring fence as proposed by the Independent Commission on Banking is a better way to achieve sensible and safe separation of functions within a bank while not causing great disruption to the overall financial system. Interestingly, the argument against narrow banking from the "big" equity school is that narrow banking exports all of the risk in the financial system to so-called shadow banks, thereby making them a danger to the system[4]. Again, this amounts to an argument that unmanageable risk should be kept in banks which must therefore attract substantial equity funding. It's not a winner I'm afraid.

This brings me right back to the argument for what we are doing today, namely to strengthen the loss absorbency, risk management, governance, supervision and resolvability of the banks we do have. I do not accept the proposition that we can only abandon all hope of understanding the risks in banks. Likewise, I do not agree that large banks are unsupervisable and ungovernable. And, I do not concur with the view that large banks can never be resolved, thus leaving too big to fail always with us, and with the answer then to either require a lot of equity funding or to hope that the shadow banking system does not cause risks that threaten the whole system.

Let me finish by focussing on resolution and supervision. We went through the crisis without properly functioning bank resolution regimes in many countries including the UK, with the consequence that the response was a combination of using public money and improvisation to create resolutions where possible. But now we are well on the way to having properly functioning resolution regimes in place. So, what is the argument for why they will be ineffective? This is a crucial piece of the story, because it is a fundamental principle of the big equity school of thought that they reject resolution as a usable solution. The argument seems often to come down to doubting the will of the authorities to enact resolution[5]. True, in the past it was much harder to enact resolution in the absence of the means to do it, but that will not be so in the future. It is also true that resolution necessarily involves changing the property rights of investors which is a big thing. Will the authorities have the nerve? My view is that we must, because the alternative is much worse. We are making huge strides in resolution as a technical matter. Last year's agreement on TLAC in the G20 was a landmark. But alongside that is a vast amount of work to get to grips with what it takes to resolve a major bank. If you are involved in that work, as I am, you can see that there is no lack of commitment and progress.

The remaining challenge then is whether the authorities will have the nerve to follow through and carry out a resolution. This is the charge that comes from opponents, namely that it will be "bottled". I don't see this as likely to be an issue, because if resolution is a credible route to take, as it will be, why would the authorities want to put the cost somewhere else?

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[3] John Kay "Should we have 'Narrow Banking'?" The Future of Finance, LSE Report, 2010

[4] Anat Admati and Martin Hellwig: "The Bankers New Clothes: What's wrong with Banking and what to do about it". P271

[5] Anat Admati and Martin Hellwig: "The Bankers New Clothes: What's wrong with Banking and what to do about it". P74–78

Now for supervision and whether it too can function effectively. Make no mistake, in many countries supervision failed badly in the run-up to the crisis. Prudential supervision of banks is all about understanding the risks firms take, the effectiveness of the controls in risk management, using the framework of rules and regulations to create the right incentives to control risks appropriately, and where necessary intervening directly to require actions to be taken that would otherwise lead the firm to a potentially unsafe or unusual position. There is nothing easy about this activity, and the lessons of the pre-crisis and crisis periods demonstrate the dangers of encouraging broader attitudes which act to discourage the work of supervision in favour of a light touch approach in which the risks in the system build up and are praised as contributors to stability and prosperity, until that is the crash comes.

Supervision is a continuous activity which needs to benefit from constant public attitudes towards it, and in turn supervisors need to be accountable and explain what they do. We have made big strides forward on these fronts in recent years. When we talk about banks, solvency and capital is at the heart of effective prudential supervision. The capital regime that is being put in place is stronger not just in terms of the quantity and quality of capital that is funding banks, but also because of the incentives that are being embedded in the regime. To end, I don't believe that we can ignore the risk in banks, and the consequence if it crystallises. This helps to explain why the exercise of judgement is such an important part of the supervision of banks. Therefore we have to create a system of rules, we have to supervise banks and have the scope and freedom to apply those rules in ways that create the right incentives for banks to maintain safety and soundness, and to guard against the time when something does go wrong we must be confident that our resolution regimes will work. I simply do not believe that the alternative approaches are sufficiently credible.