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The Outlook for Countercyclical Macroprudential Policy – speech by Sir Jon Cunliffe

In a speech to the Graduate Institute in Geneva on Tuesday, Sir Jon Cunliffe considers the level and composition of credit in the economy and discusses the ways in which policymakers may need to assess the credit cycle and address risks as the economic recovery continues.

"As the UK economy continues to expand, and as monetary policy normalises – which we expect to be limited and gradual – we will more and more need to think about the time-varying element of our mandate, how the associated credit cycle is developing and whether and how we apply our reforms to address this," Jon says.

Jon then considers developments in the provision of household and corporate credit and concludes that the overall picture of the credit cycle in the UK suggests that it is entering into a more "normal" phase. He notes that although at an aggregate level credit in the economy is growing below pre-crisis levels, that metric might be misleading, whilst aggregate indebtedness is considerably below pre-crisis levels, but remains high.

"As we move forward in the credit cycle, I think we will need to consider whether and how risks are building in the financial system and how they should be addressed. This is of course already a regular and important element of the FPC's discussions. But my guess is that it will become even more so in the next phase of the cycle," Jon says.

One question that will be increasingly important to the FPC, concerns the objective and framework for time-varying macroprudential policy. One approach to macroprudential policy is to aim to ensure that tail risks do not increase with the credit cycle, so that the resilience of the system is maintained over time and does not change with the distribution of risks.

Stress testing of banks can play an important part in assessing resilience through the cycle, Jon argues. Stress tests provide an assessment of whether the capital buffers held by banks are sufficient to absorb losses in a stress, so they are well suited to guide the calibration of counter-cyclical capital buffers. The Bank's counter-cyclical approach to annual stress testing of banks, to be introduced in 2016, will be a key part of a forward looking, data driven approach to setting the countercyclical capital buffer for banks.

Jon highlights three issues facing the FPC: first, assessing the costs and benefits through time, another is where to set the counter-cyclical capital buffer in different parts of the cycle to enable it to be relaxed at times of stress, and a third, how far in advance one needs to act.

“If you thought that the impact of changes in the CCB happened with a lag, that there were benefits in a CCB above zero that could be relaxed, that risks were building or that there were benefits to moving policy gradually, these would point to moving earlier rather than later in the cycle,” Jon observes.

Another approach to time-varying macroprudential policy would take this further and set it with the explicit objective of pushing back on the cycle until the level and perhaps the composition of credit was judged to be more acceptable in risk terms. Jon says this would be a bigger “call” for policymakers and should not be the starting point of the macroprudential framework, the starting point should be maintaining resilience.

“But given the history and the objective of maintaining financial stability, I do not think that the macroprudential authority can foreswear making such calls when necessary,” Jon says, citing the FPC’s action on high LTI mortgages as one example of this approach.

Jon concludes that whilst the credit cycle remains hard to identify with precision, a key element of the mandate of macroprudential authorities is to try to assess it and to address the risks that build up in the financial system over the cycle – an issue that is becoming more pertinent in the UK.

“There is a benefit in ensuring that the financial system maintains resilience as the distribution of systemic risks moves through the cycle and where necessary trying to ensure that such risks do not build up unchecked.”

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