Industry Seminar – 20 October 2011

Keynote Speech

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Thank you for inviting me here to Guernsey and it is always a great pleasure to come to the Island. Apart from the obvious physical attractions, it is always a pleasure to be in a jurisdiction which recognises the importance of financial services.

Too often now, financial services is somehow considered to be inferior to other aspects of the economy – the real economy as it is usually termed - when this is not the case.

I come from the manufacturing heartlands of the UK; from Sheffield. I am not surprisingly therefore supportive of manufacturing industry. But a good strong economy requires a good strong financial services industry and that is the piece that can get forgotten - but it is not forgotten here in Guernsey.

Let me turn back the clock for a moment to September 2007, just a few months after I had joined the BBA. The reason for choosing 2007 for my start, is that it was the start of the crisis as it was the month and year in which we had a run on the Northern Rock - a relatively small and predominantly retail bank.

The wholesale market had been drying up across trelatively 2007 and the Northern Rock was particularly reliant on the wholesale market due to it's skewed business model. When the market froze it could no longer fund itself and had to go to The Bank of England for lender of last resort facilities.

Nobody explained to the public what lender of the last resort facilities meant; and so the assurance that the Northern Rock could pay people their cash was not given. We had a run on a bank for the first time for more than 100 years, which was transmitted (In the way that things are these days) around the world and instantly and to the significant reputational damage and detriment to the UK.

A big question mark appeared over the UK's hard won reputation for running a good financial centre.

As we all know, in the summer of 2008, wholesale markets dried up again and this time we the consequences were huge. AIG, Merril Lynch, Washington Mutual and Citi had to be bailed out and then came the collapse of Lehmans which froze the system completely. HBOS was over exposed and had to be rescued by Lloyds with taxpayer involvement and RBS required a huge injection of tax payers money not just to stabilise it but to ensure the continuing provision of the normal financial services of a country – cash out of the ATMs, provision of credit for individuals and to businesses.

This damaged our reputation further, but it was the right steps to take.

The UK Government then took the view that as a primary requirement very significant changes then had to be made and commenced the process of ensuring increased stability of the individual

banks and the system as a whole. This stability has improved radically over this last three years and will be strengthened further by a number of measures that are currently in hand. Taken together these measures have collectively placed UK banks on a very different footing than they were before the crisis and are building the strength of the financial system right across the piece.

When the UK does things it acts quickly; it acts openly; and because we have an inquisitional competitive press - and we tell the world about it - and not least because the world speaks English.

The UK, the industry, and indeed I personally as the public face of the industry, took a huge amount of public anger and international criticism, with the strong message being received that all problems sat only at theand or of the banks.

Meanwhile, many of our European colleagues considered that the UK had a "Anglo Saxon" problem and that this banking industry crisis was not one for them. I found this at many of the European institutions and groupings that I visit.

Recent events however have shown though how prompt action is vital, that the problems are not "anglo-saxon and that failure to act openly and with clarity at the start of the crisis, has not served other countries or our region well.

Turning back to regulatory change, let me look for a moment on what has already been done. I have my list. A dull and boring list but also a very significant and comprehensive one.

- **Core Tier 1 capital:** international agreement has been reached on the Basel III capital accord and is close to being made a statutory requirement in the European Union in the form of the Capital Requirements Directive IV. The risk weights applied to instruments within the trading book have increased substantially. And, notwithstanding losses, based on the definitions used by the Bank of England for its Financial Stability Report, Core Tier 1 capital held by UK banks has risen from £100bn in 2000 to £300bn at the end of last year. Capital ratios are increasing rapidly towards not 7% but 10%. Basel 3 has been implemented in the UK early.

- **Additional capital or SIB surcharge:** it is accepted in Europe, (but not necessarily in the United States), that there should be an additional countercyclical capital buffer up to 2.5% at the top of the cycle. The SIB surcharge of 2.5% has been agreed and the Basel Committee will release further proposals on the trading book this Autumn. The UK is considering more.

- **Further loss absorbency:** work is also being undertaken to ensure that subordinated debt is truly loss absorbing at the point of non-viability. Consideration is also being given to whether and how under 'bail-in' arrangements, creditors should bear the cost of failure. The theory has good merit and there is support from the banking industry for much more detailed discussions and with the investors.

- **Leverage:** discussions are at an advanced stage in the Basel Committee on the introduction of formal 3% leverage ratios. In the meantime leverage in UK banking has almost halved since the period directly before the financial crisis.

- **Liquidity:** the need for higher liquidity requirements was a key learning point of the crisis and the volume of instruments held for liquidity purposes has increased at least fivefold. This will be formalised in a new Liquidity Coverage Ratio to apply from 1 January 2015 in Basle 3.

Although a reporting requirement only in CRD4, the UK already has a liquidity regime reflective of much of what Basle require. This has and remains a costly procedure.

- **Taxation:** the annual £2.5bn UK banking levy – which is at the top end of levies introduced within the EU and elsewhere.

- **Infrastructure:** changes are being made to require OTC derivatives to be cleared through central counterparties supported by higher collateral arrangements in effect building stronger firewalls into the financial system.

- **Depositor protection:** in addition to deposit insurance limits rising from 90% coverage of £33,000 to 100% of £85,000 under the FSCS scheme funded by financial institutions, UK banks lead the field in the establishment of a 'single customer view' designed to facilitate the continuity of essential banking services in the event of failure and a 7 day payout as a backstop.

- **Banking supervision:** The FSA signalled an end to 'light touch regulation' as part of its post-Northern Rock analysis and has since embarked upon a substantial shift in its approach to banking supervision – a process that will be continued by the new Prudential Regulation Authority.

- **Accounting:** the International Accounting Standards Board and the US Financial Accounting Standards Board are working together on a convergence programme aimed strengthening the key accounting standards that apply to banks and other financial institutions.

- **Corporate governance:** the Walker Review into the corporate governance of British-owned financial institutions made 38 recommendations spanning the size, composition, qualification, functioning and performance evaluation of boards of directors, the role of institutional investors, risk governance and remuneration. These are now included either in the Financial Reporting Council's Corporate Governance Code or by the FSA and the banks have made the changes.

In just about all of these instances, the UK authorities have adopted a leadership position and are front running both the liquidity requirements as well as the capital requirements of Basel and the approach that they are taking with the industry to stress testing or in transparency is much tougher than others leaving no wiggle room. Few counties for example have actually required the banks to take the degree of right downs or impairments that the UK banks have even though they are exposed to very similar investments including those of sovereign debt.

And then there are the Recovery & Resolution Plans which in future would mean a bank can fail in a manner which minimises the impact on financial stability, protects depositors and protects public funds and maintains the supply of credit in to the economy. The UK is both more advanced and much more stringent in these requirements than is the case in many ither countries - and these Recovery and Resolution plans flow of course through to the business as usual operations of a bank.

All this regulation also has a cost and an impact that is seldom properly assessed. Stability is attractive but the economic consequences of such substantial change as that which is flowing through, has to be assessed as well.

To give them their due, the Commission has tried to cost the ceconomy piece of CRD4 and has estimated that for the EU, the Eurozone banks will have to raise somewhere between 400-500 billion Euros. That was without fully factoring in the current crisis. No policy maker has attempted to price the liquidity piece of Basel/CRD4 but JP Morgan has and they have come up with about another 500 billion Euros.

These are big numbers.

McKinsey meanwhile has endeavoured to model the business lines that will be most affected amongst the major banks and their answer that it will be in structured credit and in rates. So even before we go to that big additional capital there is some very serious costs and impacts.

This demonstrates the fundamental importance of considering regulation and economic

Let me now turn to the new two specific UK actions.

Before the general election, the Conservatives were in opposition and the crisis took place on the then Labour Government watch. Their policy unsurprisingly was focussed on sorting out the crisis. Meanwhile the Conservative policy was that the cause of the crisis was in part due to our regulatory structure which had been put in place by Labour and so should be broken up. The FSA should be abolished and bank supervision put back into the Bank of England. The Lib-Dems meanwhile, had to have their own policy different from the other two parties before the general election and so they said that the cause of the crisis was that banks were too big and too complex (even though it was mostly small and/or simple banks that failed) and so banks should be split up. The election took place and we got a coalition. For four days the two parties' negotiators were in darkened rooms to agree the coalition policy. A document was agreed and working down that document in each of the main policy areas there were compromises, except in banking where we have now the policies of both parties.

So not only is the UK changing who regulates banks and breaking up the FSA, but also investigating bank structure as well, through the Independent Commission on Banking, or IBC.

Who regulates what is not usually a discussion which causes much excitement as it seems irrelevant to most lives. I would be so lucky! But in part part that is correct; and so on the face of it to split up our Financial Services Authority and put part of the regulation back to the Bank of England, move conduct of business regulation to a new regulator looks it to be merely moving the jobs around and in the eyes of some putting the regulation of banks where it ought to be and that is with the Central Bank.

We all have our lists for what the new PRA should or should not do, and the same for the Financial Conduct Authority. Many are concerned also that the markets division does not get subsumed into retail conduct of business, and where wealth management sits in the new structure is important too.

The Prudential Regulatory Authority will be the principle regulator for banks, building socieities, insurers and financial services firms deemed to be systemic. It will have a board with some independent non executives as members, it will be chaired by the Governor of the Bank of England and will have a principle responsibility for financial stability.

The PRA though will not have responsibility for conduct of business which means that everyone who is regulated by the PRA will also be regulated by the new Financial Conduct Authority as

well. It will therefore be essential that our new regulators must talk to together and act together. That is what didn't happen with the Northern Rock.

We need one place to send data and information and not two places. Supervision has to be undertaken
coherently by both of the authorities. I can see, and indeed hope, that the quality of supervision will increase, and certainly as far as the calibre of individuals attracted into the PRA is concerned that may well happen as it holds the cache of being under the Bank of England. The jury is out with the Financial Conduct Authority.

But I am going to concentrate additional remarks elsewhere - and that is to the new macro prudential regulator, the Financial Policy Committee.

This will be part of The Bank of England who will have responsibility for the PRA and also for monetary policy too, through the Monetary Policy Committee (MPC)? So the Bank therefore has control over supervision of banks, of interest rates and in this macro prudential area it has responsibility for macro prudential too. The intention of the FPC is to use macro prudential tools to smooth the peaks of a boom and minimise the troughs of a recession. The theory is interesting.

Meanwhile, the FPC tools are actions like raising capital ratios further. So this means that the control over both interest rates (the MPC) and the availability of credit (the FPC) has been given to the Bank of England. The MPC had a good record of controlling inflation in the good times, but with interest rates at 0.5% and inflation over 5% this now shows the limits of monetary policy as currently constructed.

For someone in the street, monetary policy is about how much they have to pay for credit. The FPC committee meanwhile by its decisions affects the supply of credit. It can restrict the availability of mortgages for house purchase; it can alter Loan to Value ratios. It can constrain the ability for individuals to raise a loan to buy a car; or the supply of finance particularly to small and medium size business.

So both the price of credit and its supply have been given to a third party. This may not be wrong but as curently proposed, regulators are therefore being given powers that are more than just regulation. I am a democrat and it is my belief that where decisions are taken that have a societal impact these should be taken by the elected representatives of a country – the people that you can get rid of if you do not like what they do. We will see what happens as the legislation gets debated. In fact a much more open and honest debate is required on these issues.

The second major change is the Independent Commission on Banking. The ICB is a body that recommends and not a body that decides, nevertheless it is extremely influential. The ICB produced its recommendations last month and the Government is now deciding its response.

The ICB proposes that further reform measures are necessary in order to ensure not only greater resilience against future financial crisis and removing the risk banks to the public finances, but also to achieve a banking system that is effective and efficient, providing the basic banking services of safe guarding retail deposits, operating secure payments systems, and efficiently channelling savings to protect investment, and managing risk. Such intentions are worthy ones. In order to bring this about, the IBC proposes a retail ring fence, more loss absorbing capital and more competition in retail banking.

However, already in the UK there are requirements for banks to put in place the recovery and resolution plans and the retail ring fence is a different proposition. It may well put in place a firewall that reduces the prospect of the retail entity being exposed to untenable losses in the wider group but in so doing it comes at the cost of increased organisational complexity which in turn is a potentially significant detriment to business customers in normal times. And whilst life may still be uncomfortable, "normal" is still much more frequent than "crisis".

The bank meanwhile looses the benefits of diversification which in turn works against financial stability by reinforcing the procyclical nature of retail and small business lending. Moreover, the UK experience of the financial crisis was that the losses did not rise principally in the wholesale area but from retail and commercial lending by banks. That is the banks that got into difficulty did so from classic bad banking practices of lending too much to the wrong people at the wrong price.

And of course the ICB ring fence does not line up with the Dodd Frank requirements in the US either as they require a separation out of wholesale activities through what is referred to as the Volker rule.

If the UK proceeds down this route then the reaction elsewhere is important. Either other countries will do the same thing which in turn will lead to trapped pools of capital and liquidity, reduce the open market for capital finance and so reduce lending capacity in good times and in bad times reduce the ability of banking groups to respond to financial problems. Or other countries do not follow the UK lead in which case cheaper retail and wholesale services can be passported into the UK from banks and financial services providers in other countries without either the costs or constraints of a ring fence.

We see the point that the ICB is trying to address. The unintended consequences though are potentially significant. It serves no purpose if the end result of a major change such as this simply results in business moving from UK banks to non UK banks and increase costs and problems for the very customers that it seeks to protect.

The ICB's second important recommendation is one which proposes a significant increase in loss absorbing capital than is being proposed by the international standard setters of Basel. Basle gets to 7% plus a little more in certain circumstances and the UK variant gets to 10%. The ICB proposition is that the UK banks hold 17% loss absorbing capital plus up to another 3% taking to 20% or more or less double the international standard.

Will this make the system more stable? The answer to that is 'maybe'. But at the same time there is a cost. There are some theoretical calculations to show that it will apparently not cost the industry that much more to fund itself to these levels, but few believe they pass the test of practicality.

I sincerely hope that the investors will be up for this ICB proposal. If they are there will be a significant price tag. Add this to the other price tags and this represents a much higher fixed cost of a operating bank. As every business men and women knows, you cannot increase the fixed cost of being in business without it having an effect on the price of the goods and services the business offers. If the investors are not up for the ICB, then the industry will have to deleverage further and that in turn starts to reduce the potential to lend. These are not easy issues; they require clear and careful cost and benefits and impact studies; we have to undertake the impact on the economy and what it is that we really want as a nation.

As you may have seen, the rating agencies have recently made assessments which have down graded the rating of the UK banks. At the same time, they have all made very similar positive

comments. These are firstly that the downgrade is because they believe that the UK Government is simply not prepared to step in and rescue a bank in future. That is they believe us when we say that the implicit guarantee has been removed. Second, the rating agents are saying that the financial strength of the UK banks is good. Thirdly that they believe UK banks have in fact raised sufficient capital. Good statements in the current climate.

Elsewhere however very significant concerns remain centred around the actual position of European banks outside the UK, particularly Eurozone banks. The stress test process commenced some eighteen months ago, but the first round of stress tests was widely discredited and even before banks that had apparently “passed”, such as the Irish banks, subsequently failed and very quickly indeed. No haircut was taken for sovereign debt for example. This year the stress tests were tougher but were also not particularly believed and notably again round the areas of sovereign debt. For example, Greek sovereign debt was haircut by 20% so 100 Euros of debt was assumed to be worth 80 in the stress test. At the same time in the secondary market it was trading at 50%. Hardly surprising that the tests were not particularly believed.

The issue though then and indeed now is not just a banking one. Banks and countries are closely entwined and always have been and banks have always held some of the sovereign debt of their country and sometimes of other countries. However one aspect of recent regulatory change is that banks have been required to purchase significantly more sovereign debt and the reason is that from the regulatory view, sovereign debt is on of the few true liquid assets and so should be the principle part of the increasing liquidity buffers that a bank needs to hold.

This assumption has proven not to be born out by practical experience in two fundamental ways. The first is the sovereign debt is not necessarily liquid and the second is that sovereign debt is not necessarily worth its face value.

Where Governments make poor fiscal decisions, then the more sovereign debt its banks are holding the more they will be destabilised by the economic decisions of that Government - and Governments do not necessarily always make good fiscal decisions and its not just a Greece problem either.

A number of European countries have exceeded sensible public expenditure levels for many years. So that, coupled with the failures to adequately asses and recapitalise banks early mean that in some countries we now have both a fiscal crisis and a banking crisis.

After more than a year of talking, decisions were taken on the 21st July to address Greece and put in firewalls. But these were not been acted upon. Looked at from the outside of Europe the Eurozone has let a problem of a small country destabilise larger countries and with an overspill effect not just to the rest of Europe but to other parts of the globe as well. Prompt action works, but is politically difficult. Slow action can be politically preferable but in so doing risks increasing the size of that problem and the difficulty of resolution. That is what has taken place with the Eurozone.

If proper stress tests had been undertaken across the EU in 2008 and 2009 when they were first done in the UK and if they had been done with the rigour of the UK, the chances are that may more banks and other European countries would have been recapitalised. That would have helped now.

This did not happen and so now just to talk about recapitalising the banks now is not the right way round as it is asking banks to save a sovereign. The sovereign failures however need to be accepted and not hidden.

The Eurozone in fact must take three simultaneous actions. The first is resolve the Greek situation by re-pricing properly the assets, the sovereign debt and other debts of that country so it has then a believable economy. Uncomfortable as it is for some, this is a crisis of some countries spending too much -sovereign crisis- so a short and long term solution for the sovereign is required. The second is that a large and believable ring fence has to be put in place under the Eurozone, such as an insurance, which acts as a security for investors in these countries, and each country's debt should take a formal risk premium according to the substance of the country. It will not be cheap and it is not easy, and whichever option is implemented it will cost much more money than would have been the case if action had been earlier.

Thirdly some banks will need to be recapitalised because of the size of the loss they will then be taking. If they cannot raise that capital themselves and that may well we the case with a number, then it is their own sovereign that needs to step in even if they are rerated. And if the sovereign is unable to do this then this may mean that some banks may have to take the British route and be wound down.

In all this some countries will end up paying for others and it is difficult to see that this is acceptable to them unless there is a stronger fiscal governance across the Eurozone as well. Monetary policy and fiscal responsibility go together.

So in Europe we will have a more integrated group and a less integrated group and we will need to work out how those of us who are part of the less integrated group can manage to maintain the strong powerful open market which is so important for all our economies.   In fnanical services the list of Directives and regulators is extraordinarily long – over twenty major proposals right now. They are mostly not costed, their interactions with other EU proposals not known and their affect on international trade unassessed. Important some of them maybe, but the fire burning now is not one that will be put out by more regulation. So part of that future of how the EU 27 acts together, has to be how the fundemntal assessment of what is it that really needs to be done.

As events are moving also to more national solutions so protection is rising. This is hardly surprising as we have the three crisis of firstly banking, secondly economies, and now the hardest of all, crisis of sovereign debt. Just one crisis can bring protectionism, three certainly is doing so and some of that is cloaked in regulation. As a large international financial centre in the UK we notice with concern just how many of the current directives and related proposals do not have sufficient internationality about them.

Opportunities for the European financial sector though are clearly there. Once stability is restored then the feeling of constant crisis will start to diminish and that will help. Late it may be but the serious movement towards better capitalised banks stronger liquidity buffers, improved governance, better risk control, more transparency and indeed more honesty will in turn provide a greater trust of the industry.

Meanwhile the financial services industry itself needs to get back closer to its customers and see early what changes need to be made. It must stop looking as if its always been dragged into altering its behaviour or its actions.

Economies can only grow if the financial services industry can finance them.

For centres such yours you have the opportunity to pick a little and choose a little. To be part of the region but not the union. To be a place of choice for the services you are good at.

Pick well; regulate well; and enjoy.