Bank of England speeches

A short summary of speeches and *ad hoc* papers made by Bank personnel since publication of the previous *Bulletin* are listed below.

The dog and the frisbee

Andrew Haldane, Executive Director for Financial Stability, and Vasileios Madouros, Economist, Financial Stability, August 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf

In a paper co-authored with Vasileios Madouros, Andrew Haldane explored why the complex financial regulation developed over recent decades may be a suboptimal response to the increasing complexity of the financial system. He used a range of examples from other disciplines to illustrate how decision-making in a complex environment has benefited from simple rules of thumb or 'heuristics'. Andrew argued that complex rules can have punitively high information costs, can yield unreliable predictions, especially in the presence of limited samples of data and might induce defensive behaviour. Andrew used a set of empirical experiments to assess the relative performance of simple versus complex rules in a financial setting. He found that simple metrics, such as the leverage ratio and market-based measures of capital, outperformed more complex risk-weighted measures and multiple-indicator models in their capacity to predict bank failure. In line with evidence from other settings, a consistent message from these experiments was that complexity of models or portfolios can generate robustness problems in finance. Andrew outlined five policy lessons from these findings, covering both the design of financial regulation itself and possible measures aimed at reducing complexity of the financial system more directly. These might include taking a more sceptical view of internal risk models used as part of the regulatory framework, treating simple leverage ratios equal to complex ratios, applying more judgement to supervisory approaches and applying price and quantity-based restrictions on banks to encourage them to simplify their balance sheets.

We are not 'risk nutters' stifling the recovery

Andrew Haldane, Executive Director for Financial Stability, July 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech595.pdf

In an article published in *The Times*, Andrew Haldane discussed the mandate of the Bank of England's Financial Policy Committee (FPC) and addressed concerns that it will focus exclusively on reducing risk, to the detriment of growth and lending.

The FPC has a main statutory objective to preserve the resilience of the financial system. But, mirroring the Monetary Policy Committee's dual inflation and growth mandate, the FPC is also required to support the Government's growth and employment objectives, so long as they do not conflict with stability.

Indeed, recent FPC actions have aimed to achieve precisely this. In particular, the FPC has recommended UK banks temporarily raise capital levels as insurance against eurozone risks, a policy aimed at supporting credit growth at the same time as increasing resilience. It has also recommended the FSA adapt regulatory guidance on UK banks' liquid asset buffers, with the aim of allowing more of those assets to support credit growth. Going forward, the FPC will continue in this vein, with eyes on both stability and supporting the real economy.

Let's make a deal

Robert Jenkins, Financial Policy Committee member, July 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech593.pdf

In this speech, Robert discussed three concerns voiced by bankers about the rise in regulation; they complain that regulations are too tough, damaging and numerous.

First, Robert disagreed that regulation was too onerous or severe. He suggested that pre-crisis rules — that required banks to have no capital for government bond exposures and minimal levels of capital for complex securitisations — were inadequate. And he noted that the backstop introduced by the forthcoming Basel III regulations — of 33 times leverage — remained relatively loose.

Second, he argued that higher capital levels would not be damaging, but instead would be consistent with the supply of lending to the real economy and long-term shareholder value. Higher capital requirements were just not compatible with non risk-adjusted banker pay.

Finally, Robert conceded the possibility that regulations were too numerous, noting that the regulatory establishment was not exempt from culpability. But, speaking in a private capacity, he proposed a moratorium on all new regulation followed by a review and rollback of the rule book, conditional on banks raising their tangible equity capital to 20% of assets, to protect the taxpayer from future collective failures of bankers and regulators.

FPC: one year young

Robert Jenkins, Financial Policy Committee member, July 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech594.pdf

In this article, Robert reflected on the recommendations of the Bank's Financial Policy Committee (FPC) in its first year. During the past twelve months, systemic fragility and troubles in the eurozone had been key threats; restoring confidence in the UK banking system has been the priority.

In response, the FPC has urged banks to increase levels of loss-absorbing capital, as opposed to capital ratios. This reflected the Committee view that balance sheet strength is compatible with the supply of credit to the UK economy — while lack of resilience, real or perceived, would curtail it.

Robert noted that the nature of the UK banking system permitted a differentiated approach to the resiliency recommendations. He encouraged vulnerable banks to continue to build capital, while suggesting that those less exposed to risks and who are well-positioned by their franchise to lend to the domestic economy should feel free to utilise any excess liquidity buffers to do so.

Reflecting the recent announcement of an additional objective for the FPC, to capture economic growth as well as financial stability, Robert noted that the Committee were already there, and the tension between the two would be the timing and not the goal.

Monetary policy: navigating rough waters

Martin Weale, Monetary Policy Committee member, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech590.pdf

In a speech delivered at the Hart Brown Economic Forum, Martin Weale reviewed the outturns for inflation and growth compared to the first forecasts he contributed to as a Monetary Policy Committee member. In considering the weaker-than-expected growth he noted that the productivity lost seems unlikely to be recouped, but that it could return to trend growth if demand were more buoyant and that the recent easing of inflationary pressures reduced the risks associated with this. Looking at the more immediate prospects for the economy, Dr Weale said he shared the view of other Committee members at the June meeting that further monetary stimulus could be applied to the economy without putting the inflation target at risk, but he wanted to wait for the outcome of the discussions between the Bank and the Treasury on possible new measures before he felt able to come to a view on the appropriate stimulus. After commenting on some of the new measures announced by the Governor, Dr Weale concluded that the Bank and the Treasury have taken important steps to provide extra monetary support for the financial system and thus the economy as a whole.

Shining a light in the shadows — reflections on transparency in the securities lending and repo markets

Andrew Hauser, Head of Sterling Markets Division, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech591.pdf

In a speech delivered to the annual International Securities Lending Association conference in Madrid, Andrew Hauser set out the key conclusions of a recent review of transparency in the securities lending and repo markets by market practitioner members of the Bank's Securities Lending and Repo Committee (SLRC).

The review had concluded that there were clear transparency gaps in certain parts of the securities lending and repo markets. A well-designed trade repository would be one way to help throw light on those markets, give timely insight into the build-up of potential systemic risks, and thereby provide for a more targeted and proportional response by regulators. For a repository to succeed, SLRC practitioners felt that regulators needed first to give a clear steer on the data they would require and ensure they had the analytical tools needed to interpret those data effectively. The group had also stressed a strong preference for a single, global solution which paid close attention to operational and legal details. The group had concluded by stressing the need to maintain the momentum for change, and had fed its conclusions into the Financial Stability Board's review of shadow banking, which would be making policy recommendations later in the year.

View from the macroprudential bridge

Robert Jenkins, Financial Policy Committee member, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech589.pdf

In this speech, Robert discussed developments in the eurozone, the stability of the global financial system and the nature of market liquidity.

First, Robert recognised that the notion of cross-border risk would need to be banished in order to prevent the economic recovery in the euro area from being constrained. Cross-border risk — the risk that borrowers might not be able to repay euro lenders due to fears about re-denomination or exchange controls — had previously been assumed absent from the fabric of the eurozone, but had recently been impairing the free flow of capital within the euro area.

Second, the global financial system was highly accident prone due to both the size and interconnectedness of the system. The size of the system was problematic because even small moves in percentage terms could lead to large losses; and, the system had now become large even relative to sovereign balance sheets. This led Robert to question whether systemic risks exceeded the system's ability to absorb potential losses.

Third, Robert recognised that the days of instant market pricing and limitless liquidity were fading. He suggested that the risk that governments might intervene in the interests of stability might undermine the perception that market liquidity was limitless and free, even for seemingly more liquid assets.

The Governor's speech at the Mansion House

Sir Mervyn King, Governor, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech587.pdf

In his speech, the Governor commented on three themes: the prospects for the UK economy; measures to ease the flow of credit to the economy; and the new approach to banking supervision under the Prudential Regulation Authority.

The prospects for a recovery and rebalancing of the UK economy remained difficult. Unexpected increases in world energy and commodity prices had led to a squeeze in take-home pay and weak consumer spending. The cost of credit to households and firms had also risen, prompted by the 'black cloud of uncertainty' from the euro area, which was also acting as a brake on growth.

The Governor noted the case for further action by the authorities to ease the flow of credit. Central bank purchases of private sector assets were one option. But the decision of which assets to buy, and hence, which risks to expose taxpayers to, remained a decision for elected governments.

The Governor explained that measures to ease conditions in the banking sector could complement monetary policy easing. The Bank had set up and activated its Extended Collateral Term Repo Facility to provide short-term sterling liquidity to banks. The Bank was also working with HM Treasury on a Funding for Lending Scheme that would provide funding to banks for several years, at rates below market rates, and linked to the performance of banks in lending to the real economy.

The Governor concluded by noting the three key principles on which prudential supervision, under the new Prudential Regulation Authority, would be based. First, the need for banks to have adequate loss-absorbing capacity, as measured using both capital and leverage indicators of risk. Second, the importance of a resolution mechanism to successfully resolve failing banks, doing away with the 'too big to fail' problem. Third, a shift from rules-based supervision to judgement-led supervision, focusing more on the big risks, and less on unnecessary details. The new approach would be a positive change for banks, regulators and taxpayers alike.

Property booms, stability and policy

Paul Tucker, Deputy Governor, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech586.pdf

Paul Tucker identified three lessons from past excess in property markets. Losses on lending demonstrated commercial banking can be just as risky as investment banking. The costs of bank failure can be greater when the industry is concentrated. And persistently easy monetary policy can fuel exuberance. He then set out thoughts on policy in the current conjuncture. Credit conditions had tightened following increases in bank funding costs. That reflected the risk of a bad outcome in the euro area. The authorities, including the Bank, needed to consider what more could be done to alleviate tight credit conditions. On regulatory policy, while threats persisted banks should take what opportunities they had to build capital levels. When threats recede, capital planning should then normalise. Liquidity was different. Central banks stand ready to provide liquidity in stressed conditions. As such, there was currently less of a case for banks to maintain their stock of liquid assets. Liberating this part of balance sheets could free up reserves injected through QE.

Making the most of doing more

Adam Posen, Monetary Policy Committee member, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech585.pdf

In this speech, Dr Posen called for new means of monetary policy stimulus in the United Kingdom and abroad. Policy defeatism was unjustified because targeted monetary ease would alleviate investors' risk aversion and spur investment. The weak UK recovery reflected insufficient policy stimulus to date, given the forces weighing on the economy, but also signalled the need for more targeted policy given high and rising spreads on mortgages and on loans to small and medium-sized enterprises (SMEs). Dr Posen advocated the purchase by the Bank of SME loans bundled into securities by a Government entity. The pooling of risk would insulate the Bank from credit risk while Bank purchases would deepen the market for securitised SME lending. Dr Posen dismissed worries about asset purchases diminishing central bank independence from politicians, calling on finance ministries to follow HM Treasury in indemnifying central banks from losses incurred in performing their duties.

Tails of the unexpected

Andrew Haldane, Executive Director for Financial Stability, and Benjamin Nelson, Economist, Financial Stability, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech582.pdf

In a speech at the University of Edinburgh Business School, Andrew Haldane and Benjamin Nelson discussed risks to financial stability arising from overreliance on use of the normal distribution to measure tail risk.

Since Galileo, the normal distribution has become a cornerstone of statistical analysis — first in the physical sciences, then in the statistics of social, economic and financial systems. But real-world interactions rarely conform to normality. Whether natural or economic, complex systems are prone to fat tails, meaning assumptions of normality can lead to massive underpricing of catastrophe risk.

Accounting for fat tails will be a key challenge in avoiding future crises. There is a need to incorporate complexity and uncertainty into economic theory and for a fundamental review of institutional risk management tools. Policymakers will have a key role to play. This includes through: the introduction of systemic oversight agencies, including the Financial Policy Committee in the United Kingdom; efforts to develop data and common languages to map economic interactions; and recognition that system robustness may be found in structural simplicity, rather than complex regulatory rules.

Resolution through the lens of corporate restructuring

Andrew Gracie, Director, Special Resolution Unit, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech583.pdf

In a speech delivered to the International Association of Deposit Insurers' conference, Andrew Gracie, Director of the Special Resolution Unit, discussed the parallels between bank resolution and corporate debt restructuring. It was noted that while bank failures pose a different set of challenges to corporate failures — including the risk of severe disruption to the rest of the financial system — clear similarities between the two processes can be drawn. Both bail-in within resolution and corporate debt restructuring return an institution to solvency by reducing the company's outstanding debt burden through the imposition of losses on certain creditors and/or by converting certain creditors into equity. Both processes seek to avoid the value-destructive process of insolvency and liquidation, both maintain continuity of core functions provided by the institution and both respect the hierarchy of claims in insolvency law to the extent possible. These parallels have informed the resolution policy making process, and should give G-SIFI creditors and other stakeholders increased comfort around the tools and objectives of G-SIFI resolution regimes.

Banking myths and shibboleths

Robert Jenkins, Financial Policy Committee member, June 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech584.pdf

In this article, Robert rebutted concerns that an increase in regulation had become the greatest risk facing the banking sector.

Robert conceded that regulators were not exempt from culpability from the recent crisis. The regulatory establishment misjudged the breadth and depth of the risks that banks were running. And regulators also misjudged the ability of bankers to judge those risks.

But he dismissed bankers' concerns that higher capital requirements were not compatible with economic growth and shareholder value. First, Robert argued that more capital would not necessarily lead to lower lending. And second, he argued that return on equity was a poor measure of shareholder value, as it did not adjust for risk. On a risk-adjusted basis, investors may prefer less-leveraged firms; Robert noted that the market was attaching relatively higher valuations to the relatively less leveraged as evidence of this.