Andrew Bailey: Defining the objectives and goals of supervision

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 New York Fed conference "Defining the objectives and goals of supervision", Federal Reserve Bank of New York, New York City, 18 March 2016.

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First of all, many thanks to the New York Fed for organising a conference on supervision of banks. This sounds a strange thing to say in one sense – not in another because the gratitude is genuine – but strange in the sense that surely supervision is such an important part of what we do that we shouldn't be particularly surprised at the idea of having a conference on it. But in my experience, it is surprising how little time we spend being more reflective about supervision.

I want to start with some important definitions. Frequently, and mistakenly, "supervision" and "regulation" as terms are used interchangeably. That's wrong. Regulation is to do with the framework of rules and guidance that put the structure around the objectives that as authorities we are usually given in statute. In the UK, the PRA has a primary objective in terms of the safety and soundness of firms we authorise to do business, and safety and soundness are expressed in terms of the stability of the financial system.

There is then a rulebook that tells us what safety and soundness means. That's the framework of regulations. Supervision is about how we use it in practice. For me, two critical elements of supervision are that it is forward-looking, and it requires the use of judgement. Sounds obvious, but sadly hasn't been consistently done well in the past, with bad consequences.

Supervision is therefore a skill – in fact it's quite a few skills. The essence of the job is to understand risks in firms, and where necessary to step in and do a number of things: point out risks, or their significance when the firm seems to have failed to notice – through either lack of awareness or intent; or point out that while the firm may have identified the risk, it has failed to understand or calibrate its significance.

This leads me to a couple of important points.

First, our assessment of risks can differ from firms because our objective represents the public interest, and there is an externality in the risk in question which affects the public interest in ways that do not register with a definition of private interest. The causes of the financial crisis sadly remind us of this.

It means that we have to be very clear and forthright on what is the public interest, and thus why we supervise.

Second, risk is our business. This conference is about supervising large, complex financial institutions. I read too often the criticism of supervision that we cannot understand the risks of these institutions, and so we should give up all hope of doing so. It's an argument which seems to say, we can't value the firm, we can't supervise it, and we can't resolve it, so therefore let's ensure it has a very large amount of equity financing, what I call the "Big Equity" argument. Honestly, it's a nonsense. Large amounts of equity financing will not be available for such firms, so the best we can say is that this is a route to a radically different financial system, but in that world the risk goes somewhere else, and we shall still be worried. But this is not an argument against having non-risk based tools like the leverage ratio in the supervisors' toolbox. They are very important, because to understand risks well, we need more than one view of the firm. And the leverage ratio is an important other view. But I want to emphasise that understanding risk is at the heart of supervision.

But this, of course, begs a very important question. Why did supervision go wrong in the period before the financial crisis, and what do we learn from that bad experience? Let me offer a number of thoughts on that.

First, supervision was never given sufficient prominence and attention. It's a very real skill. In my experience it demands not just high levels of technical skill but also interpersonal skills – to get very strong egos to change their thinking and actions – do things that they had not intended – to recognise the public interest.

Second, I think we saw pre-crisis a tendency for what I, probably too loosely, call the political-economy to be pro-cyclical and thus approve of excessive light-touch supervision. This was a problem I think on both sides of the Atlantic. The public interest in financial stability was lost amidst an enthusiasm for the persistence of growth and easy credit. In 1979, the former chairman of the Federal Reserve Board, Arthur Burns, gave a lecture entitled "The Anguish of Central Banking". It was about monetary policy, and how there had been a build-up of ideas which had accommodated inflation.

Historians have suggested that Burns himself was not innocent in this respect, but the point is that there was a role for broad ideas which enabled the accommodation of pernicious inflation. It was dressed up as enthusiasm for growth and societal change which was ultimately unsustainable. We saw similar traits before the financial crisis, with the consequence that supervision was supressed. The whole thrust of the post-crisis changes in my view is to make supervision less pro-cyclical – not to aim off in the good times, but also not over-compensate the other way in the bad times.

A third thought in this respect is that we underestimated the importance of system-wide risks and

macro-prudential policy. Supervision – and particularly large complex firm supervision - cannot be remote from macro-prudential policy. To be honest, while I think we have made some progress breaking down the barriers, we still have a long way to go to integrate micro and macro prudential approaches. Douglas Elliott has made the point that we entered the crisis at a point in the history of economic policymaking where we had abandoned all macro tools other than the use of interest rates, the price of money. This was fairly unprecedented. We had lost confidence in quantitative tools in monetary policy, and the role of reserve money had been diminished.

We had very little in the way of bank liquidity policy, of which holdings of reserve money are an important part. The experience of the crisis tells us that we have to keep working hard to re-develop these tools and to knit large firm supervision into the picture. In my experience, it doesn't happen naturally.

This brings me to the fourth and final thought on supervision. It was absolutely essential and natural that the immediate reaction to the crisis was to re-build regulation and supervision in respect of the core prudential All speeches are available online at building blocks, which are solvency (capital) and liquidity (funding). And, we had work to do, and still have, to get these core elements into better shape. And the work of interpreting these standards will never stop because the precise forms of risk taking will evolve. But, when I have stepped back and looked at the causes of the crisis in firms, another thing stands out. In the UK, I don't think we saw a major prudential failure of capital and liquidity which did not have a governance and management story at is root, and we had a system which was very poor at creating the right incentives for good outcomes. Here I want to put the emphasis on creating the right incentives.

In my experience supervision is in part about creating and overseeing those incentives. The critical distinction here is that supervision is not just about doing things to firms, it is also about creating the conditions for firms to do this right thing in the first place. Let me give three examples of what we are doing.

First, we have been much more active in remuneration policy and practice. I have no interest in regulating the level of pay, but we are interested to ensure that remuneration is compatible with meeting capital requirements (so it can be varied to do so) and that variable remuneration is deferred and can be withdrawn, and is thus compatible with creating the right incentives by putting that remuneration at risk if the firm fails to conform with the objectives of safety, soundness and good conduct of business. I am not in favour of limiting variable pay in the way European legislation has done through the so-called bonus cap because it reduces the opportunity to create the right incentives. We then supervise firms to ensure those incentives remain in place.

The second example relates to senior individuals in firms. Earlier this month we introduced the new Senior Managers Regime.

The aim of this regime is to establish clear responsibilities for senior managers, including chairs of Board Committees. This is not to create new responsibilities, but rather to be clear on what those responsibilities are, and then to supervise to hold individuals to those responsibilities. In the previous regime, we had too many examples of individuals shirking their responsibilities. My strong view is that senior figures cannot delegate responsibilities. We will then direct our supervision to support this new regime operating effectively.

The third example concerns the supervision of governance, executive and Board level. We are in the process of revamping our approach here, recognising that too many problems of the past have had their roots in ineffective governance. This is probably the prime area where supervision is distinct from regulation, because there is very little regulation, rightly so. Supervising governance is inherently a matter of judgement based on evidence.

So, to conclude, we should devote more time to discussing the skill of supervision. It has at its heart the understanding of risk. And, we should devote more time to developing supervisors and value then for the skill that they need to do the job well. Thank you.