BANK OF ENGLAND

We are not ‘risk nutters’ stifling the recovery

Article by

Andrew G Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee

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As recent events illustrate, restoring trust in our banking system is an urgent priority. To do so will require at least three things. First, a thorough cleansing of the banking stables so that errors of the past — from bad loans to bad advice — are no longer a drag on investor and customer confidence.

Second, a reconfiguration of the structure of banking so that in future basic services are no longer contaminated by investment banking activities. Key to that is faithful implementation of the proposals of the Independent Commission on Banking. Indeed, we may need “Vickers plus”.

Third, we need a regulatory structure that promptly identifies risks that might emerge across the financial system and protects households and businesses from them. This is so-called “macroprudential policy” and a new Financial Policy Committee (FPC) was set up by the Government last year to execute it.

Because it is early days, understandable questions have been raised about the role of this Bank of England committee. In particular, some worry that it will focus on reducing risk in the financial system to the detriment of growth and lending.

The Bank of England has been here before. In 1997, when the Monetary Policy Committee (MPC) was established, some worried that it might become an “inflation nutter” with a one-eyed focus on reducing inflation to the detriment of growth and unemployment. Since then, many sceptics have been won around. The FPC’s mandate and its actions to date suggest that those “nutter” accusations are no truer of this committee today than they were of the MPC in 1997.

Consider first the FPC’s mandate. Its main statutory objective is to preserve the resilience of the financial system. But the Chancellor’s Mansion House speech last month importantly made clear that it should also support the Government’s objectives for growth and employment so long as they do not conflict with financial stability.

The objectives of the FPC and the MPC now have a clear symmetry — for the FPC financial stability, for the MPC monetary stability. Both have a common secondary objective of supporting growth and employment. And both are expected to play a role in smoothing out the bumps in the macro-economic road, curbing booms and cushioning busts.

That is precisely what the FPC’s actions to date have aimed to achieve. Over the past six months it has asked UK banks to take out additional insurance against adverse eurozone developments by raising temporarily their levels of equity capital. With credit weak, this has led some to argue that the FPC could be undermining lending and growth — a “risk nutter” strategy.

In fact, its recommendation is meant to support both. Credit growth is weak because banks’ lending rates have risen sharply in line with their funding costs. Those higher funding costs reflect market fears about the safety of banks. Raising the capital cushion of banks lowers this risk, thereby reducing their funding and lending rates. This should support credit growth and spending in the economy.

Higher levels of capital also help to directly finance extra lending. Capital is not mattress money. It is there to fund loans to businesses and households — something both badly need as credit conditions have continued to tighten. In this way, the FPC's recommendations directly complement the new "funding for lending" scheme being developed by the Government and the Bank to support lending to the UK economy.

Last week the FPC took further steps to support lending and growth. It recommended that the Financial Services Authority (FSA) adapt its regulatory guidance to UK banks on their stocks of highly liquid assets. Currently, these liquid asset stocks exceed half a trillion pounds. They are also well in excess of the FSA's own liquidity guidance. This is precisely the point in the economic cycle when some of those assets could be put to work to support credit and growth, not stuffed under banks' mattresses. The FPC's advice, and the FSA's subsequent actions, are a step towards achieving that objective.

It is early days. But provided it keeps its sights set on preserving stability and supporting the real economy, the FPC can do its bit to rebuild trust in the banking system.