BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

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The Financial Policy Committee of the Bank of England; an experiment in macroprudential management – the view of an external member - speech by Richard Sharp

In a speech at the London School of Economics, Richard Sharp – external member of the Financial Policy Committee – discusses the background to the creation of the FPC, its powers and objectives, and some of the challenges he sees facing the Committee. Richard stresses that trying to predict financial shocks is extremely difficult, given the degree of uncertainty about how the financial system operates. For that reason, he argues that the FPC should ensure that "the system has built up sufficient strength and resilience so that such events can be effectively managed", while also achieving its secondary objective to support the government's economic policy.

Richard explains that the recent financial crisis caused governments and regulators to rethink and redesign much of the global regulatory framework. In the UK, the regulatory architecture is now vastly different: "roles and responsibilities are more clearly defined and accountability is clearly allocated". Among the most important of these changes was the introduction of the FPC. As Richard says, "Critically, it is now understood that effective macroprudential policy sits at the heart of interconnected policies which all touch on financial stability…Hence the importance in creating an appropriate structural response which has a singular entity charged with financial stability. In the UK that is the FPC."

Richard describes the roles and responsibilities of the FPC. It has two statutory objectives: "First, to contribute to the achievement of the Bank of England's Financial Stability Objective and, second, subject to that, to support the economic policy of HM Government, including its objectives for growth and employment." He explains that, in order to achieve these objectives, "The FPC has powers to give directions to the PRA and the FCA in relation to the use of certain specified macroprudential instruments – which are currently the sectoral capital requirements and countercyclical capital buffer; it can make recommendations to anybody, including to the PRA and the FCA on a "comply or explain" basis; and it is able to make recommendations to HM Treasury, including on the boundaries within and around the perimeter of the PRA and FCA regulatory regimes."

The conduct of macroprudential policy, Richard argues, "is vitally important but is unfortunately particularly challenging". Among the challenges he identifies are: identifying the build-up of systemic risks; the lack of empirical evidence on the impact of macroprudential tools; the need to balance the objectives of financial stability and economic growth; and understanding the interaction of macroprudential, monetary and microprudential policy. In addition, the openness of the UK financial system means unpredictable external events can have a profound effect on financial stability, and data gaps limit the understanding of correlations between firms' assets and financial interlinkages more generally.

Uncertainty is a common theme behind these challenges. Richard reminds us that predicting financial crises is difficult, and economic history is a useful reminder that seeking to "forecast future market directions or developments is invariably an extremely hazardous exercise."

Given that, "a central belief of mine is that macroprudential regulation and policy making should always prioritise protecting the robustness and resilience of the financial system and not act on the expectation that significant systemic risk can always be appropriately anticipated and thereby be securely avoided."

Richard concludes by outlining what he sees as the current challenges facing the FPC. These include: risks around the economic recovery; the need for the banking sector to move along the transition path to higher levels of capital; the risk of a correction in asset prices were there be to a snap-back in interest rates; and vulnerability to external shocks. He says that the "last year has seen a tremendous move towards more economic stability" but, "it is perfectly conceivable that new shocks or difficulties are just around the corner."

Given this uncertainty, Richard stresses that: "when it comes to evaluating the FPC, please do not expect an omniscient Committee which, by their collective capabilities, can always successfully anticipate shocks. Whilst we will do our best to anticipate shocks and minimize the possibility of them arising, it is better that the FPC should be viewed as unequivocally accountable for ensuring that, when such shocks do occur – and indeed they will – the system has built up sufficient strength and resilience so that such events can be effectively managed."