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News release

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The Debate on Financial System Resilience: Macroprudential Instruments - Speech by Paul Tucker

In a speech in London today, Paul Tucker - Deputy Governor for Financial Stability and a member of the MPC - discusses the possible role of macroprudential instruments in making the financial system more resilient to swings in the credit cycle.

As part of the backdrop to that debate, he highlights the need for banks to hold more capital, which is properly loss-absorbing, and high-quality liquidity. He also favours reviving a supervisory culture centred on making forward-looking judgments about an institution's management and business resilience. But he stresses that: "However good a country's supervision, banks and other firms will fail." That requires decent resolution regimes, something the UK now has. As chair of the Financial Stability Board's working group or cross-border resolution, he describes the international plan of work on 'Living Wills'.
Paul Tucker goes on to discuss the case for macroprudential instruments to address sources of instability that are beyond the circumstances and regulation of individual firms. He says booms are partly spurred by illusions about risk and returns along with ". a potent collective action problem in getting off the dance floor" such that "an intervention of some kind is needed from someone outside the dance" to maintain the stability of the banking system as a whole. He considers four issues that the debate about macroprudential policy needs to address, stressing that the Bank was contributing to the debate rather than advocating a fixed position.

Objectives. Paul Tucker says that the Bank currently favours an objective of strengthening the resilience of the banking system during credit booms - dynamic resilience of the banking system.

Instruments. He is doubtful that the instrument should be variation in required headline minimum capital ratios over the course of the credit cycle. That might be insufficient to deal with exuberance in lending in specific sectors and indeed could even permanently lead to cuts in lending to unexuberant parts of the economy. He says, ".quite often a credit boom is at least initially concentrated in one or a few sectors of the economy. That being so, the appropriate instrument needs to be able to work with a degree of granularity". Therefore, the Bank sees a stronger case for adjusting risk weights, or collateral haircuts, to particular classes of borrower to address incipient problems emerging from credit exposures.

Rules or discretion? He outlines the arguments for constrained discretion rather than a specific rule on the grounds that: "To steer the banking system towards increasing its resilience to incipient problems in a stretched sector, a whole series of judgments would have to be made. Whether the rate of credit growth seemed excessive; whether terms were overly lax; or whether the 'bubbles bursting' would materially damage banks." He says, " ...it seems to us implausible that the instrument could be applied according to a rule. Instead, policymakers would need to meet periodically to make judgments faced with enormous uncertainty." This would make it difficult to define a rule that a macroprudential instrument should follow. But discretion would need to be constrained by transparency and accountability. Paul Tucker argues that this would probably enhance the effectiveness of any macroprudential tool.

Leakage. Paul Tucker draws attention to the inevitable hazards in trying to influence domestic credit conditions in a world in which capital can flow freely across borders. But even if lending to a sector was untamed by changed capital requirements on domestic banks because borrowers turned to overseas banks, UK-based banks might prove to be more resilient when losses arose. It would be important to share analysis with international peers and it might even be feasible to explore some degree of co-operative macroprudential response in some instances to avoid conflicting policy responses.

Concluding, Paul Tucker says: "The current crisis has reminded everyone that our primary interest in regulating the banking sector is the preservation of systemic stability and so of the vital services banks perform in our economy and financial markets. There are two great lessons from the crisis. One is banks can fail and so we would be wise to have robust resolution regimes and plans. The second is that the financial system is a system. One that contains complex and shifting inter-connections. And one that can generate pronounced credit cycles, which even if they initially affect only asset values, eventually can materially affect the real economy. This is why the macroprudential debate is so important. It has been a long time coming."

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech407.pdf

Notes for Editors

1. A discussion paper on macroprudential policy will be published by the Bank of England in the coming weeks.

2. Paul Tucker chairs the Financial Stability Board Working Group on the Principles for Cross-Border Co-operation on Crisis Management.

3. Today's speech follows a series of speeches on the theme of the social contract for banking. The first discussed the micro and macro supervision of banks - 'Remarks at the Turner Review Conference'.
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech384.pdf
Panel session at The Turner Review Conference, London, 27 March 2009. A second speech addressed the liquidity insurance provided by central banks to banks and markets - 'The Repertoire of Official Sector Interventions in the Financial System: Last Resort Lending, Market-Making, and Capital'.

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech390.pdf
Bank of Japan's 2009 International Conference, Tokyo, 28 May 2009. A third speech discussed the need for banks to run themselves in a way that facilitates the orderly management of crises, including through deposit insurance and the resolution of distressed firms - 'Regimes for Handling Bank Failures: Redrawing the Banking Social Contract'.
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech396.pdf
British Bankers' Association Annual International Conference, London, 30 June 2009.