BANK OF ENGLAND

Speech

Strong and Simple

Speech given by

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Introduction

I am reliably informed that following my last Mansion House speech the chair of one of our banks was so enraged that I had spent ten minutes talking about credit unions that they nearly choked on their beef fillet.

This, arguably, did not advance the PRA's objective of safety and soundness. So it's a very good thing that this year the Lord Mayor has introduced new safety measures by removing all food from this event. You will, however, still need a strong dose of caffeine in order to make it to the end of my speech.

I'm also delighted to join the Lord Mayor in welcoming Nikhil to this event. Nikhil and I have known each other for a long time. I'm sure he will be a great leader of the FCA and I'm confident that with him at the helm the two regulators will continue to work well together.

Now, coming back to those credit unions – the reason for the chair's anger was that I announced that we would bring in a radical simplification of capital requirements for credit unions, but didn't announce anything on banks. Since then, we have motored ahead and put in place that new regime for credit unions.

But we have not forgotten about banks. In fact, despite the huge pressures of the Covid crisis we have taken care to preserve one vital part of our work programme: our plans to bring in a simpler prudential regime for small banks and building societies.

A new style of regulation

The reason we have kept up work on this topic is that our exit from the EU provides us with the first opportunity we have had in a long time to make real progress on it.[1]

But before coming to that, let me make a few brief points about the broader regulatory scene as we exit the EU.

I should say first that, despite the fears sometimes articulated by politicians in the EU, we have absolutely no intention of weakening prudential regulation in the UK. It would be mad for us to do any such thing only a decade or so on from a crisis in which the British taxpayer footed the bill for one of the biggest banking disasters in history, with a financial sector around ten times the size of our economy, and with clear evidence in front of us that the post-2008 reforms have allowed the banking system to support the economy through the Covid crisis so far. You only have to ask yourself the question "How would the financial system have fared if Covid had hit in 2007?" to appreciate this point.

[1] Notwithstanding the fact that the EU has introduced additional proportionality measures in its updated Capital Requirements Regulation.

As the host of a very large international financial centre, we also have a global responsibility to maintain high prudential standards in the UK. This is important for the Bank of England's objective of financial stability, but it also makes sense for industrial policy for the UK financial services industry: we want people to bring their money to the City for the right reasons, not the wrong ones, and we have no interest whatsoever in a race-to-the-bottom approach to financial regulation. And it was very good to see the Chancellor making this same point clearly in his wide-ranging address to the House of Commons on Monday.

None of that is to say that nothing will change as we leave the EU. Financial regulation is constantly developing as financial services change, and it is clear that neither the EU nor the UK wishes to be shackled in lockstep with the other as these developments occur in both jurisdictions. But of course financial regulators tend to be interested in similar things, we coordinate with each other across borders constantly, and we hammer out international agreements at the Financial Stability Board, the Basel Committee, and the International Association of Insurance Supervisors in order to keep us moving forward together as we tackle issues like climate change, cyber and operational resilience. Indeed, the Lord Mayor's Green Horizon Summit in London this week is a great example of this sort of activity.

Our commitment to those mechanisms of international coordination, including working closely and cooperatively with our European colleagues, will not waver with Brexit – indeed we will double down on them.

Still, it is reasonable to ask: what will be different? I have a strong interest in this but ultimately it's for the government and parliament to decide, and the Treasury already has this question firmly in its sights in the form of its Future Regulatory Framework consultation, which was published last month.[2] But as one very small contribution to that debate, I would like to suggest three lodestars to guide us:

- first, high regulatory standards – no surprise to find that on my list! More seriously, for the reasons I just gave I do think that is a vital ingredient of our future success;
- second, responsible openness. By international standards the UK is very open to financial services, and we will continue to put a huge effort into making this work safely for us and the rest of the world, including those in the EU who want to do business with the UK; and
- third, dynamism. The UK's success in financial services has been built on the ability to innovate, adapt to new developments[3] and allow a suitable rough-and-tumble of financial services firms entering and exiting the market – we should take this further in the years ahead.

2 See: https://www.gov.uk/government/consultations/future-regulatory-framework-frf-review-consultation
3 The PRA's and Bank's leading work on FinTech and climate related financial risks are prime examples.

There is no free lunch here, in that none of these three elements is free. Strong regulation is not cheap. Openness exposes us to risks from elsewhere. And dynamism means some businesses and investments inevitably fail. But together, this trio can make a big contribution to our economy. I want to focus today on the third – dynamism – where both we and the government are now taking concrete steps to move forward.

Dynamic plumbing

Now, the most important thing that has happened recently to improve dynamism has attracted very little comment at all – other than from a select band of enthusiasts for regulatory plumbing, buried deep within the PRA and the Bank.

On 23 June, the Treasury published a document snappily named "Prudential standards in the Financial Services Bill: June Update – Policy statement". This provided an update on the government's approach to implementing Basel 3.1 and a UK version of the second Capital Requirements Regulation (CRRII).

Perhaps we should not be too surprised that this utterance was greeted by the financial commentariat with less than delirious excitement. There was, however, an outbreak of delirium within the PRA – which I can assure you is an exceedingly rare event, in part due to the dour leadership style I try to affect.

The reason for this was the government's view that "the most effective way to [implement these regulations] is to delegate responsibility for the implementation of firm requirements to the Regulators, subject to an enhanced accountability framework. This means that the vast majority of the updated banking regime will be implemented in PRA rules."

In short, for implementing this set of Basel rules the government proposes to move back to a more British style of regulation, with the rules made by regulators rather than set out in law. This is quite different from the EU approach, where a huge volume of detail is locked down in law because that is the only practicable way to ensure that 27 countries do the same thing. Absent that imperative, it makes much more sense to have these details in regulators' rules, as most other countries do, so that we can keep pace with developments in financial markets and adapt the rules as needed – subject, of course, to us being fully accountable to parliament for our actions.

Now this may sound rather boring. Indeed, to everyone apart from me and the PRA policy team it is rather boring! So boring in fact that when I gave an inordinately long speech on this topic I went all the way to Switzerland so that I could inflict it on their bankers rather than all of you – had I done otherwise I am sure the Lord Mayor would finally have banned me from speaking at this event. But this is a very, very important issue for financial services in the UK because it is the fundamental bedrock of increased dynamism in our

regulation. I am delighted therefore that this is the approach the government has proposed in its consultation on the Future Regulatory Framework, and I hope that it will be taken forward as the wider regime develops.

Graduation

At this point I fear that the chair whom I annoyed so much last year is becoming restive again, fearing a long lecture on regulatory plumbing. So let me stick with dynamism, but move us on to something a little more tasty that we have been cooking up in the PRA kitchen.

We made changes to simplify the credit union regime last year both because it is a good idea and because we are not constrained by EU regulation in that area. It is natural, therefore, as we leave the EU, to have another look at the next-smallest set of UK deposit-takers – small UK banks and building societies (hereafter "firms") – and ask whether we could do something similar for them. This question may also of course be relevant for insurers, but my focus today will be deposit-takers – in part because the government's Solvency II review is already underway and can explore these issues on the insurance side.[4]

Our habit, within the EU, of applying broadly the full weight of regulation to firms of all sizes is not motivated solely by prudential considerations. Rather, it is driven by the understandable desire to harmonise practice across the different countries within the EU, and by the difficulties of agreeing a definition of "small" which works for everyone given the widely varying sizes of national economies within the EU.

This approach gives rise to the "proportionality" problem. The costs of understanding, interpreting and operationalising prudential requirements, which have become more complex since the 2007-08 crisis, may exceed the associated social benefit for small firms (but not large ones). On the cost side, a fixed element of these costs may mean that average costs will be higher for small firms. And on benefits, these may be relatively higher for large firms whose resilience the Basel Committee has had mainly in mind when designing regulation – indeed research by our PRA team suggests that some Basel metrics are more effective for large firms than small ones, whereas supervision of their governance seems to be even more important for small firms than for large ones (See Figures 1A and 1B).

At the same time, in addition to the "proportionality" problem we face the "barriers to growth" problem – that if we strip parts of the regime away for small firms this will create new barriers for those firms as they grow out of the "small" category and need to take on additional regulation.[5]

4 See: https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence
5 Another piece of simplification work that we are quietly progressing is a rationalisation of the various regulatory thresholds a deposit taker may find themselves subject to.

Ideally, therefore, and with our competition objective in mind, we should want to move towards a graduated regime in which firms can migrate from a very simple regime, up through a series of steps towards the full Basel regime as they become larger and/or involved in more complex activities (See Figure 2).

Strong and simple

Moving to a fully graduated regime of this kind would be a major undertaking. But it has occurred to the team working on these issues in the PRA that any version of that regime would probably involve, as a first step: the simplest regime, for the smallest firms. We are therefore attracted by the idea of putting such a first step in place early on, rather than waiting until we are ready to implement all the steps of a fully graduated regime.

Before coming to design choices, however, it is important to establish one basic principle at the outset. We have absolutely no interest in moving to a weaker prudential regime for small firms. Small firm failures will inevitably occur as part of having a dynamic banking sector. On the one hand, we have been very successful in our efforts to encourage new entry: since 2013 we have approved 25 new UK banks (as well as 24 international ones), including one hardy soul who set sail this week on the choppy seas of the Covid crisis. On the other hand, the PRA does not seek to operate zero failure regime,[6] and we have quietly overseen the exit from the market of 12 small UK banks in recent years. But the key principle is that this process must be orderly, and that principle relies on strong prudential standards.

Having had these two thoughts – to start with the simplest step on the ladder, and to keep it strong – the fevered minds of the PRA competition team turned to branding questions. If we do this what will we call it? We thought perhaps we could go for: “strong and simple”. I rather like this, but perhaps others will say it is clear why we are not in the advertising industry.

Simple design

In designing a strong and simple regime we will have to decide on two things:

- first, which firms are in it; and
- second, how to simplify requirements.

On the first of these, size measured by total assets is likely to be one good proxy – not least because it is simple. But other factors could also perhaps be brought in. For instance, purely as an illustration we could consider making eligible all firms with total assets of less than £xb and who are also:

- not systemically important;

6 In fact, the Financial Services and Markets Act 2000 (as amended) is explicit that it is not our role to ensure that no firm fails.

- not internationally active;
- not involved in trading activities;
- not approved to run an internal model for capital requirements; and
- capable of exiting the market in an orderly way, for example through solvent wind-down or an insolvency procedure.

Now I'm quite sure that our disgruntled bank chair will be spluttering over their coffee at one or other of the items I just listed. Indeed each of these elements could be hotly debated, and doubtless will be if we proceed to a consultation. For example, what should the "x" in "£xb" be? On the one hand it would be good to have as many firms as possible benefit – but on the other hand, as "x" gets higher the scope to simplify will probably diminish. And to give you a sense of the distribution, out of the PRA's current population of 110 UK deposit-takers a cut-off of £1b would capture 48 firms, £5b 78 firms, £10b 84 firms, £20b 91 firms and so on.

Of course in thinking about these thresholds one immediately runs into two issues. First, the barriers to growth problem – by creating a new step in the regime we might add to the difficulty of growing. One solution to this could be to make the simple regime optional – firms that have no great ambitions to grow could opt in, while those who want to become large and prefer to get to grips with the whole regime early could opt out. Second, those firms who don't meet the definition might feel hard done by and lobby against it, or lobby for other changes which make the overall regime less strong. There is no avoiding this, other than to appeal to the greater good.

The second design question is how to simplify. There are two main options, which are not mutually exclusive: replace existing requirements with simpler versions; and/or narrow the set of applicable requirements.

On the first of these options, we would want to look at which requirements the smallest firms find the most complex. For example, if it turned out that small firms struggle with some of the complexities of our Pillar 2 framework for liquidity, could we simplify the framework for them? Alternatively, on the second option one could imagine a regime in which more liquidity requirements get added as a firm's funding model becomes more complex (See Figure 3).

Other countries around the world have taken various approaches to this simplification issue. For example, in Switzerland small banks are subject to simpler prudential requirements if they have high enough leverage and liquidity ratios.[7] Australian small banks are instead always subject to simpler risk-based requirements.[8] On the other side of the globe, the smallest Canadian banks are proposed to be subject to simpler risk-based

[7] See for example: https://www.finma.ch/en/supervision/banks-and-securities-firms/kleinbankenregime/
[8] See for example: https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis_0.pdf

requirements as well as a more tailored liquidity requirement.[9] Whereas in the rest of North America, most US banks[10] face increasingly more severe risk-based, leverage ratio, and liquidity requirements as they grow in size.[11]

As you can see, it's not at all obvious from this picture what is the right approach to simplification, and there will also surely be lessons to draw from how small firms deal with the current crisis. But what does strike you is a broader point: that it is normal to have simpler requirements for the smallest banks. And as our early research indicates, the most sophisticated capital and liquidity requirements may not be as important, relative to sound governance, for small firms as they are for large ones.

KISS

I am conscious that we are all at the moment very much focused on the Covid crisis. This is a hard time for the economy and for many of the firms that we oversee. There are also, as ever, many issues du jour for us to debate – dividends, the MREL Review and resolution topics, buffer usability, and mortgage risk-weight floors to name just a few. There is the small matter of coming to the end of the Brexit transition period and finalising our new relations with our neighbours. And further afield we face a world of heightened geopolitical and trade tensions.

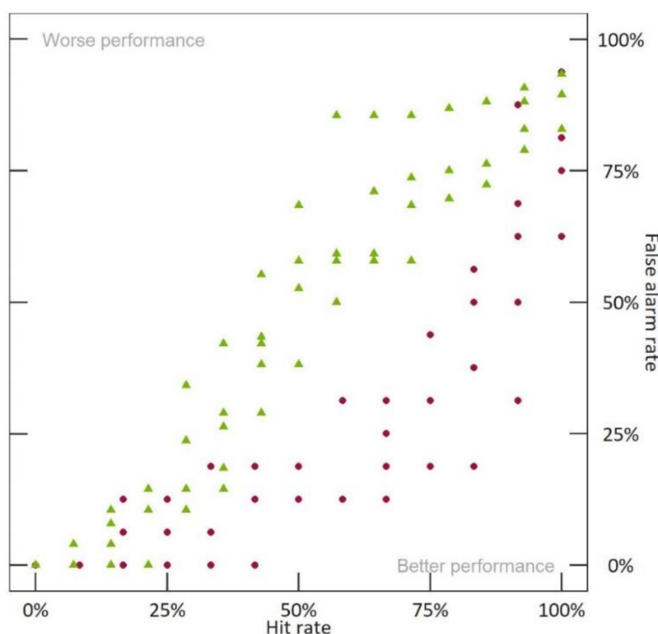
So this is not an easy time. But while doing everything we can to manage the risks we face, we also need to keep an eye to the future and to opportunities. With that in mind I hope that the short sketch I have provided today will trigger a debate about the merits or otherwise of introducing a simpler regime for small UK banks and building societies. If it does, we will progress to a discussion paper in the Spring and take it from there.

In the meantime, a surprising new acronym has entered the PRA lexicon: KISS. This is not a reference to a 70s rock band – we do have some rockers in the PRA but they seem mainly to be Status Quo fans. It's also not a homage to the song by Prince or the London radio station. Still less is it a breach by the PRA of social distancing guidelines. Rather, Lord Mayor, instead of "keep it simple, stupid", in the PRA we say: keep it strong and simple!

9 See for example: https://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/SMSB20_cp.aspx#fnb19
10 Community banks meeting a 9% leverage ratio criterion can opt into a different regime.
11 See for example: https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf

Figure 1A: Predicting distress by setting regulatory thresholds

To help us understand the need for a tailored approach for smaller banks and building societies, we've been testing how well some of the metrics in our current regime would have performed if we'd used them to identify vulnerable banks in 2007. We've done this by applying to historical data about banks' **leverage ratios**, **risk-weighted capital ratios**, and **net stable funding ratios**, a technique used in existing Bank research.[12] What we're looking for is combinations of these balance sheet ratios which help us separate banks which got into trouble during the succeeding crisis from those which didn't. Good combinations produce high hit rates and low false alarm rates. Our findings suggest that these metrics are not as well-suited to identifying small banks that are headed for trouble.



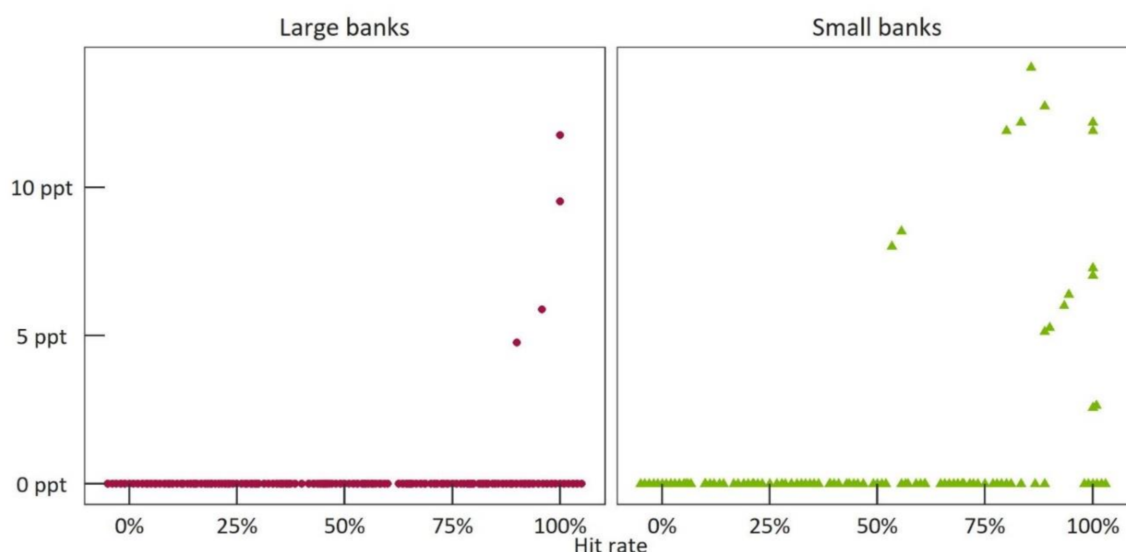
Source: Bank of England and Bank calculations.

Notes: For a description of the methodology, see David Aikman, Andrew G Haldane, Marc Hinterschweiger and Sujit Kapadia, 'Rethinking financial stability', BoE Staff Working Paper 712 (2018); and Marcus Buckman, Paula Gallego Marquez, Mariana Gimpelewicz, Katie Rismanchi, Sujit Kapadia, 'The more the merrier? Evidence from the global financial crisis on the value of multiple requirements in bank regulation', BoE Staff Working Paper (forthcoming). Balance sheet data is from historical regulatory returns (see Sebastian J A de-Ramon, William B Francis and Kristoffer Milonas, 'An overview of the UK banking sector since the Basel Accord: insights from a new regulatory database', BoE Staff Working Paper No. 652 (2017)). 'Large' means total assets of £5bn or above. Distress is defined as receiving worst possible supervisory rating between July 2007 and December 2008, or any instance of default, receipt of state aid, or merger with or acquisition by another bank under stressed conditions during the same period. Data on supervisory ratings is from historic FSA records (see Joel Suss and Henry Treitel, 'Predicting bank distress in the UK with machine learning', BoE Staff Working Paper No. 831 (2019)).

[12] See David Aikman, Andrew G Haldane, Marc Hinterschweiger and Sujit Kapadia, 'Rethinking financial stability', BoE Staff Working Paper 712 (2018); and Marcus Buckman, Paula Gallego Marquez, Mariana Gimpelewicz, Katie Rismanchi, Sujit Kapadia, 'The more the merrier? Evidence from the global financial crisis on the value of multiple requirements in bank regulation', BoE Staff Working Paper (forthcoming).

Figure 1B: Improvement in performance after adding Governance scores

Figure 1A naturally led us to ask whether there are other measures which can better anticipate problems at smaller banks and building societies. We know that the quality of governance is vitally important, so we repeated our experiment, adding PRA supervisors' judgements about the quality of a firm's governance. We found that adding judgements about governance reduced our false alarm rates more often – and by more – for small firms than for large. This of course doesn't mean governance isn't important at larger firms – the opposite is true in our view. But it does suggest that supervising governance can be even more important for small firms.

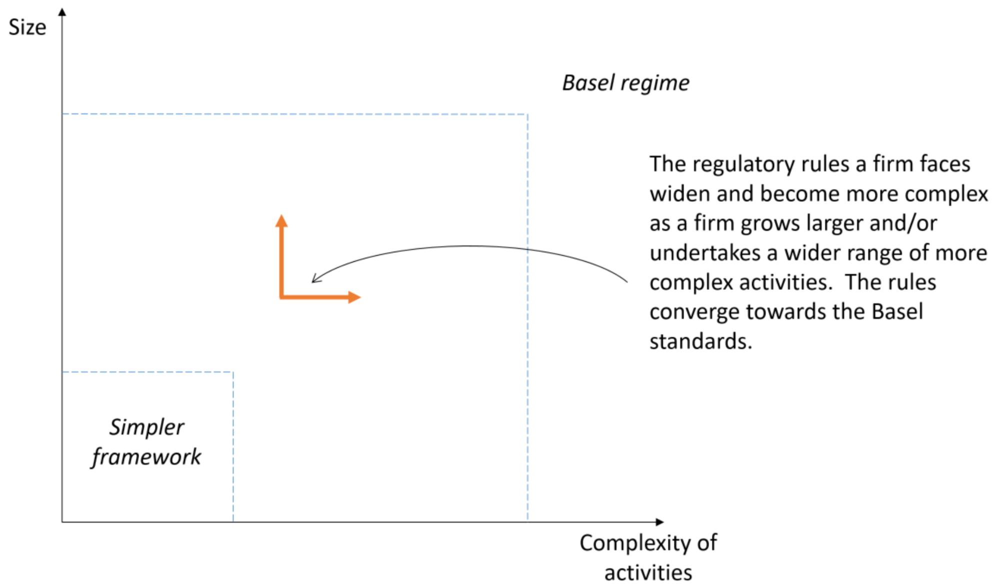


Source: Bank of England and Bank calculations.

Notes: Balance sheet data as of July 2007, taken from historical regulatory returns (see Sebastian J A de-Ramon, William B Francis and Kristoffer Milonas, 'An overview of the UK banking sector since the Basel Accord: insights from a new regulatory database', BoE Staff Working Paper No. 652 (2017)). Supervisors' scores for Governance from historic FSA records (see Joel Suss and Henry Treitel, 'Predicting bank distress in the UK with machine learning', BoE Staff Working Paper No. 831 (2019)). To test the robustness of our findings to definitional choices, results are shown for two different definitions of "Large" and six different definitions of distress. The "Large banks" panel shows results for all banks with total assets of £1bn or above, and separately calculated results for all banks with total assets of £5bn or above. For both of these definitions of "Large", results are separately calculated using six definitions of distress: 1) Distress defined as receiving worst possible supervisory rating between July 2007 and December 2008; 2) receiving worst possible supervisory rating between July 2007 and December 2009; 3) any instance of default, receipt of state aid, or merger with or acquisition by another bank under stressed conditions between July 2007 and December 2008; 4) any instance of default, receipt of state aid, or merger with or acquisition by another bank under stressed conditions between July 2007 and December 2009; 5) meets definition 1 or 3; 6) meets definition 2 or 4. Similarly, the "Small banks" panel shows results for all banks with total assets of less than £1bn, and results for all banks with total assets of less than £5bn, in each case using all six definitions of distress.

Figure 2: Illustration of a graduated prudential framework

Under a graduated prudential framework, the regulatory rules a firm faces would widen and become more complex as a firm grows larger and/or undertakes a wider range of activities that are more complex, converging eventually on the Basel standards, as illustrated by the following diagrams.



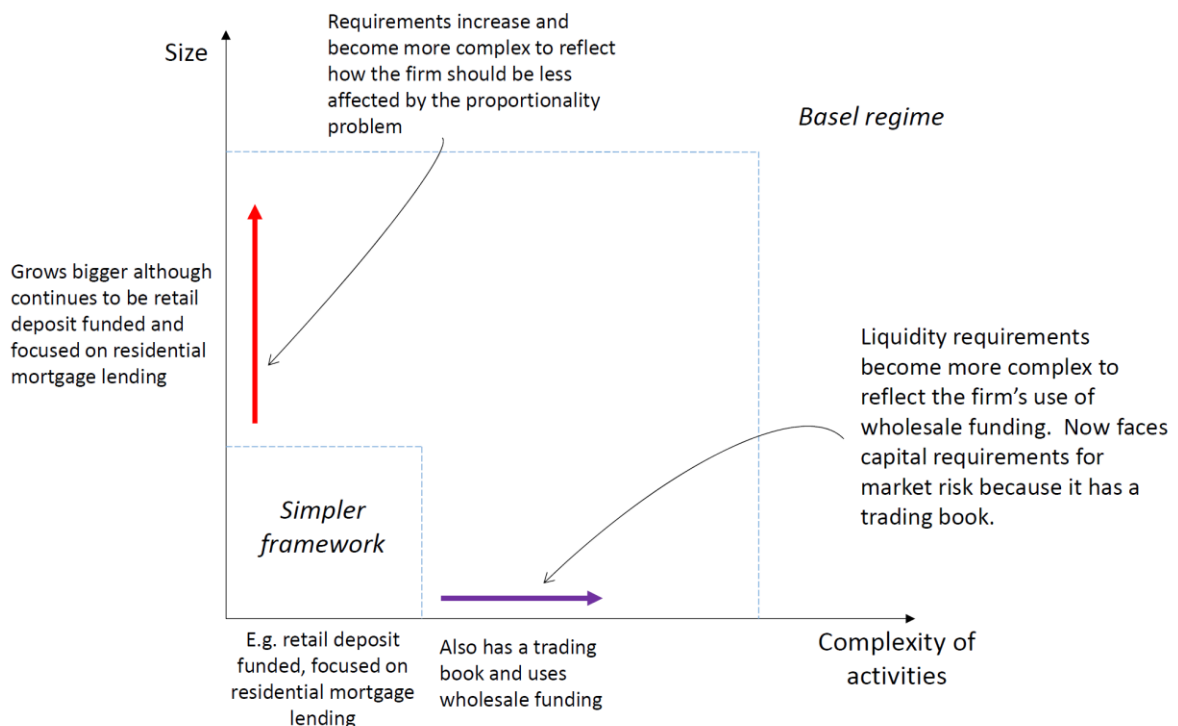


Figure 3: Illustrative example of graduated liquidity requirements