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Speech

The Financial Policy Committee at the Bank of England

Talk given by

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An important and interesting aspect of my post-Federal Reserve life has been my membership as an "external" on the interim Financial Policy Committee at the Bank of England. And I thought this audience might find it interesting to hear a little about the implementation of macroprudential policy in the United Kingdom. We issued our third set of recommendations just yesterday, so this is a good time to discuss our efforts to identify and deal with threats to financial and economic stability.

The Financial Policy Committee

I'll begin with some background on the establishment of the interim Financial Policy Committee. As in many places, the elected officials in the UK saw room for improvement in the performance of the various authorities responsible for financial stability, both in the build up of vulnerabilities and the response to the subsequent crisis. And they saw the shortfall as partly reflecting structural issues. In particular, the separation of bank supervision from the central bank, which occurred in 1997 when the Bank of England was given a clear price stability mandate and a greater degree of independence, seemed to impede the efficacy of supervision and of crisis response. The Bank retained generalized responsibility for financial stability and it published a much admired Financial Stability Report, but it did not directly participate in formulating and implementing the supervisory policies to establish and protect financial stability, and so did not itself have the levers to carry out its role effectively. The most obvious failing of the UK system, however, was that no single institution had the responsibility, authority, or powers to monitor the system as a whole, identify potentially destabilizing trends and respond to them with concerted action.

Shortly after the new government took office in the spring of 2010 it published a discussion draft of a new structure that moved the regulation and supervision of individual firms back into the Bank of England. Meanwhile the regulation of conduct within the financial system – including the conduct of firms towards their retail customers and the conduct of participants in wholesale financial markets – is to be carried out by a separate, dedicated, specialist body. To focus responsibility and accountability the Government has proposed a new subsidiary of the Bank – the Prudential Regulatory Authority – that will concentrate on microprudential oversight, while a new Financial Policy Committee will provide for the dedicated macroprudential overlay. The law to implement this new structure is still under discussion, but in the meantime the government has established an "Interim" Financial Policy Committee and given it two charges: First, identify risks to financial stability in the UK and make recommendations to deal with those risks; most of the recommendations are to financial institutions and Financial Services Authority, the FSA, which still has the responsibility for oversight of financial institutions. Both the risk identification and the recommendations are included in the Financial Stability Report, which is now the responsibility of the FPC.

Second, we are to make recommendations to the government about what tools we will need in the new law to do our job. Ultimately, we are to have two kinds of powers with respect to tools. First to make recommendations to the authorities where the FPC believes that specific regulatory actions are required in order to protect financial stability. These recommendations are subject to consideration by the relevant

authority and then to the usual rulemaking process if the authority decides to go forward. Second, if we see the threat to stability as being immediate and serious, we will be able to issue directives to the microprudential authorities on regulatory tools that should be deployed in the pursuit of macroprudential policy.

The interim FPC has 11 members, including four externals serving on a part-time basis, and it is chaired by the Governor; an observer from the Treasury also attends. The discussions have been vigorous and good – a wide range of views are solicited and expressed about the risks to the financial system and what can be done to ameliorate them. Meetings tend to focus on narrowing the number of issues and identifying the most effective responses. We greatly benefit from the range of backgrounds members bring to the task. Two members come from the FSA and are responsible for microprudential regulation and for implementing many of our recommendations; several are from the financial stability side of the Bank with their macro-financial perspective; several are macroeconomists who have dealt primarily with monetary policy issues and see the relationships between developments in the financial sector and the real economy; and importantly two of my fellow externals have quite extensive experience in the London financial markets, which they have utilized to bring issues to our attention and to inform many of the rest of us without such experience how our concerns are playing out in the "real world".

I am going to concentrate on the leg of our mandate that asks us to identify risks and make recommendations to preserve financial stability.

Risk Identification

Unfortunately, in one sense this hasn't been difficult. The UK is part of Europe, even if it's not part of the euro area, and its banks and businesses are exposed to developments in the ongoing saga of the fiscal, banking and business stresses so evident there. As a consequence, each time we met, we identified exposure to these developments as the primary systemic risk to the U.K. financial system.

We are also building on a risk-identification structure already in place at the Bank of England. Staff provide extensive briefings to FPC members in advance of our meetings. This includes information and analysis on the macrofinancial environment and short- and medium-term risks to financial stability – both in the UK and abroad in those markets in which UK banks are active. A key aspect of that analysis is the ability of the UK banks to withstand potential adverse developments. We review many different metrics and model outputs within this process. In addition, the Bank has an active market intelligence function that produces reports on what is going on in markets and the views of market participants about emerging risks. But of particular value is that members bring their own knowledge and understanding of the UK financial and economic system to the meetings. For myself, I make it a practice to talk to people in the financial sector on my visits to London so I can learn first-hand what stability issues are on their minds.

Recommendations

With very few exceptions, our recommendations have fallen into one of two broad categories. One category encompasses acquiring additional information for ourselves and for the public that we believe is necessary for the FPC and the markets to monitor and take actions to contain risks to financial stability. The second category has been a series of recommendations to build additional resilience into the banking system without impairing its willingness and ability to perform key intermediary functions, and in particular to supply credit to UK households and small and medium-sized enterprises.

On the information side, we have identified several practices that raised questions about stability, but for which we didn't know enough to make a judgment and we asked the FSA to gather additional information. One such practice involved complex funding structures, including those associated with synthetic ETFs and collateral swaps. We were concerned about a potential build up in interconnections that were difficult to understand, opaque to investors and counterparties, and therefore could contribute to mispriced risk and instability in a stress situation. The FSA found that British banks were not active in this area, but it will be important to monitor this sort of complex interconnection going forward to assure that the kinds of complex, opaque funding structures that contributed to the buildup of risks and proved so fragile in the crisis do not re-emerge.

We also have asked the FSA to look into loan forbearance and associated provisioning. By allowing both borrowers and lenders additional flexibility to work through debt obligations during temporary periods of stress, forbearance can be a stabilizing force for the economy and financial markets. But loans that have been subject to forbearance are also inevitably subject to greater risk than loans that did not need special treatment. If those risks are not adequately provisioned for, banks are in effect not as resilient as they might appear from their published capital ratios and balance sheets. The FSA had already looked into forbearance in residential real estate, but we asked that this work be extended to UK banks' household and corporate sector exposures on a global basis. Initial results for the UK commercial real estate sector indicated some under provisioning, but not enough to constitute a systemic risk. Under a risk-based approach, more work will be done on global exposures.

We also asked that the banks publish additional information so that private parties can better judge the safety and soundness of UK bank counterparties, increasing the role of market discipline in maintaining financial stability. As a generalization, UK banks are not as transparent as those in the US - for example complete reports are published semi-annually, not quarterly, and the published reports are just for one day, with very little if any information about intra period balance sheets. So one recommendation to the FSA has been to work with the British Bankers Association to increase the transparency of UK banks along a number of dimensions; this is an ongoing project we shall be returning to periodically.

Last June we were especially focused on European sovereign exposures and the just completed EBA stress tests. Uncertainty among those extending credit to banks about such exposures could undermine financial stability by inducing a generalized reluctance to fund UK banks in response to the threatening situation in the euro area. We asked the FSA to ensure that the exposures of individual major UK banks were released to the public and we asked the FSA to look at, and publish aggregate information on, exposures of the banks below the few largest. The publication of the requested information did occur and for the banks below the top few, it showed that euro area exposures were quite limited.

Just yesterday we recommended that the publication of leverage ratios be accelerated from 2015 as required under the Basel 3 guidelines to no later than the beginning of 2013. Widely varying applications of risk weights distort comparisons across banks and have the potential to reduce public confidence in the information content of capital ratios that use risk-weighted assets in the denominator. Leverage ratios, which weigh all assets equally, are imperfect metrics for resilience, but they can be valuable supplements to supposedly more sophisticated measurements; the sharp rise in such ratios before the crisis at a number of institutions were a warning sign of vulnerability. We expect that the additional public information about over all leverage will help counterparties evaluate risk, bolster market discipline, and provide greater incentive for UK banks to raise capital and constrain leverage.

The second category of recommendations has focused on building bank resilience, especially in light of the growing risks from the euro area. It is critically important that banks not try to bolster their own individual strength by reducing the availability of credit to UK businesses or households, even in periods of stress. Although a definitive parsing of weakness in credit growth between supply and demand is never really possible, credit availability is seen as somewhat constrained in the UK, especially for small and medium-size businesses, and further restraint would tend to weaken an already slow recovery, feeding back on the banking system. The best way to build resilience while maintaining lending is to increase the level of capital – and that has been a main objective of the FPC. In June and September we advised the banks to take advantage of any opportunities to increase capital in periods of strong profitability by retaining those earnings and not distributing them in dividends or additional compensation, and to reduce distributions when earnings fell short. We asked the FSA to work with banks on the follow through to this recommendation.

When we met a week ago, we recognized that the threat from the problems in the euro area had intensified and as a consequence so had the need for an ample capital cushion. At the same time, a variety of forces had weakened the growth of bank earnings, which consequently had been inadequate to build any extra cushion. One of the effects of the increased threat relative to the level of capital had been a rise in funding costs for UK banks and reduction in availability, especially at longer tenors. Those funding constraints could well begin to feed through to the cost and availability of credit to households and businesses. Consequently we strengthened our recommendation to the banks to say that "if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in

coming months." The FSA will carry this message to the banks in coming weeks as it reviews banks plans for compensation and dividends, and as it assesses the adequacy of their capital plans.

In addition to building capital levels, banks can take steps to manage their balance sheets to increase resilience without reducing critical lending and other activities. In September and again yesterday, the FPC advised the FSA to work with banks to identify such opportunities to strengthen balance sheet resiliency without exacerbating market fragility or reducing lending to the real economy.

On the liability side of the balance sheet this entails obtaining term funding whenever possible and reducing reliance on short-term wholesale funding sources that are subject to being cut off suddenly were counterparties to become concerned about the creditworthiness of the borrower or indeed about their own vulnerability so they begin to hoard liquidity in even safer forms. As we saw in 2008, even secured short-term funding is vulnerable when confidence is undermined.

Among assets, intra financial sector claims could be a channel for contagion when counterparties get in trouble and reductions in some of these claims might also free up capital for lending to nonfinancial counterparties to support the economy. At the same time, we need to recognize that borrowing and lending among financial institutions can perform valuable economic functions in supporting real economy lending by smoothing the availability of funds to lenders and redistributing savings from lenders with a surplus to those facing stronger loan demands and who can use the funds more productively. The FPC has identified for further examination the role of different kinds of intra financial sector transactions in financial and economic stability. Among other things, the financial stability perspective – the externalities of individual transactions - may imply different risk weights for capital requirements than those derived from microprudential considerations.

<u>Countercyclical Macroprudential policy</u>.

Much has been written and analyzed about the challenges of conducting macroprudential policy in good times – taking away the prudential punch bowl as the party gets going. The earnings and capital of institutions will look strong; borrowers will be in good financial shape even after they have increased their use of credit; asset mispricing will be difficult to identify and will entail overriding market judgments; vested interests in the private sector and at the intersection of the private and public sectors will be resistant to change; and it will be difficult to convince even dedicated and dispassionate elected representatives that the good times can't go on forever – or at least until after the next election. It won't be easy, but in my view the widespread awareness of these problems along with the memory of the very tough times we are now experiencing because of past credit excesses will make it reasonably likely that the authorities will do the right thing under these circumstances.

The other side of countercyclical policy – easing when times become tough – confronts a different and perhaps more difficult set of challenges. When the economy is weakening and bad debts are building, easing requirements may reduce the effect of financial sector problems on the real economy. But how do you know the problems won't get much worse, perhaps for reasons entirely external to the economy in question and out of control of the authorities. If conditions do continue to deteriorate substantially, releasing capital and liquidity buffers – lowering requirements – could come back to haunt the economy and the authorities if it results in widespread failures, unemployment as credit tightens, and if it comes to require fiscal action to stem the downward slide. The FPC has faced just such an issue as the situation in the euro area worsened last summer and fall, and its discussion of the conflicting pressures is reflected in the record of our September meeting, already published. The committee concluded that lowering buffers would not be appropriate at that time, out of concern about what might be coming next.

The cost of leaning unnecessarily hard against expanding credit and rising asset prices would be growth and innovation foregone – very hard to see. The cost of inadequate capital and liquidity is large and visible – a loss of confidence and an unstable financial system. A risk averse, or even a risk neutral, macroprudential regulator will find it more comfortable to take away the punch bowl in good times than to spike in bad times. We need more thought and research about appropriate countercyclical policies in tough times.

Conclusions

Although forms of macroprudential policies have been practiced for many years in a number of countries, the consistent and systematic application of this perspective to highly sophisticated globally integrated markets and institutions as is now being undertaken in the UK, US, and other advanced economies is in its infancy. I've drawn a couple of conclusions from my experiences in this new endeavor.

1. It's no accident that many of the FPC's recommendations have centered on information. The authorities can't conduct macroprudential policy and the markets can't reinforce the efforts of the authorities without detailed knowledge of key elements of the financial markets and their interrelationships. The work of the Office of Financial Research and of the researchers at this conference is essential to establishing and preserving financial stability. It is necessary, but it is not sufficient. That information and analysis must feed into an open and inclusive process that brings a wide variety of experience and judgment to bear. We are all learning from each other.

2. Building additional resilience into the system in difficult times without impeding the flow of credit to households and businesses is hard. It will be at just those times that resilience is most needed, but also when earnings are likely to be low and capital markets expensive to access. Surely the solution is to require high levels of capital and liquidity before trouble hits, so bad times are much less likely to call the viability of financial institutions into question. Unfortunately, the current threats to financial stability are occurring while the transition to this stronger regime is underway, but not yet complete.

3. Countercyclical macroprudential policy is challenging. This is true in good times when it appears the system is strong and there will resistance to damping the upswing. But it may be even more difficult to allow or even encourage drawing down of capital and liquidity buffers in bad times to reduce the potential for tightening credit conditions to feed weakening economic trends. This problem illustrates nicely the different perspectives of macro- and micro-prudential regulation. From a micro perspective, conserving capital and liquidity by reducing lending and being tough on restructuring troubled credits under such circumstances strengthens the bank and helps to keep it from failing. From a macro perspective, however, those actions will tend to activate an adverse feedback loop between the financial sector and the real economy that will weaken both. Congruence between micro and macro considerations requires that financial institutions have high levels of capital and liquidity before trouble hits.