BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Speech

The changing face of prudential policy

Speech given by

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Many thanks for inviting me here today to talk about the changing face of prudential policy. Ongoing and far reaching change has for many of us become the new normal. Reforming the prudential framework for banks in the wake of the crisis has been a multi-year programme of negotiation, legislation and implementation. It's a programme that continues to progress through the FSB, Basel and European institutions as well as national governments and will do so for some time to come.

In the half decade or so since the onset of the crisis we have changed very many aspects of the prudential framework and the way it's applied, nationally and internationally. A new prudential accord has emerged from Basel; the European architecture for financial services regulation has been thoroughly reformed and indeed is going through a second wave of fundamental reorganisation with the establishment of the Single Supervisory Mechanism and new machinery for the resolution of cross border Eurozone firms. In the UK we have new regulators who are approaching their first birthday; in each case the new bodies have changed the way they approach the supervisory task and the way they identify and address risk. Ideas such as structural reform of banks, resolution planning and bail in are now common currency, at least in the kind of places we work.

Given the scale and pace of change it can feel sometimes as though the goal of a steady state for prudential regulation is as far away as ever. But we have made strides towards greater clarity and certainty about the steady state framework, in the particular with the implementation of much of the Basel III accord through CRDIV at the end of last year. We are still involved in development of a number of the key standards that underpin CRDIV and with the specification of EU legislation to implement a liquidity coverage requirement and a leverage ratio. We will also be consulting on changes to our Pillar 2 approach in the middle of this year. Work at the Basel level on elements of the standardised regime, on treatment of securitisations and the framework for the trading book continue but are now nearing their conclusions. Compared to where we were even a year ago, we now have greater clarity about the operation of the core of the capital framework and much of the supervisory approach that underpins it; and the end is in sight on a series of other significant policies.

Perhaps above all else the issue now urgently confronting prudential regulators and supervisors is the need to put in place a credible and functional set of measures to ensure that large firms do not, when they fail, externalise the costs of their failures to society. It is a political, economic and regulatory imperative that must be convincingly addressed if we are to feel that we have genuinely moved on from the glaring weaknesses in the system exposed by the crisis.

However, there is more to the post crisis reform project than the quantitative requirements we place on firms in relation to their funding, their capital, their liquidity and their resolvability. Banks are run by people, individuals and teams whose actions have effects for the stability not only of their own institutions but on occasion for the system. Regulators must engage with the behaviours, responsibilities and incentives of those individuals and teams, and that area of policy is where I will concentrate my remarks today.

Remuneration is an issue that continues to preoccupy the public consciousness and feed public debate. This year's bonus season has been dominated by allegations that banks are circumventing the bonus cap imposed by CRDIV. The prudential case against the bonus cap gets lost in headlines about eye watering sums of money and accusations of arrogance and greed. The underlying media story is: 'most people have seen their incomes fall in real terms; but the bankers still don't get it.' A wider debate about relative incomes is being played out through what is ordinarily a fairly narrow space of prudential regulatory action.

It is therefore perhaps worth reiterating our misgivings about the effect of the bonus cap. A key principle for us is ensuring that incentive structures are set up to encourage appropriate behaviour and risk taking. As we have said publicly on a number of occasions, a consequence of the cap may well turn out to be an increase in fixed pay. This would in turn have a negative effect on stability by locking in costs and reducing the scope for withholding individuals' unvested variable remuneration, sometimes referred to as 'malus'. We understand banks will want to retain some flexibility to reduce overall pay when conditions are tough. This would be good for financial stability. But we must also ensure that the structure and operation of pay schemes are compatible with the legal requirements set out under CRDIV.

Beyond the controversy over the bonus cap, this year and next will bring considerable change in some other key aspects of remuneration policies and how they are regulated, and I want to talk briefly about those changes now.

Later this week we will publish a consultation paper on clawback. It will propose a change to the Remuneration Code requiring firms to amend employment contracts to include a provision whereby, in certain circumstances, clawback can be applied to vested variable remuneration. This will complement the existing rules on the application of malus, which have been used increasingly by firms in recent years. The ability to apply clawback should further encourage the avoidance of excessive risk taking and the alignment of incentives with firms' longer term interests. Our intention is that the new rule will come into force from the beginning of 2015.

Another area which has attracted a significant amount of publicity has been the identification of material risk-takers, in other words those individuals who are subject to our Remuneration Code. The draft EBA standard, which we believe is proportionate and fair, is currently being reviewed in Brussels. If it is approved by the Commission, the European Parliament and the Council within the next few months, it will come into force in time for the next round of bonus payments. It is perhaps worth spelling out why this standard is necessary, and we believe that it is. It is now widely recognised that the CRD3 remuneration rules were not tight enough. They gave firms scope to under report those in their firms who were material risk takers, and many firms made full use of that scope. Some, for example, did not identify a large proportion of their highly remunerated traders on the grounds that what they did had no significant impact on a firm's risk profile, an approach which fails any post-crisis plausibility test. Under the new standard, all this will change and quite

right too. We will be looking very carefully at the lists of risk takers submitted by firms to ensure they comply with the standard and we expect the numbers to go up significantly.

Later this year we will also be taking forward the recommendations in the report by the Parliamentary Commission on Banking Standards, and there too we will be issuing a consultation. On remuneration specifically, we have said publicly that we very much welcome the thrust of the Commission's recommendations, which provide the opportunity to strengthen key aspects of the current regime. One of these is deferral, where the Commission argued for longer deferral periods for variable remuneration. We agree. The current CRD requirements of 3 to 5 years are clearly not sufficient in providing adequate alignment between risk and reward and there is, in our view, a strong case for longer periods. We will also want to look carefully at the structure of deferral and consider, for example, whether there is a case for promoting the greater use of cliff vesting in remuneration policies ensuring the right to receive full benefits is earned.

More generally, the PCBS was critical of the FSA's approved persons regime. It criticised some aspects of how the regime had functioned, [for example that it was used as a check at the point of approval only, with insufficient follow-up on any concerns that were identified during that approval process] and how the requirements were structured – in particular the regulator could only apply conduct rules to the population it vetted.

We, along with the Government and the FCA, recognise and accept the majority of the criticisms. As the PRA, we had already begun to make changes to how we supervised under the existing Approved Persons regime, but we think that we can go further and the Banking Reform Act provides us with new powers that will support that intention.

We are still developing our policy in response to the new powers and duties we were given in the Act. So I'm not in a position to describe a new regime in detail to you today. What I can do is set out – in broad terms – what we want to achieve with our regulation of individuals, how the new powers we've been given will help us do this, and the questions and challenges we will face.

First of all, we want a regime where firms, individuals and regulators all know who is responsible at a senior level for each aspect of a firm's regulated affairs, and that those people can be held accountable for failures that they could reasonably have been expected to prevent or reduce.

One of the key challenges here is to define the scope of the regime and to pitch it at the right level.

By this I mean that we think it's right that senior people should be responsible for any failures which they preside over; after all, senior management in firms are not generally slow to claim credit for successes in their sphere of responsibility. On the other hand, it's not a strict liability regime, so people won't be punished

solely in virtue of their position, with no reference to their actions or intentions. So we need to decide how to pitch the regime at the most senior people who can meaningfully be held responsible for what goes on in the firm.

Another challenge in relation to accountability is to establish the extent to which we as a regulator should tell firms how to organise themselves and how to allocate responsibilities. However the regulator is not responsible for running the firm; firms and their management remain responsible for conduct and operation of their business. The PCBS report highlighted that there was often insufficient clarity within firms about who was responsible for a particular issue. There's a balance to be struck here between doing our jobs and making sure there are some minimum standards, whilst at the same time enabling firms to operate in a way which works best for their business model and circumstances and not imposing a one-size-fits-all approach.

The legislation also requires regulators to establish a certification regime, under which firms will have to confirm that those within the regime are fit and proper on an annual basis. Naturally there are also questions here about scope and how regulators can successfully establish and police such a scheme. Do we look at the overall processes and criteria a firm has put in place? Do we review a sample of the firm's assessments to provide some 'quality assurance'? Or do we just step back entirely and only intervene if it becomes clear that what the firm has put in place is not working?

On a related theme we will now have the power to write and enforce rules about the conduct of all employees in a bank or PRA-designated investment firm. So again, we will need to make a decision about the extent to which we want to involve ourselves directly in the detail of how a firm operates, versus standing back and letting the firm take responsibility for its operations (with the option of taking action against the firm and / or its senior management if we think it is not discharging that responsibility effectively). There is also a question about the role to be played by the new organisation on Banking Standards Sir Richard Lambert is setting up – his consultation paper proposed that the new organisation could work with banks to assess how they are implementing their own standards and benchmark themselves against their peers in a number of areas. It could also help establish standards around training and qualifications which could support the certification regime. It will be interesting to see how firms work with the new organisation, including and how openly and robustly they engage in any benchmarking and assessment exercises.

Finally, there is a not insignificant question about how we transition from the old regime to the new. On the one hand we recognise that it would be a huge operational exercise both for firms and ourselves to re-assess the fitness and propriety of all the current approved persons who are going to become senior managers. But on the other hand, we are conscious that some of the assessments made under the old regime (some of which have featured in the press), were inappropriate. We therefore have to recognise that there may be people who were approved by the FSA in the past who would not receive that approval were they to apply to the PRA (and FCA) today. So a 'grandfathering' of the entire population may not be the right answer either. Again, we will need to strike an appropriate balance.

We have already said that we expect to consult on final rules by the end of the year. This means we will need to put out a consultation by the summer – so you can expect to see then some more detail on the challenges I've highlighted today.

There is a lot to do but we are determined to make real and substantive progress to address firms' behaviour both in terms of our remuneration agenda and implementing the wider PCBS proposals. Our overarching aim is to have a Remuneration Code which is fair but which addresses the real and understandable concerns in wider society about incentives in financial institutions and their relationship to risk taking behaviour. On other PCBS issues, we will have more detail in the summer, but it's clear that we need to work with firms to ensure their management bear appropriate accountability for the risks these institutions pose.

There is a risk, in the world of prudential regulation, that we think of banks merely as balance sheets. Regulation of quantitative requirements for complex institutions is an absorbing and frequently challenging task. But the human element of these powerful and complicated organisations has a profound effect on the direction and impacts of their business and this too is a matter for regulators. Firms tell us behaviours have changed and there is no going back to the bad pre-crisis days. A necessary corollary is that this has to be backed up with appropriate regulation which has real bite.