BANK OF ENGLAND

Speech

The revolution is over. Long live the revolution!

Speech given by
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My Lord Mayor, Ladies and Gentlemen

Let me begin by saying that it is a great privilege to be here tonight, and a great honour to lead the Prudential Regulation Authority (PRA) within the Bank of England.

Tonight I am going to start with a word you don't usually hear from a regulator. My theme is revolution. Not a political revolution, but a prudential revolution, a revolution that has occupied your minds – and our speeches – since 2008.

Before I come onto that, Lord Mayor, I must point out that you have allowed a renowned and formidable revolutionary into our midst right here in Mansion House tonight. What's more, he is the Chief Executive of the Financial Conduct Authority.

Now, it is true that Andrew Bailey doesn't immediately make one think of Che Guevara. But Andrew has been right at the forefront of the revolution in prudential regulation we have had here in the UK over the last 8 years. Nobody has done more to rescue, repair and reform the UK financial system.

Andrew, it has been an absolute pleasure to serve as one of your guerrillas, and I very much look forward to working hand in glove with you in our new roles.

For the 1,580 banks, building societies, credit unions, insurers and major investment firms we supervise, there is a simple message about my approach to the role of running the PRA[1]. That approach is: more of the same. That means supervision which is firm but fair, using all of the latest analytical tools and techniques, together with a healthy dose of common sense.

My job is to serve the public interest by focusing on the objectives given to us by Parliament: promote safety and soundness, protect insurance policyholders, and – secondary to both – facilitate effective competition.

These three objectives form a complete and coherent whole and I am absolutely committed to them. But they are easier said than delivered. So I am very proud of the effort my 1,325 colleagues at the PRA put in every day in pursuit of them, steadily implementing the post-crisis reforms[2]. But as I shall explain: the end of one chapter is the start of another. Firms need to renew their business models for the new world.

A mixed economy

I think that the approach we have adopted for the PRA is the right one, but I am not starry-eyed about the system we are operating.

[1] Firm total correct as at 19 October 2016. Source: Financial Services Register
[2] Staff total correct as at end-September 2016.

In financial services here in the UK we have a mixed economy. The aim is that firms are owned privately (by their shareholders or members) and run for private interests, but within a framework of regulation which makes them internalise our objectives and therefore accommodate the public interest.

This system is based on the premise that a healthy element of risk-taking in the financial system is an essential part of a well-functioning economy, but that such risk-taking may become excessive without some kind of check. Few people I know seriously contest that basic premise. But firms frequently contest how we are going about securing the public interest.

That tension is natural, given the system we have chosen. There inevitably are and will be significant frictional costs, as the objectives of supervisors, employees, shareholders, members, creditors and customers jostle alongside one another. This means there will be disagreements. But we shouldn't disagree without having made a real effort to understand each other's perspectives.

I am convinced that this system (including the judgement-based, forward-looking supervisory model we have adopted for the PRA), while imperfect, is much better than the alternatives of a financial sector owned by the taxpayer or a laissez-faire, tick-box regime – especially because history teaches us that the latter may well lead to the former. We cannot have a system where the private sector enjoys the profits of excessive risk-taking while leaving the public sector on the hook for the losses.

The post-crisis reforms

The ways in which firms organise themselves, and the tools by which we apply our supervisory judgements, are shaped by global regulatory standards. And in those standards, there has been a revolution.

Responding to the emergency of the 2008 crisis, governments set the direction of travel and parameters for regulators to act. We took our mandates, assessed the system accordingly, and set in train a series of unprecedented changes to deliver financial stability. Key to this effort was more effective co-ordination between national regulators and co-operation through international bodies.

For banks, this was the right response to the financial crisis, which showed that the standards we had been using were woefully inadequate. The toolkit we have today is miles ahead of what the authorities had as queues grew outside Northern Rock branches – for example the UK has led the way in developing a resolution regime so that we can intervene to manage the orderly failure of a firm. At the same time, UK banks have increased their equity capital by approximately £130bn since the end of 2008 and now hold more than £600bn of high-quality liquid assets, four times the level they held before the financial crisis. Governments, regulators and firms together have transformed the banking system.

Insurers – with one spectacular exception, AIG – generally fared relatively well during the crisis. UK insurers' balance sheets were in general more robust, and they did not hold many of the same assets that proved so toxic for our banks. Capital resources within the insurance sector did take a hit, but not a fatal one, though of course they benefited from the bail-outs of the banks.

But a revolution was a necessary step to achieve greater consistency in insurance regulation across Europe. The UK had already laid the ground for a market-consistent capital regime, through ICAS[3]. But despite this, as the industry knows all too well, the introduction of Solvency II ended up being a rather long and exhausting revolution. There are some bugs we need to iron out (on which I will say more later), but the core elements of the regime are sensible and we will continue to work with the industry to make a success of it.

Moreover, across both banking and insurance we now have a robust accountability framework for senior managers, reduced scope for dangerous pay structures, and more effective board governance. In no small part this is thanks to the pioneering work of the Parliamentary Commission on Banking Standards, leading to the introduction this year of the Senior Managers and Certification Regimes.

The revolution is over

Stepping back, where are we in the course of this revolution?

It is sometimes claimed that we regulators are hell-bent on pursuing the stability of the graveyard by crushing all life out of the financial system – in other words, that we don't really believe in the mixed economy system. I will leave you to judge whether our regulation, which allows a medium sized bank to run a balance sheet that is thirty three times bigger than its shareholders' equity, is consistent with the idea that we are insisting on a risk-free system. This is plainly not a zero-failure regime.

I also sometimes find individuals in institutions we supervise and regulate who think we take a wicked glee in constantly rewriting the rules. That is also wrong. Revolution is not of itself an objective, so like all self-respecting revolutionaries we are focused on defined goals:

- a strong and stable banking system with no taxpayers' money spent on bailing out a PRA-regulated financial institution; and
- a resilient insurance sector which does not pass risks back to policyholders when they crystallise.

I think those goals are in sight, and the remaining path to them is now largely set. Therefore, while I cannot speak for other countries, my assessment is that here in the UK we have reached the end of the revolutionary period in which major reforms to prudential standards were required in response to the 2008 financial crisis.

[3] Individual Capital Adequacy Standards

Of course, there is important work to finish off in Basel, and constant *evolution* will be necessary as firms and financial markets themselves evolve. No regime is or ever will be perfect, but I think the one we are settling on is a massive improvement on the old one.

Long live the revolution!

But standards can't just stand there. To bear down on risks to financial stability, they have to be implemented.

Here there is still a lot of work to do, particularly on the banking side.

Banks have already made big strides in building up their levels of going concern capital, and we are close to finalising the Basel III global standard. In some other areas, implementation is only very recent. For example, with respect to accountability, we now have a robust but proportionate framework to prevent the 'recycling' of individuals with poor conduct records across PRA-regulated firms. We are also making sure that buy-outs of variable remuneration do not allow bank employees to avoid the proper consequences of their actions.

All that helps make sure that what was originally intended is efficiently and coherently implemented.

Implementation will often pass the public by. That's OK – so long as households and businesses get a resilient and reliable service from the financial system.

Ring-fencing, however, will not go unnoticed. The domestic legislative and regulatory requirements are largely in place, and firms have provided their plans to implement them in time for the government's 2019 deadline. Firms are working to implement the plans. There are many challenges ahead. We will work closely with firms as they change their structures and transfer business activity, assets and liabilities between entities. They must manage the impacts on customers, employees and other stakeholders.

The implementation process coincides with a period of heightened uncertainty before the UK – and therefore the banking system – adjusts to a new relationship with the European Union. I won't pretend this is a perfectly happy coincidence: in an ideal world we would not restructure our banking system and extricate ourselves from the EU at the same time. But the execution risks of managing these changes simultaneously are outweighed by the benefits of increasing firms' resolvability and removing the public subsidy from banks. So it is full steam ahead.

Alongside ring-fencing, the other major reform which is progressing through implementation, and is key to making big banks resolvable without recourse to the taxpayer, is bail-in. Here in the UK work on this is being led by my colleague Sir Jon Cunliffe, and we will shortly publish our final policy.

At these two frontiers, and across the whole reform programme, we must secure the progress that has been made as memories of the last crisis fade. For a start, regulation goes hand in hand with supervision. We will continue to ask searching questions about the quality of a firm's assets, the rigour of its risk management, the experience on its board, the plausibility of its resolution plan and so on. That is the bread and butter of our role.

Meanwhile, the reforms will be treated to revisionist history and the calls of counter-revolution. Now, reasonable people can disagree about the right balance of financial regulation in order to achieve our goals. The most celebrated example of this is how to trade off the cost of higher bank lending rates, which dampens investment in the economy, versus the benefit of reducing the probability or severity of future financial crises. Unless some other breed of revolutionary brings an end to capitalism itself, then I think that debate will go on for a long time after we are all dead.

But in my view, the post-crisis reform package – taken as a whole – strikes the right balance between the competing interests present within our mixed economy system. Brexit does not affect this judgement. The UK financial system must be robustly regulated and supervised whatever the outcome of the government's negotiations with the European Union.

As my colleagues on the Financial Policy Committee and I put it last month: "the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned, which itself exceeds that required by international baseline standards". In other words: no bonfire.

Market discipline

Another way we will preserve the progress that has been made is to recruit the forces of market discipline to our cause. The Treasury Committee has been right to highlight the potential for greater transparency around the capital adequacy of the banking system.

Through our stress tests, investors can already see the detail of how individual banks would maintain lending through a severe downturn. But I think we may also be able to make progress in other ways. Next week we will launch a new quarterly statistical release which will show – on a consistent basis – levels of capital and risk-weighted assets for the UK banking sector, with breakdowns of the movements in different tiers of capital and risk exposure types[4].

I am also considering whether we can build on this over time. In particular, next summer we plan to publish a Discussion Paper seeking an open exchange of views on a disclosure framework for banks' and insurers' regulatory data. Conceptually, my bias would be towards firms publishing their regulatory returns, but I am

[4] Further detail on this forthcoming release will be confirmed on 31 October. The first set of data – for Q1 2014 to Q2 2016 – will be published on 16 December 2016.

happy to debate this and I expect there will be good grounds for some exemptions. We will seek views on this, and weigh the costs and benefits, before deciding how to move forward.

Sharp edges

So while the design of the reform programme is clear, we are still mid-step in implementing it.

Of course things could go wrong, in transition or in the end-state. The world certainly gives us plenty to worry about. But I am absolutely unwilling to have things go wrong because we have retreated from the reforms agreed over the last eight years. For the avoidance of doubt: what was intended will be implemented. I hear many pleas for "tweaks". Some of these are not quite as modest as is claimed. We are wise to the disguise.

But we will of course work to identify and pursue opportunities to give a smoother finish to the reforms, addressing unintended consequences.

Solvency II provides one example. It introduced a risk margin: the compensation that a third party would require to absorb the assets and liabilities of another firm that runs into trouble. This provides an extra degree of protection for policyholders, and therefore advances the PRA's objectives.

But because of its design under the current legislation, the risk margin is very sensitive indeed to risk-free rates. This level of volatility is not justified by the historical evidence and does not in my view serve a useful purpose. Rather, it may be dangerously procyclical. So in the immediate aftermath of the referendum, we invited – indeed encouraged – firms to apply for transitional measures to smooth the impact of the risk margin during a time of market turbulence, and I also very much welcome the European Commission's request for EIOPA to review the risk margin's role more broadly.

Take the leverage ratio as another post-referendum example of steps we are taking to put a smoother finish on the reforms. The framework was originally introduced to mitigate the risk to financial stability of excessive leverage. In August we decided to exclude central bank reserves from the exposure measure. They do not expose a firm to additional risks: as the ultimate settlement asset, central bank reserves are a unique asset class. Leaving reserves in scope would have obstructed the effective implementation of monetary policy. But neither did we want to take them out only to see a reduction in the nominal amount of capital required to meet the UK leverage ratio standard. So in making the change, we made clear that we will recalibrate the standard to offset this impact. The policy intent of our framework is preserved, while the unintended consequence is addressed.

In a similar vein, let me say a quick word on the reforms currently being discussed in Basel – specifically the review of the use of firms' own internal models for calculating risk-weighted assets and therefore their capital requirements. The Governors and Heads of Supervision were very clear at the beginning of this year that their focus was on reducing unwarranted variability in risk weights, but there should not be a significant increase in global capital requirements. I am optimistic that these variability problems in risk weights can be mitigated without any such thing as a Basel IV.

This discussion in Basel has been and remains controversial, not least because, by definition, the BCBS cannot level the playing field without changing capital requirements for some firms – and for firms that are outliers, these increases could be significant. But one very important part of the package has attracted less attention. I have long been troubled, as I know have members of the Treasury Committee, by the gap in risk-weights for low-LTV mortgages between firms who use models to calculate them and (typically smaller) firms who use a standardised, and therefore relatively crude, weighting provided by regulators. Now of course the leverage ratio is an essential complement to the risk-weighted framework which mitigates the effect of such disparities. Nevertheless they still bother me both in light of our secondary competition objective, given the risk of an un-level playing field, but importantly also in light of our safety and soundness objective because of the economic incentive it provides for standardised firms to concentrate on higher-LTV lending.

We have therefore argued in Basel for a significant lowering of the standardised risk-weight for low-LTV mortgages which I hope we will be able to secure. At the same time, I intend that we will bring forward proposals under our Pillar 2 regime which should also reduce the risk that our capital standards are overly prudent for smaller firms using the standardised approach to credit risk to calculate their requirements – essentially by looking at capital requirements in the round rather than assuming that a simple "sum of the parts" approach will necessarily deliver the right answer. In the same vein, we will deliver what we promised in our Annual Competition Report this summer, improving the process by which small firms can transition to internal models.

All this demonstrates how we can address unintended consequences while remaining true to the revolution's goals.

Too early to say

In 1972, Chinese Premier Zhou Enlai was asked about the impact of the French Revolution. His answer: "too early to say".

While it emerged forty years later that Zhou was probably not referring to the 1789 storming of the Bastille – but instead thinking of the 1968 student riots in Paris – his remark is apt at the current juncture[5]. It is too early to say how business models will shape up in the future.

[5] *Zhou's cryptic caution lost in translation:* By Richard McGregor, Financial Times, June 2011, available here: https://www.ft.com/content/74916db6-938d-11e0-922e-00144feab49a

For insurers, the low rate environment and persistent soft conditions in many segments of general insurance are creating real pressures. And judging from their persistent low profitability and price-to-book ratios, developing sustainable business models remains a major challenge for many banks.

One important element of this is misconduct, where the peak of the crisis for banks has arisen more slowly than the prudential crunch in 2008. It casts a very long shadow – most importantly, on the lives and livelihoods affected by unacceptable behaviour, but as a secondary effect on banks' ability to generate sustainable returns and build capital internally. For example, in their 2015 results UK banks disclosed a further £15 billion of provisions relating to past misconduct, which reduced their pre-tax profits by around one half.

But this is only part of the picture – even leaving aside misconduct, many banks have simply not yet adapted to the new prudential constraints or the lower-rate environment. This is now a first-order issue for us as the PRA and FPC. A recent paper by Natasha Sarin and Larry Summers provides a useful reminder that on many market metrics the banking system still looks fragile, which they argue may be largely due to weakened business franchises[6].

While we have done a huge amount to repair the financial system in recent years, as supervisors we would be unwise to ignore these signals – we need to complete the implementation and give firms a proper chance to adapt to the new world. That's what our forward-looking, judgement-based approach now requires.

By remaining true to the revolution – while not wasting our time and energy in refighting it – we can all turn our attention to the challenges of the future.

In this way we will reinforce the stability of the financial system, for the good of the people of the United Kingdom.

The revolution is over. Long live the revolution!

[6] *Have big banks gotten safer?* By Natasha Sarin and Lawrence H. Summers, September 2016, available here: https://www.brookings.edu/bpea-articles/have-big-banks-gotten-safer/