



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

24 April 2012

Financial arms races - remarks by Andrew Haldane

In remarks given at the Institute for New Economic Thinking in Berlin on 14 April 2012, Andrew Haldane – Executive Director for Financial Stability and member of the Financial Policy Committee – argues that structural features of the financial system can make it prone to arms-race-type behaviour. He argues that macro-prudential policy intervention to constrain this behaviour can create healthier outcomes for the financial system as a whole.

Although financial arms-races are not a new phenomenon, the increase in financial scale over the past 30 years has intensified these pressures. Haldane uses three examples, from the past, present and future respectively, to demonstrate this point.

First, he notes that performance measures in banking, such as returns on equity and executive compensation, rose dramatically in the pre-crisis period. As banks tried to keep up with their competitors by growing their balance sheets, a spiral in a pay and returns emerged. This resulted in a “high-leverage equilibrium” that “sowed the seeds of the financial crisis.”

Second, the technological revolution in financial markets has created a quest for speed in trading activities. Despite its individual benefits, Haldane argues that the emergence of high-frequency trading may have created uncertainties and externalities. He points to market dynamics during the so-called Flash Crash: these “Liquidity mirages and message traffic congestion are nibbling away at the common good of market stability.”

Third, investors’ pre-crisis quest for return has been replaced by a quest for safety. As a result, a large and rising fraction of global banks’ refinancing has taken place on secured terms. But Haldane argues that the quest for individual safety may generate system-wide instability: “at high levels of encumbrance, the financial system as a whole may even be riskier, as it is more susceptible to pro-cyclical swings in the underlying value of banks’ assets.”

Haldane suggests that these arms-races – in return, speed, and safety – could have been forestalled. But to be effective, policy intervention would have needed to constrain behaviour across the financial system as a

whole. In other words, "... policy needs to have a macro-prudential, as distinct from micro-prudential, perspective".

Haldane then turns to the tools that macro-prudential agencies, such as the FPC, might need to tackle financial arms-races. Constraints on banks' leverage could have "... defused the return on equity race at source". Restrictions on cash distributions by banks, a favoured recommendation of the FPC over the past six months, can also help. Haldane welcomes measures such as maximum order cancellation ratios and strengthening circuit-breakers to curb speed races in financial markets. Finally, the FPC has paid increasing attention to the systemic risk posed by rising levels of bank encumbrance. Haldane suggests that greater transparency and maximum limits on asset encumbrance could be considered as possible policy options.

Key Resources

Financial arms races (101k)

<http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech565.pdf>

Remarks by Andrew Haldane

YouTube video (external site)

http://www.youtube.com/watch?v=Qjt_Oc9PJE0&list=PL6380884C0F0C996E&index=12&feature=plpp_vid
[o](#)

View the video of Andrew's remarks