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 October 2008 *Report*.

Regular publications

Markets and operations article, *Bank of England Quarterly Bulletin*, 2008 Q4.

This article reviews developments in global financial markets since the 2008 Q3 *Quarterly Bulletin* up to late November 2008. The article also reviews the Bank's official operations during this period.

www.bankofengland.co.uk/publications/quarterlybulletin/qb0804.pdf

Markets and operations article, *Bank of England Quarterly Bulletin*, 2009 Q1.

This article reviews developments in sterling financial markets since the 2008 Q4 *Quarterly Bulletin* up to the end of February 2009. The article also reviews the Bank's official operations during this period.

www.bankofengland.co.uk/publications/quarterlybulletin/qb0901.pdf

Markets and operations article, *Bank of England Quarterly Bulletin*, 2009 Q2.

This article reviews developments in sterling financial markets since the 2009 Q1 *Quarterly Bulletin* up to 22 May 2009. The article also reviews the Bank's official operations during this period.

www.bankofengland.co.uk/publications/quarterlybulletin/qb0902.pdf

Speeches

Rebuilding confidence in the financial system.

Sir John Gieve, Deputy Governor, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech363.pdf

In this speech, John Gieve set out a blueprint for the reforms that would have to be put in place to restore confidence in the financial system. He began by detailing the case for the co-ordinated policy intervention. Structural vulnerabilities in the banking system had become apparent: access to cheap funds in wholesale markets had enabled a spectacular expansion of banks' balance sheets, leaving banks with insufficient capital and liquidity buffers. The package of recapitalisation, guaranteed funding and enhanced liquidity had been necessary to demonstrate that banks were capable of surviving the downturn. Looking ahead, John Gieve outlined three key lessons that needed to be learned by policymakers around the globe. First, macroprudential policies, perhaps along the lines of the Spanish system of 'dynamic provisioning', need to be developed. Second, a more effective regime for managing failing banks needs to be introduced. Third, cross-border crisis management has to be improved.

Learning from the financial crisis.

Sir John Gieve, Deputy Governor, November 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech367.pdf

In this speech, John Gieve highlighted the fact that the crisis is a truly global event because its roots lie in unbalanced global growth and its consequence is a severe downturn worldwide. The crisis has changed in nature over fifteen months so the policy response has had to evolve too, in terms of monetary policy, emergency liquidity measures, bank recapitalisation, and lending guarantees. He then outlined lessons from the crisis which policymakers should draw for the medium term. These include closer international co-ordination of monetary policy, better ground rules for cross-border financial crises, and the development of macroprudential tools, aimed at dampening the financial cycle. He described three possible macroprudential tools: dynamic provisioning, where banks build up provisions which can be drawn upon in a downturn; growth-related capital requirements; and tougher liquidity standards that will discourage banks from using less stable sources of funding to grow rapidly.

The Governor's speech to the CBI Dinner, Nottingham, at the East Midlands Conference Centre.

Mervyn King, Governor, January 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech372.pdf

In this speech, the Governor argued that the crisis — driven by the build-up of global imbalances and the explosion in the size of the financial system — pointed to the need to create a new policy instrument to limit the build-up of debt. Bank Rate should be used for its traditional task of targeting inflation, rather than being diverted to try to control financial imbalances. The Governor pointed to a 'paradox of policy', where almost any policy measure that was desirable in the short run was diametrically opposite to the direction policy would need to take in the long run. In the short run spending must be encouraged to support the economy, but in the long term we would need to save more as a nation. Similarly banks should be encouraged to run down their capital now to enable

them to absorb losses while continuing to lend, but in the long run they would need more capital. That suggested a need for clear policy frameworks to guide the policy response. In the area of monetary policy that framework is provided by the inflation target. With Bank Rate already very low, the MPC were preparing for the possibility that they may need to consider a range of unconventional measures to meet their remit. Those would need to be carefully designed.

Why banks failed the stress test.

Andrew Haldane, Executive Director for Financial Stability, February 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech374.pdf

In this speech, Andrew Haldane diagnosed some of the market failures in stress-testing practices highlighted by the financial crisis of the past 18 months. These roughly fall into three categories: disaster myopia, network externalities and misaligned incentives. He then went on to propose a five-point plan for improving stress-testing practices going forward to address these weaknesses. These measures involved better specification and regular evaluation of stress scenarios, including their second-round effects; plus a greater degree of engagement between risk managers and senior management and between financial firms and the authorities. They would also involve much greater public transparency about risk metrics and accompanying management actions.

Opening remarks for an LSE panel on the global economic crisis: meeting the challenge.

Timothy Besley, Monetary Policy Committee member, February 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech376.pdf

In this speech, Professor Tim Besley described the three main elements of the policy responses to the downturn. The first is a series of measures aimed at limiting directly the fallout from the financial crisis — including efforts to improve liquidity in financial markets, to recapitalise banks and to limit the impact of their 'difficult to value' assets on their lending activity. The second is the loosening of monetary policy — mainly so far by lowering official policy rates. Third, there have been fiscal policy responses, which are geared towards supporting demand in the face of weakening private investment spending and softening household demand. Professor Besley concluded that direct measures to prevent a sharper-than-desirable credit contraction should be understood and evaluated against the background of clearly defined policy objectives. The inflation-targeting framework with independent decisions by the MPC remains in his view a sound structure for monetary policy in the United Kingdom.

Seven lessons from the last three years.

Sir John Gieve, Deputy Governor, February 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech377.pdf

In his final speech as Deputy Governor, John Gieve looked back at the period of Great Stability and described seven lessons from his time at the Bank of England. First, he believed regulators should have a say in banks' risk management, as the recent crisis had shown that banks relied too heavily on flawed systems. Second, he outlined the gaps that existed in the United Kingdom's arrangements for resolving failing banks. He welcomed the new arrangements established by the Banking Act which bridge those gaps. Third, he noted that international co-operation and co-ordination procedures for resolving cross-border institutions were lacking and needed improvement. Fourth, he argued that the current generation of macroeconomic models used by central banks have drawbacks that need to be addressed. Fifth, he proposed that it may be less costly to avoid a bubble forming in financial markets than simply 'mopping up' after the crash. Sixth, he believed that central banks should adopt an 'intelligent approach to inflation targeting' to counter asset price booms and credit expansion. His final lesson was that the authorities require another instrument to stabilise the economy. He considered what form the instrument could take and who should be in charge of it.

Finance: a return from risk.

Mervyn King, Governor, March 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

In this speech, the Governor discussed the nature of risk in the financial system to draw lessons about the policy responses that are required to ensure greater monetary and financial stability in the future. He considered the design of future banking regulation and the more urgent need to recover from the present crisis.

The Governor stated that at the heart of the crisis was an inability to perceive the true nature of the risks involved, which has been a persistent feature of crises over time. He stressed that regulation should be 'simple and robust'. He argued that, 'To correct these types of market failure will require a system of regulation that effectively marries the 'top down' assessment of the risks to the system as a whole to the 'bottom up' supervision of individual institutions.'

He went on to discuss why these measures should not involve monetary policy being diverted from its role of controlling inflation. Instead, he supported the introduction of additional tools. 'What is needed is an additional instrument… to

provide the authorities with the ability to control the growth of the financial sector and its interactions with the wider economy.'

He also spelt out the need to address the weaknesses in the international monetary system that allowed global imbalances — one of the underlying causes of the crisis — to grow unchecked.

Remarks to the Turner Review Conference by Paul Tucker.

Paul Tucker, Deputy Governor, March 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech384.pdf

In these remarks, Paul Tucker summarised views on a range of policy issues for making the global and domestic financial system more resilient in future. He defined 'financial stability' to a large degree as being about maintaining the value of private sector money (deposits with banks) in terms of central bank money. Alongside low and stable inflation, that is essential for broader monetary stability. He reviewed a few key issues in microprudential regulation: having supervisors prepared to face down bank management where necessary, but act with restraint; avoiding overly large exposures of any kind; and avoiding business structures that are too complex to supervise, a lesson from BCCI. He emphasised that all banks should hold a core liquidity buffer of high-quality government bonds; and that regulatory capital should essentially comprise equity, as only it can absorb losses. On the debate about macroprudential supervision, he identified five big issues that need to be resolved: whether the objective should be to dampen the credit cycle; whether it is enough to focus on banks; what the instruments should be; whether the policy should be based on rules or discretionary judgements; whether individual national authorities would need to co-operate or co-ordinate in any way. Finally, he stressed that policies to make the banking system and capital market more resilient in the event of a future bubble bursting were just as important as taming the cycle.

Rethinking the financial network.

Andrew Haldane, Executive Director for Financial Stability, April 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech386.pdf

In this speech, Andrew Haldane applied lessons from other disciplines, including ecology, epidemiology and engineering, to consider the financial system as a complex adaptive network. Using network theory, he outlined how the emergence of complexity and homogeneity in the financial network over the past decade had resulted in sharp discontinuities in the financial system. He then went on to suggest three broad areas for improvement in the robustness of the financial network. First, improvements in data are needed, in terms of better data collection, better analysis of the data, and better communication of the results to the public. Second, regulation of the network is needed to ensure appropriate control of the damaging network consequences of the failure of large, interconnected institutions — systemic regulation. Finally, the financial network should be structured so as to reduce the chances of future systemic collapse. Central counterparties, netting-off gross claims within the financial system, and public authority intervention against undesirable structural developments are possible solutions.

Containing system-wide liquidity risks: some issues and challenges.

Nigel Jenkinson, Adviser to the Governor, May 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech388.pdf

In his speech, Nigel Jenkinson set out a number of high-level objectives that should help guide future research and analysis on the development and design of a framework to strengthen the regulation of system-wide liquidity risks. He reviewed the origins of the present financial crisis, noting that defences against a rise in system-wide liquidity pressure were clearly inadequate and that attempts by banks to use defences designed to address idiosyncratic liquidity problems severely compounded system-wide stress. He noted that reducing the likelihood and impact of future episodes of system-wide liquidity risk was high on the policy agenda. He welcomed the initiatives being taken by the Basel Committee and the Committee of European Banking Supervisors to strengthen the management and supervision of liquidity risk by individual firms, but believes future financial regulation needs to take stronger account of system-wide implications. He gave a preliminary assessment of some of the issues and challenges in meeting five high-level objectives that should influence the future design of a new framework. He thought good progress had already been made in some of the areas but in others, research is only just beginning. He concluded that any new framework must balance the containment of system-wide liquidity risks against the benefits the financial system provides through maturity transformation and the taking of liquidity risk.

The repertoire of official sector interventions in the financial system: last resort lending, market-making, and capital.

Paul Tucker, Deputy Governor, May 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech390.pdf

In this speech, Paul Tucker discussed the role the authorities can play in providing crisis support to the financial system. The

current crisis has underlined how problems of funding liquidity, asset-market liquidity and solvency are intertwined. And those dimensions of a systemic crisis map into the authorities' capability, in principle, to be a lender of last resort, a market maker of last resort (MMLR), and a provider of capital of last resort. In relation to central bank liquidity insurance to banks, he explains the thinking behind the Bank of England's new permanent facilities: the Discount Window Facility and wider-collateral long-term repos. Their design reflects the Bank's objective in this area: to reduce the cost of disruptions to the liquidity and payments services supplied by commercial banks by balancing the provision of liquidity insurance against the costs of creating incentives for banks to take greater risks, and subject to the need to avoid taking risk onto its balance sheet. The authorities also need to set the right regulatory framework for banks' management of their liquidity. He argued that regulators should define the 'liquidity buffer' to comprise high-quality securities that can reliably be traded or exchanged in liquid markets, including in stressed circumstances. In practice, that would mean focusing on government bonds in many economies.

In relation to the debate about MMLR operations, he outlined for debate six possible principles, stressing the need for a central bank to perform a catalytic role, helping ideally to kick-start markets rather than replace them. He argued that there was also a need for principles and policies for what might be called 'capital of last resort' given the recurrence through history of episodes when governments have ended up bailing out banks. In that connection, he also suggested for debate that one possible approach would in future be to build on the example of deposit insurance schemes by putting more of the cost of banking system failures on shareholders in the banking system generally rather than the general taxpayer.

The state of the markets: four issues.

Paul Tucker, Deputy Governor, June 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech391.pdf

In this speech, Paul Tucker remarked on four broadly linked issues.

On the macroeconomic outlook and bank lending he said the medium-term outlook remains 'highly uncertain'. He noted that for the moment it is unclear as to whether the financial system can generate the expansion of credit that will most likely be necessary to support recovery. He warned against the risks of banks simultaneously deleveraging by cutting back on the availability of credit, pointing out that this would be a 'counter productive business and financial strategy'.

On the Bank's policy response to the crisis, he discussed quantitative easing and its interaction with the insurance industry and other long-term investment institutions. On trade and working capital finance, he welcomed the recent initiative by the insurance industry to release a code of conduct for trade-credit insurance.

On developing more resilient capital markets he noted that entrepreneurial innovation in capital markets may have outstripped the supporting market infrastructure. In particular he said that the Bank of England agreed that more of the vanilla OTC markets should be cleared via central counterparty clearing houses. He went on to say that the financial community must also be open to more trading in core vanilla markets going via exchanges or other well-designed and open trading platforms, to help preserve liquidity when times are tough. Indeed serious consideration is needed of whether the corporate bond markets could benefit from exchange trading.

Finally, on bank capital instruments, he argued that only equity should count as regulatory capital for banks in the medium term; and called for investors to consider exchanging subordinated debt for equity or senior unsecured debt, as has already occurred in some cases.

The Governor's speech at the Mansion House.

Mervyn King, Governor, June 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech394.pdf

In this speech, the Governor noted that the macroeconomic outlook is particularly uncertain. There were reasons to be optimistic about the outlook but the continued weakness of bank lending suggested a need for caution. He also noted that although it is too soon to reverse the extraordinary policy stimulus that has taken place over recent months, it is not too early to prepare for such exit strategies and explain how they would work.

He argued that we must learn lessons from the events of the past two years. One key lesson is that price stability does not guarantee stability of the economy as a whole. But this does not mean that monetary policy should be diverted from its goal of price stability. That would risk making the economy less stable and the financial system no more so.

Instead new instruments to pursue financial stability are required: a 'macroprudential' toolkit to reduce risk across the financial system. But the 'macroprudential' toolkit should not be put together in a hurry. And, more generally, we will need to reflect more deeply on the lessons from the crisis before designing a regulatory response.

Finally, the Governor noted that the Bank needs suitable powers if it is to be able to meet its new statutory responsibility for financial stability.

Working papers

Estimating the determinants of capital flows to emerging market economies: a maximum likelihood disequilibrium approach.
Guillermo Felices and Bjorn-Erik Orskaug, November 2008.

www.bankofengland.co.uk/publications/workingpapers/wp354.pdf

The network topology of CHAPS Sterling.
Christopher Becher, Stephen Millard and Kimmo Soramäki, November 2008.

www.bankofengland.co.uk/publications/workingpapers/wp355.pdf

Output costs of sovereign crises: some empirical estimates.
Bianca De Paoli, Glenn Hoggarth and Victoria Saporta, February 2009.

www.bankofengland.co.uk/publications/workingpapers/wp362.pdf

Common determinants of currency crises: role of external balance sheet variables.
Mirko Licchetta, April 2009.

www.bankofengland.co.uk/publications/workingpapers/wp366.pdf

Banks' intraday liquidity management during operational outages: theory and evidence from the UK payment system.
Ouarda Merrouche and Jochen Schanz, June 2009.

www.bankofengland.co.uk/publications/workingpapers/wp370.pdf

Payment systems, inside money and financial intermediation.
Ouarda Merrouche and Erlend Nier, June 2009.

www.bankofengland.co.uk/publications/workingpapers/wp371.pdf

Funding liquidity risk in a quantitative model of systemic stability.
David Aikman, Piergiorgio Alessandri, Bruno Eklund, Prasanna Gai, Sujit Kapadia, Elizabeth Martin, Nada Mora, Gabriel Sterne and Matthew Willison, June 2009.

www.bankofengland.co.uk/publications/workingpapers/wp372.pdf