

## Other financial stability publications

This section provides a short summary of other financial stability related publications and speeches released by the Bank of England since the April 2008 *Report*.

### Regular publications

#### Markets and operations article, *Bank of England Quarterly Bulletin*, 2008 Q3.

This article reviews recent developments in sterling financial markets since the 2008 Q2 *Quarterly Bulletin* up to the beginning of September 2008. It also reviews the Bank's official operations during this period.

[www.bankofengland.co.uk/publications/quarterlybulletin/qb0803.pdf](http://www.bankofengland.co.uk/publications/quarterlybulletin/qb0803.pdf)

### Speeches

#### The credit crisis: lessons from a protracted 'peacetime'.

Paul Tucker, Executive Director for Markets and Monetary Policy Committee member, April 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech348.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech348.pdf)

A key message from Paul Tucker's remarks was that the stresses and risks that were currently affecting the financial system had been built up during a protracted 'peacetime'. The financial community and the authorities should not lose sight of that when 'peacetime' was eventually regained. As part of this the authorities should take an interest in the regimes which govern and drive changes in the structure and behaviour of the financial system. And policies should be developed to contain or head off the risk of systemic problems in the first place. The crisis had exposed issues with elements of the armoury available to the authorities. First, the conjunctural environment had tested what had been a creeping orthodoxy that monetary policy could effectively cushion the economy from the bursting of asset price bubbles. Second, the stigmatisation of central bank premium-rate standing facilities had disturbed part of what he described as a '*de facto*' Social Contract between the banking system and the authorities. Innovation and permanent reforms in the area of liquidity insurance would be needed to redress that. Finally, policymakers needed to consider ways in which the international and domestic credit cycle could in future be tamed, whether by macro or micro tools.

#### Banking and the Bank of England.

Mervyn King, Governor, June 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech347.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech347.pdf)

In this speech, the Governor discussed methods that could be used to establish a stronger framework for financial stability. He discussed the relationship between the Bank of England and the banks, noting that in this relationship the two sets of interests would not always coincide, with the use of the Bank's balance sheet being one area where clashes might occur. The Governor observed the need to develop a strong framework for financial stability. Such a framework included a special resolution regime for failing banks, changes to deposit insurance and an improved regime for the regulation of bank liquidity. He highlighted three key features that would be central to the success of the special resolution regime. First, responsibility for winding down a failing bank should be delegated to a resolution authority. Second, the circumstances in which the regime would be triggered should be spelt out as clearly as possible. Finally, a clear framework of accountability should be established to give confidence that decisions relevant to the resolution regime would be exercised in line with the objectives set out in legislation. He welcomed domestic and international initiatives to develop liquidity regulation. The Bank intended to learn from the experience of the special liquidity scheme and so put in place a liquidity facility that worked well in all seasons — both 'normal' and 'stressed'.

#### A tale of two cycles.

John Gieve, Deputy Governor, June 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech350.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech350.pdf)

In this speech, John Gieve discussed the challenge faced by the Monetary Policy Committee (MPC) from the tale of two cycles: the downswing of the financial cycle and the upswing in the commodity cycle. He argued that, although the banking cycle is not a new phenomenon, the scale and speed of the downswing in the past year has been exceptional. However, at the same time, the emerging and developing countries had contributed to strong world growth and driven the upswing in oil and commodity prices. He noted that balancing the downside risk to demand associated with tighter credit conditions against the inflationary pressures emanating from the rest of the world was the greatest challenge the MPC has had to face, but concluded that the monetary policy framework and independence of the Bank was designed for difficult times as well as plain sailing.

### Financial innovation: what have we learnt?

Nigel Jenkinson, Executive Director for Financial Stability, Adrian Penalver and Nicholas Vause, July 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech351.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech351.pdf)

In this paper, Nigel Jenkinson, Adrian Penalver and Nicholas Vause discussed what has been learned since the start of the financial crisis about the limitations of innovative financial instruments. Financial engineering can help decompose, transfer and pool risks to match the risk appetite of lenders and improve the options available for households and companies to manage risk. But the paper argued that market frictions and imperfections can limit the effectiveness of financial innovation. Information is lost when there are chains of parties involved in credit creation. The ability to sell on or pool credit risk can reduce incentives to screen and monitor borrowers. Products with tailored risk profiles can be difficult to sell. The paper argued that these frictions have become more apparent since the onset of the credit crisis. The paper concluded that removing these frictions, for example through better credit screening, will be costly. Innovative financial instruments will also require a higher liquidity premium. Recognising these costs, though, will strengthen the resilience of the financial system and underpin the durability of the benefits of financial innovation.

### The financial cycle and the UK economy.

John Gieve, Deputy Governor, July 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech353.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech353.pdf)

In this speech, John Gieve discussed the financial cycle and the UK economy. He argued that the US sub-prime market provided only the initial spark and fed a fire fuelled by much broader weaknesses in the financial sector. He outlined a number of factors in modern credit markets that have tended to amplify the financial cycle, including a growing reliance on credit ratings, a greater proportion of balance sheets coming under mark-to-market accounting, asymmetric remuneration structures that reward risk-taking, and regulatory incentives. He concluded that the Bank was assessing proposals to make the regulatory system more countercyclical and was discussing the best approach with the Financial Services Authority and international colleagues at the Financial Stability Forum.

### The credit crunch and the UK economy.

John Gieve, Deputy Governor, September 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech358.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech358.pdf)

In this speech, John Gieve discussed how the credit crunch was affecting the wider UK economy. He noted that like other central banks, the Bank of England had adapted its money market operations to provide the liquidity the banking system as a whole should require. First, the Bank of England had allowed banks to increase their reserve balances held at the Bank, increasing the size of overall provision of central bank money. Second, within that larger total, the Bank had shifted the balance towards longer-term lending as the terms of market finance had shortened. Third, the Bank had widened the collateral accepted for longer-term repos. And in April, the Bank had introduced a special scheme to provide banks with up to three years' finance for legacy assets which had become illiquid. He explained why the risk of inflation expectations drifting upwards had been such a central concern of the MPC over the past year. He highlighted the importance of not underestimating the deflationary consequences of the credit crisis and that the news on that front remained worrying. He noted that although the Bank would continue to work for the return of calmer financial markets, this work should not be relied upon to deliver a quick reversal of the macroeconomic slowdown. On the contrary, the risk at the moment was that the slowdown in the real economy could be amplified through a contraction in banks' balance sheets. He concluded by noting the need for longer-term measures to prevent such financial imbalances from building up again in the next upswing and commended the countercyclical 'dynamic provisioning' approach to capital that has been developed in Spain.

### The Governor's speech to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds.

Mervyn King, Governor, October 2008.

[www.bankofengland.co.uk/publications/speeches/2008/speech362.pdf](http://www.bankofengland.co.uk/publications/speeches/2008/speech362.pdf)

In this speech, the Governor explained how the industrialised world had been engulfed by financial turmoil and why the radical action taken by the UK authorities to recapitalise the banking system had been needed to ensure its survival. He noted that the scale of central bank liquidity support had been unprecedented but was not, and never could be, the solution to the banking crisis which reflected deeper structural problems in the banking sector. Risks built up during benign times, from securitised mortgage lending, particularly US sub-prime mortgages, from banks' own mortgage exposures and from their funding through short-term wholesale

borrowing had been exposed by rising defaults and falling house prices, with the effects amplified by very high levels of borrowing relative to capital. The value of banks' assets had fallen with liabilities unchanged. And as uncertainty about the value of banks' assets had risen, markets had sent a clear message to banks around the world that they did not have enough capital. As that view spread, confidence in the system had been eroded. The recapitalisation plan was having a major impact in the restoration of market confidence in banks. But it would take time before the recapitalisation led to a resumption of more normal levels of lending and there might still be problems in other parts of the financial system and the emerging market economies. Attention had moved to the outlook for the UK and world economies, which had deteriorated quickly. It seemed likely that the UK economy was entering a recession. There were implications for fiscal policy, as well as monetary policy, from the crisis, though it should be possible for the Government to reduce its stake in the banking system, for example by selling units in a Bank Reconstruction Fund, and repay the additional debt issued. But a fall in capital inflows to the United Kingdom would, unless replaced by other forms of external finance, lead to adjustments in the trade deficit and exchange rate that would be larger and faster in the short term than otherwise, implying weaker domestic spending in the short run.

## Working papers

### Dealing with country diversity: challenges for the IMF credit union model.

Gregor Irwin, Adrian Penalver, Chris Salmon and Ashley Taylor, May 2008.

[www.bankofengland.co.uk/publications/workingpapers/wp349.pdf](http://www.bankofengland.co.uk/publications/workingpapers/wp349.pdf)

### An agent-based model of payment systems.

Marco Galbiati and Kimmo Soramäki, August 2008.

[www.bankofengland.co.uk/publications/workingpapers/wp352.pdf](http://www.bankofengland.co.uk/publications/workingpapers/wp352.pdf)