



BANK OF ENGLAND

Speech

Policy making at the Bank of England: the Financial Policy Committee

Speech given by

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As a student alumnus of Warwick University myself (MA, 1983; PhD, 1990), and for 10 years a member of staff there, I am delighted to have been invited to address you this evening. The University of Warwick remains one of the top universities in Europe for studying and researching economics (among other subjects) – and has been one of the Bank of England’s top five recruiting universities in each of the past five years. Indeed, two of my fellow directors at the Bank – Spencer Dale and Andrew Haldane – are also masters graduates in economics from Warwick (both 1989). Today I want to talk about what those recruits have been devoting their time to at the Bank of England: policy making.

The Bank of England has two core policy purposes – which can be broadly translated into two objectives. The first, monetary stability, entails maintaining stable prices and confidence in the currency. The Monetary Policy Committee (MPC), of which I have been a member for the past 3 years, is charged with pursuing that objective. The second, financial stability, entails detecting and reducing threats to the financial system as a whole. I think it is safe to assert that this has been a less widely understood objective, but it has been brought to the frontline of UK policymaking by the financial crisis that began in 2007. It is this objective that I want to focus on today and, in particular, the advent of the newly created Financial Policy Committee (the FPC) which started work just last year and on which I also sit.

A brief reprise of the Bank’s recent role in financial stability

In order to understand the purpose of the new FPC, it is important to see its creation in the context of recent economic history. In the decade before the financial crisis broke, the UK experienced a period of unparalleled macroeconomic stability - the so-called Non-Inflationary, Consistently Expansionary (or ‘NICE’) decade – with low and stable inflation, steady growth and low rates of unemployment. Much of the world economy also enjoyed a benign environment. But despite the apparent success of economic policy, fault-lines were emerging across the global financial system.

One symptom of these vulnerabilities was the emergence of ever-larger global imbalances – with much of the developed world (including the UK) running persistently large trade and current account deficits. Crudely, we were importing too much and exporting too little. Those current account deficits were unsustainable in many countries. And in financial markets, risk – liquidity risk, interest rate risk, credit risk – had become underpriced, leading to excessive leverage and indebted borrowers in all sectors of the domestic economy.

Even though this build up of leverage and unsustainable debt seems an obvious problem for policy in hindsight, it was much less clear at the time. And even with hindsight, it is not clear what the Bank could have done about it with the policy instruments at its disposal then. Average inflation rates over the decade to 2007 were very close to the MPC’s target, with growth stable around its previous trend. So it is difficult to argue that monetary policy should have been set any differently. Indeed the UK had the highest policy interest rate among the G7 economies for much of the NICE decade, and raising rates further in an attempt

to restrain the leverage of banks or the indebtedness of households and firms would have necessarily meant missing the inflation target on the downside. And higher UK real interest rates might have initially driven both our external and internal imbalances to be even larger, by attracting greater capital inflows, strengthening the exchange rate and exacerbating the domestic credit cycle.

When the credit cycle eventually turned, a wide number of fragilities in financial markets and individual firms crystallised. And even though Bank Rate was cut to a record low level, and unconventional monetary policy measures were adopted, that could not prevent the deepest recession since the Great Depression of the 1930s. And in order to safeguard the provision of financial services to the real economy, such as lending and deposit facilities, the government deployed large sums of public money to support individual banks. One conclusion at least was clear: that we need a more resilient financial system with better defences.

This period of history demonstrated the well documented result that policy makers cannot achieve two different policy objectives with just one policy instrument. Although the Bank had had a responsibility for financial stability for many years, it had never had any policy levers it could pull. Indeed, with the decision in 1997 to remove banking supervision from the Bank, one of the primary platforms for direct action in support of financial stability had been placed with a separate authority. All the Bank could do then was to warn of growing vulnerabilities via its publications, including the bi-annual *Financial Stability Review*.¹ But, as the Governor noted it in 2009, issuing carefully-crafted sermons isn't enough to deliver financial stability.²

In response to the crisis, much progress has been achieved to redress the policy-making gap. In 2009, the Bank's financial stability responsibility was put in statute,³ along with a new resolution regime to deal with failing banks in an orderly manner. In 2010, the new Government unveiled a more wide-ranging overhaul of the financial stability arrangements in the United Kingdom. The plan involves setting up three new bodies (see figure 1 in the Annex). In 2013, the current FSA responsibilities for supervising banks (and some other financial institutions), will move to the Bank of England, and will be housed in a wholly-owned subsidiary, the Prudential Regulation Authority (PRA). The existing FSA responsibilities for business and market conduct, competition and consumer protection issues will move to a new Financial Conduct Authority (FCA). That re-arrangement will allow a clearer focus for each activity and better exploitation of synergies between the PRA and the Bank. But the third new body is truly ground-breaking. The Financial Policy Committee (FPC), housed within the Bank of England, is charged with the job of setting macro-prudential policy.

What is macroprudential policy?

In the UK, the concept of macroprudential policy appears to be complex and still novel to policymakers, financial market participants and the general public alike. In fact, the UK has used policies in the past which

¹ Since 2005, the *Financial Stability Report*.

² Mansion House speech <http://www.bankofengland.co.uk/publications/speeches/2009/speech394.pdf>

³ The Banking Act 2009 at http://www.legislation.gov.uk/ukpga/2009/1/pdfs/ukpga_20090001_en.pdf p132

are akin to those of macroprudential policy – a range of credit controls for example. And many countries, especially emerging market economies, still use them in an ad hoc fashion. It is the idea of having an independent FPC, to set these policies, which is really new.

People may be used to the idea that some parts of the financial sector need to be regulated, in part to address the fact that individual firm behaviour can have consequences for the system as a whole. That leads to policies of ensuring the safety and soundness of individual firms (micro-prudential supervision), to be undertaken by the PRA. Macroprudential policy goes beyond that to say that we need policies which address system-wide financial risks top-down as well as bottom-up. In many cases those policies will be captured by a consistent approach to individual firms, applied by co-ordinated supervisory actions. But the possibilities for macroprudential policy stretch much wider, beyond the behaviour of regulated firms.

The responsibility of the FPC in the draft Financial Services Bill⁴ is:

“the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system”

In plain language, that means detecting and reducing threats to the financial system as a whole, and ensuring that the flow of financial services to the wider economy is maintained. This is a tough ask. The UK economy is constantly subject to shocks and varying pressures, many of them from abroad, which cause fluctuations in economic activity in general and in the financial system in particular. The job of policy makers is to recognise and assess such developments, and subsequently take actions to mitigate their impact. Once action is taken it then may need time – and we could be talking years – for the economy to respond fully. So expectations of maintaining financial stability continuously would be over-optimistic – just as monetary policy makers will never be able to abolish the business cycle, financial policy makers will never be able to abolish the credit cycle. Instead, the best contribution we can make to financial stability is probably in making the system as a whole more resilient, so that the costs of any specific financial instability shocks are reduced.

In anticipation of the legislative changes, an interim FPC has been created in the Bank, holding its first formal quarterly meeting in June 2011. The interim Committee comprises eleven voting members – five executives from the current Bank;⁵ the Chairman and the Chief Executive of the Financial Services Authority (FSA);⁶ and four “external” members. The latter, who are appointed by the Government, include experts from the fields of public policy and the banking industry. They bring with them extensive experience and an in-depth understanding of both banks and markets, from both the UK and abroad.

⁴ Available at <http://www.publications.parliament.uk/pa/bills/cbill/2010-2012/0278/2012278.pdf>

⁵ The Governor, the two deputy Governors, the Executive Director for Financial Stability, and the Executive Director for Markets.

⁶ To be replaced in due course by the Chief Executive Officers of the PRA (who will also become a Deputy Governor of the Bank) and FCA.

Eleven voting members (plus the non-voting HMT representative) makes for a large committee, and the range of possible decisions is much wider than for the MPC. So we envisage that the Committee will operate by consensus as far as possible – if only to reduce the range of possible decisions to something manageable and reach an end conclusion. But ultimately, if there is disagreement, dissenting votes will be recorded, just as they are on the MPC.

Although it is not yet on a statutory footing, the FPC has already made a number of policy recommendations aimed at the FSA and the financial sector more widely. I will say more about those recommendations shortly.

Some specific challenges for macroprudential policy

I first want to set out a few challenges I see facing macroprudential policy makers. It is worth noting as a general point that, as with monetary policy, financial policy is trying to affect the behaviour of individual firms or people and that is often done most effectively and fairly by changing incentives, rather than by fixed constraints or rules – although both types of policy may have their role to play.

During the NICE decade, the degree of macroeconomic stability meant that the economy appeared to have become a safer place. When risk clearly became underpriced, people (in all sectors of the economy) responded as they normally do to under-pricing: by demanding an excess. As markets apparently became more stable, people took more risks. As a specific example: recorded Value-at-Risk measures fell along with the measured volatility of asset prices and, for a given numerical risk limit, many market participants could, and did, take larger risk positions.

Although financial markets are inherently forward looking, they can also be short-termist or myopic, in part reflecting the very high short-term monetary rewards that have been available in the sector. Before the crisis broke in 2007, many senior figures in financial markets would admit that the trends were unsustainable, but few were prepared to take the business risk of being ‘the first to leave the dance floor’. Influencing these wider behaviours will be a key consideration for macroprudential policy in the medium-term.

A particular challenge – discussed by the Treasury Committee, for example – is the potential for conflict between the decisions of the MPC setting policy to meet its inflation target, and the FPC meeting its financial stability objectives. I will argue that this is not the problem that it may appear to be. There is a very extensive economics literature – going back over many decades – about economic policy co-ordination when there is more than one objective (often concerning monetary and fiscal policy and/or output-inflation trade-offs). A founding result from that literature is that to hit two distinct objectives, policymakers need at least two instruments that are sufficiently independent (i.e. their impacts on the two objectives have to be different). A second result is that separate policy committees, each with a single clear responsibility, should

be able to achieve their different objectives as long as it is clear who sets which instrument. Each should have control of the instrument which has the comparative advantage in favour of their own objective.

There are some important conditions of course. The two objectives need to be individually achievable (eg one cannot achieve a 0% unemployment rate) and mutually feasible. And the more recent literature⁷ highlights the difficulty of achieving stable prices if fiscal policy is not being set appropriately. Given lags in the system, there could be a risk (albeit a remote one) of unstable iterations between policy makers, even if the final objectives were mutually compatible in steady state.

The institutional arrangements to address these issues seem to me to be fairly straightforward: the MPC has a very specific objective and instrument. The FPC needs equally clear objectives – which must not be in conflict with a stable macroeconomic outcome – and it needs its own instruments, the impacts of which must be sufficiently different from those of monetary policy. The co-ordination problem is addressed by both committees being chaired by the same person (the Governor), with three other members in common (two Deputy Governors and the Executive Director for Markets). The committees will also set policy at different times and frequencies. At its monthly meetings, the MPC will be able to take any FPC actions into account, as it does any fiscal decisions by the Government. And the MPC's reaction function (i.e. how it responds to changes in the outlook for growth and inflation) should be fairly clear in advance to the FPC, as it currently is to those setting fiscal policy.

Although I think conflict between the policies of the MPC and FPC is unlikely, that does not mean that there won't be difficult choices and trade-offs for each committee to wrestle with. The current conjuncture certainly offers plenty of challenges. The proposal to adopt a macroprudential policy framework originates in the context of limiting the build up of a credit bubble, often described as 'taking away the punchbowl before the party gets started'. Most of the literature has been about methods of achieving that end. To my knowledge, relatively little has been written about 'how to cure the hangover after the party has ended' – which of course is the situation we find ourselves in today.

One might expect to apply such policies symmetrically. If banks had built up capital and liquidity buffers sufficiently in the upswing, then those buffers could be allowed to be used in a stressed situation. Indeed, during the September 2011 meeting, the FPC discussed the possibility of allowing banks to reduce capital ratios, so long as it reflected an increase in lending to the non-financial sector. But we agreed that, while it would be possible in principle for capital to be deployed counter-cyclically without compromising banks' resilience to stress, it would be premature for banks to reduce their ratios now, so depleting resilience, in light of the shocks that had occurred in the recent past, and the risk that larger shocks could lie ahead.

⁷ See for example, Canzoneri, Cumby and Diba (2011), "The interaction between monetary and fiscal policy" in the Handbook of Monetary Economics, North-Holland, edited by Friedman and Woodford.

Setting macroprudential policy now means some tough trade-offs. Policy-makers, including the FPC, are trying to address this by, for example, balancing appropriate targets for capital and liquidity in the medium-term with a long transition period to meet them. That should help ensure that banks don't need to rush to meet these stability objectives in the short-term, at the expense of lending to the real economy.

That trade-off between lending and capital protection is a very real one. It would be relatively easy to reduce financial system risks by stopping banks from lending, but output and employment would be severely affected as a result. Indeed, that is why the Financial Services Bill does not authorise the Committee

“to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.”

Pursuing a financial stability objective does not mean eliminating all risk.

Even if we had started from a better position, there are other problems with cleaning up the aftermath of a party. It is one thing to try and limit over-exuberance on the way up. It is another to try and assuage fear on the way down. For example, it is relatively easy for a regulator to insist on a bank increasing its capital levels in good times. It might prove much harder to get a bank to allow capital, or even capital ratios, to decline when the markets are looking nervously to see who is least well capitalised. And even if the FPC can incentivise banks to use their capital and/or liquidity buffers during a crisis, it will doubtless be very tough to judge the point at which that should happen. Somehow, macroprudential policies, whilst alerting everyone to the very real risks facing them, need to support confidence in returning the financial system towards a sustainable path.

The FPC so far

The FPC has held three rounds of meetings since its inception, with formal meetings in June, September and December 2011. Two of those three rounds of meetings have been focused on the current financial situation and making recommendations to improve the resilience of the banking system. Some of those key recommendations have been aimed at encouraging banks to build capital levels opportunistically, including through retained earnings and limited distributions to shareholders and staff where appropriate, without doing damage to the real economy through cutting back lending. Indeed, to reduce the risks from excessive deleveraging, the FPC recommendations have been specifically couched in terms of raising capital levels, rather than just the ratio of capital to risk-weighted assets.

Other, important recommendations to date include increasing the transparency of bank exposures to European sovereign and banking sector debt; publishing Basel-3 consistent leverage ratios; enhanced

regulatory monitoring of the extent of loan forbearance; and highlighting the risks associated with opaque funding structures, such as collateral swaps.⁸

As well as making recommendations about the financial system, part of the job of the interim FPC is to advise HMT on which tools the FPC should, in due course, have statutory control. There are a lot of tools and levers that might affect financial stability, but following a preliminary discussion of its potential toolkit in its September 2011 meetings, the FPC concluded that it favoured (at least initially) a relatively narrow range of tools specified in law. Broadly speaking they range over three areas:

- a. those that affect the balance sheets of financial institutions (e.g. the amount of capital or liquid assets that banks need to hold);
- b. those that affect the terms and conditions of loans and other financial transactions (e.g. the maximum loan-to-value or loan-to-income ratio that banks can apply on household lending, or haircuts/margin requirements on secured loans within the financial system); and
- c. those that influence market structures (e.g. the obligation to clear certain standardised derivatives contracts through a central clearing counterparty (CCP)).

The Bank published a discussion paper in December 2011, which set out a list of possible macroprudential instruments, alongside the advantages and disadvantages of each.⁹ Since its publication, we have been receiving comments and thoughts from interested parties, in advance of making formal recommendations to HMT about which of these the FPC should have statutory power to enforce, following the (imminent) March 2012 meetings.

Where it has statutory powers, the FPC will be able to direct the PRA or FCA to implement its decisions. To be considered appropriate for inclusion in these directive powers, beyond being helpful in meeting the FPC's financial stability objectives, tools will need to be effective at addressing systemic risk, efficient in not generating unwanted spillovers, specific and transparent. They will also need to form an appropriately diverse set.

In addition to directive powers, the FPC will be able to recommend anything to anyone. Within that, where it doesn't have directive powers, the FPC will be able to make recommendations to the PRA and FCA on a 'comply or explain' basis.

⁸ More information on these recommendations, the analysis underpinning them, and progress made against previous recommendations, are available in the June and December 2011 *Financial Stability Reports*.

⁹ <http://www.bankofengland.co.uk/publications/other/financialstability/discussionpaper111220.pdf>

The FPC is also tasked with responsibility for advising the Government on the so-called 'regulatory perimeter' – i.e. what parts of the financial system should (and should not) be subject to regulation. This will essentially mean that the FPC needs to keep a close eye on the 'shadow banking sector' – comprising firms engaging in banking-like activities but not regulated as banks (for example, hedge funds, money market funds etc). Given that the financial system constantly evolves, and that some financial activity might migrate from the regulated banking system to the shadow banking system, advising on the location of the perimeter will be very important.

Personal reflections

With all that in mind, I wanted to share some personal reflections on the FPC so far. First of all I think we are already seeing the benefits from the FSA and the Bank staff working in closer co-ordination. It is key to the FPC's success that micro-prudential regulators can provide much of the evidence which the Committee needs in order to make informed decisions, and can take away relevant FPC policies and implement them. That means a change in the way that banking supervisors work. But if it also means that we have a safer financial system which supports the real economy, then FPC-related work should become one of the corner-stones of good supervision.

In a synergy flowing the other way, the Bank has a specialist knowledge of markets through its own sterling and foreign currency operations; an intimate non-supervisory dialogue with the major financial institutions; and an unrivalled network of financial sector contacts across a wide range of markets, both in the UK and across the globe. The Bank leverages off this unique position using its Market Intelligence (MI) programme which, through a continuous series of meetings and conversations between Bank staff and external contacts, gathers and analyses information from market participants. That intelligence can provide vital insights into the behavioural drivers underlying movements in financial market prices, can help fill in data gaps where reliable statistical information does not exist, and can provide an immediate indication of emerging themes and risks.

In my view the new system is already achieving one of its aims of joining up the authorities in a more effective fashion.

Effective communication, both to the general public and the wider financial community, clearly remains a challenge. There are people directly affected by the FPC's actions who are still not yet really aware of its existence, let alone its decisions and reports. So we need to convey the message to a wider audience, as I am seeking to do today. Monetary policy makes for instant headlines: **'RATES HIKE!'**. Macroprudential policy does not seem to scan so easily: the objective is not as easily quantified as the inflation target, there will likely be a number of macroprudential tools (some of which might be quite technical), and many people, particularly those who are unfamiliar with the inner workings of the financial sector, might find them rather

opaque. In addition, there will be times when the recommendations are based on private information – perhaps about an individual firm – which cannot be revealed to a wider audience. As a result, the policy decisions do not generally translate so easily into day-to-day public discourse. So there is a premium on keeping communications short and intelligible. We also need to build the legitimacy of the Committee by being transparent and accountable for our actions – the Treasury Committee have a very important role to play here, as they do with monetary policy.

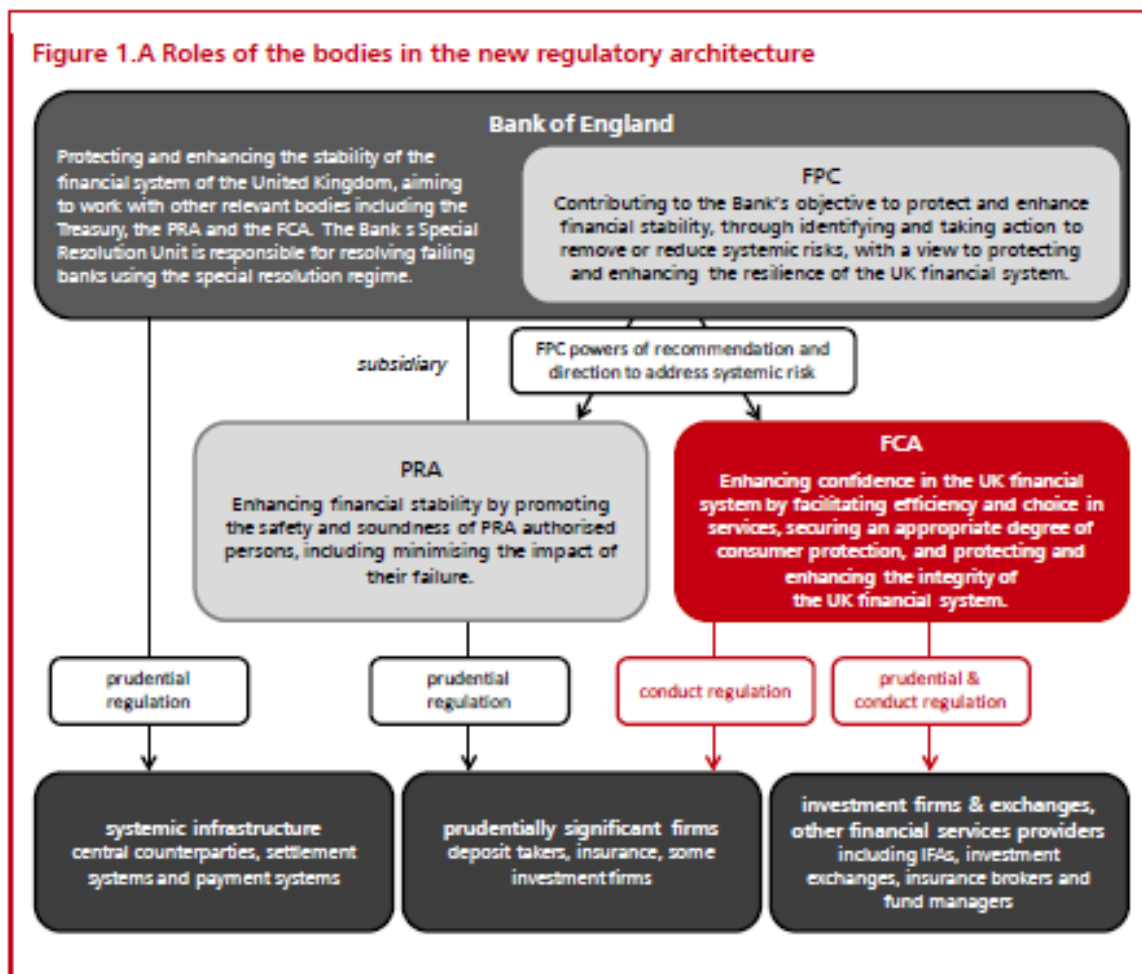
Concluding remarks

Overall it is still early days for the FPC, and there remain significant challenges going forward. Most pressingly, we need to do what we can to ensure that the UK banking system increases its resilience to shocks, particularly given the backdrop of subdued domestic growth and the precarious economic situation in some European countries. But we must not lose sight of longer term issues which will shape the future of our domestic banking system. Those include the most basic questions around the structure of firms, markets and their regulation, much of which will be discussed in broader international groups as well.

That said, the interim FPC is making recommendations, which are being implemented, and which will make a difference. It is important that everyone with an interest in the financial sector is aware of what we are trying to do, so that they can participate in the debate about macroprudential policy, and so that they know what progress has been made towards achieving a safer and more resilient financial system. I hope this talk today will help contribute to that process.

Finally, I just want to say a word of thanks to the staff supporting the FPC work at both the Bank and the FSA. We couldn't carry out our policy making functions without the talented and dedicated people that we have to call on. I hope the University of Warwick in particular continues to produce as many quality alumni as it has during my 20 years at the Bank.

Annex: Roles of the bodies in the new regulatory architecture



Source: "A new approach to financial regulation: building a stronger system", available at http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf