BANK OF ENGLAND

Speech

Remarks given by
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I can't tell you how agreeable it is to be with you in Wolverhampton here today. For all of us connected with the Bank of England this is a seat of education - the place where our last governor, Mervyn King, went to school and honed his formidable forensic powers. For me it has a more personal echo - a couple of English watercolours from the 1830s hung on the walls of the flat in Switzerland where I spent much of the last eight years – one of Bodiam castle in Sussex, then a moody ruin until that Derbyshire-boy-made-good Lord Curzon preserved it for the nation; the other of a handsome town – a church with a splendid fifteenth-century tower surrounded by Regency houses. Research showed the church to be St Peter's, Wolverhampton, and I hope to see today whether anything else in the town centre would still be familiar to the Rev J W Petitt, the watercolourist.

I remember as a small boy from Burnley seeing the mighty Wolves – to my undisguised pleasure – destroy our Lancashire neighbours and rivals, Blackburn Rovers, in the 1960 FA Cup Final. Thank you. I haven't paid much attention to Wolves in the intervening 53 years, I'm afraid to say, but I suspect I may not have missed very much.

Such inattention was until recently characteristic of public attitudes towards the Bank of England's Financial Policy Committee – the FPC, on which I sit as an external member and about which I want to talk to you today. The Bank has begun, up-to-date Old Lady that she is, to commission regular opinion surveys – it's hard to imagine the titanic governors of the distant past doing that. The most recent of these showed, when it came to the FPC, that the number of people who claimed to have heard of it (I choose my words carefully) had fallen from a modest 16% in May 2013 to a mere 11% in July 2013. We seemed to be on course for oblivion by 2015. The FPC may just be one of those things you think you understand when it's being explained to you, but somehow nothing seems to stick. And I'm sorry to have to tell you that even fewer people in the West Midlands claimed to have heard of us than anywhere else. Perhaps you're just more truthful than the others.

The good news, though, was that a rising percentage of the dwindling band who had kept us in their memories actually seemed to have some idea of who we were and what we did. Fully 41% associated us with the Bank of England, and 38% correctly identified our remit from a prompt list. (It might not be encouraging to look too closely into what the other 62% thought we were up to). Part of my purpose in coming here today, then, is simply to promote name recognition.

I expect, though, that our recognition score will be up quite sharply next time the question is asked, if only because the idea seems to have entered the public mind that we might, or even ought to, do something about the more excitable conditions now visible in the housing market in some parts of the country. Anything to do with house prices is dead certain to secure attention in Britain, and articles about the FPC have recently begun to appear well beyond the so-called serious press. I shall come back to this issue later.

The FPC's job is to protect and enhance the stability of the financial sector in the UK, while remaining mindful of the need to support economic growth. I don't need to tell anyone here what havoc was wrought by the financial crisis – by financial instability – among businesses and in people's everyday lives. So our committee was brought into being because the financial crisis revealed a gap in the regulatory framework. Policymakers around the world recognised that focusing separately on control of inflation on the one hand, and on the regulation of individual markets and firms on the other, was not enough. No one had been properly considering the resilience and stability of the financial system as a whole, and it is our job to manage so-called "macroprudential" policy and to fill this gap. Like the railway station here in Wolverhampton, the FPC is High Level.

It's instructive to contrast what we do with the role of the Monetary Policy Committee, whose work is now well understood – it's been responsible for setting interest rates and controlling inflation since 1997; more recently it's carried out asset purchases under the Quantitative easing programme. Quite simply – and I speak here as someone external to the Bank of England – it's become part of the country's deep institutional framework. The MPC meets monthly, and has a precise numerical target to aim at. The FPC meets quarterly to consider the fundamentally imprecise question of financial stability. Both committees are made up of senior Bank of England staff and a group of external members, appointed by the Treasury; both are chaired by the Governor.

The MPC has the power to vary interest rates, and decides the scale and pace of asset purchases by the Bank. The FPC has 'powers of direction' to instruct the regulators to alter the amount of capital banks have to carry; it's also able to make policy recommendations to other public and private bodies, including the Treasury. Any recommendations we might make to the micro-prudential regulator, the PRA, or the conduct supervisor, the FCA, can be made on a "comply or explain" basis, and I would hope that recommendations would be complied with. Many commentators have concentrated on the narrowness of the FPC's capital tools and have suggested that this may limit our effectiveness. But our powers of recommendation are very considerable and should not be overlooked.

The FPC is also increasingly being given a backstopping role in policies that are designed by others to pursue their – quite desirable – objectives, but that have the potential to generate financial instability at a later date.

Our friends on the MPC (without whose reputation and success over the years, by the way, no one would have dreamed of creating the FPC) consulted us on becoming a backstop to their commitment not to raise interest rates at least until unemployment falls to 7%. That policy is designed to promote a recovery in jobs, incomes and output in the UK. We agreed to tell the MPC if, in our judgement, persistently low rates were generating risks to financial stability that we could not contain with the tools available to us. They will reconsider their policy if we do so.

More recently, the Chancellor (without whom, by the way, the FPC would not exist) has said that he will once a year take recommendations from the FPC - beginning in September 2014 – on changes to the details of his Help to Buy scheme. That Scheme, designed in its entirety by the Government, not the FPC, has been put in place to give access to the housing market to those with the income to service mortgage debt but without the capital for a large deposit.

We are fast becoming the most fashionable backstop in town. Being fashionable, unfortunately, probably will not be enough to ensure we are well liked, as our opinions on these issues might sometimes be unpopular. More on that particular perk of our role – unpopularity – later.

It is a great compliment to the FPC that it is thought fit to carry these responsibilities and I can assure you that we take them very seriously. But we must recognise that, as we take on responsibility to backstop policies designed by others to pursue their objectives, the balance of our work will shift, away from adjusting the structure of the financial system to make it more resilient and towards monitoring the current situation for emerging risks.

Early in the days of the interim FPC, before we had become a statutory body, one of my predecessors, Alastair Clark, said in a speech that the committee was "the fire prevention officer, not the fire brigade". To some extent now, we need to be ready with high-pressure hoses as well as our clipboards.

At the end of every MPC meeting there is a numerical outcome – a change in interest rates, or in QE, which may well be zero but is always explicit. At the FPC, no such clarity is imposed on us. We need to survey threats to financial stability across a wide spectrum and decide what action, if any, to take.

Our interventions have to be proportionate; they should be timely without being premature. They have to be fact-based: the FPC has made public a large number of indicators on which it relies. But in the end, of course, our actions will also be based on judgement, and this judgement needs to be explained to the public and defended before a parliamentary committee.

The most substantive action of the FPC so far – a matter of the first importance, in my view – was carried out by our predecessors on the interim FPC. It concluded that British banks were, to put it simply, exaggerating the amount of capital they carried by a number of means – over-aggressive risk modelling, over-stating the value of dubious loans, under-stating the likely fines and penalties for various conduct issues. It asked the PRA to sort this out, and the PRA has spent the last few months doing just that.

Some of the banks, while accepting that their past undercapitalisation had been a major cause of the crash, argued that correcting the position too rapidly risked holding back their ability to lend, and thus jeopardised the economic recovery. In general, though one certainly needs to be sensitive to the pace of balance sheet repair, the opposite has proved to be the case. An undercapitalised bank is in no position to extend credit, while a

stronger capital base gives the management of a bank more room for manoeuvre and more confidence. Unfortunately the atrocious pre-crisis habit of juicing up returns, nominally to shareholders, in practice mostly to staff, by holding very skinny capital dies very hard. (The shareholders don't really benefit because an undercapitalised bank's equity is so risky). In this case the Bank of England was the only adult in the playground, and it was heartening to see the problem confronted squarely by the PRA in its first few months of existence.

Not only do we have to decide which of the many potential threats to financial stability need to be attended to, we need to agree – not just among ourselves, but in a broader public debate – what financial stability really means. The Act of Parliament asks us to "remove or reduce systemic risks" and it talks about the financial system. At its narrowest, the definition of the financial system could be taken just to refer to the banks, in which case our job would simply be to ensure the safety of the banking system. Do please remember, though, that we're not talking about a super-restrictive zero failure regime – we don't want to make it impossible for banks to take risks, while we do want badly-run financial institutions to be able to go out of business without bringing everyone else crashing down with them.

It's clear that the safety of the banking system is an absolutely central objective, and one which the FPC has already worked on and will continue to address. But is that enough? People and businesses are part of the financial system too (there would be no banks without them), as are insurers, financial market infrastructure and non-bank institutions like asset managers. The Act requires us to counter unsustainable levels of personal and business debt, and of bank credit growth. "Unsustainable", like "stability", is a word about which people can disagree. We humans often believe that what's going on at the time is fine, but if it got worse it would be unsustainable; then when it does get worse we just get comfortable with it. That's how booms develop.

This is all germane to the present state of affairs in the housing market, where – rather to my astonishment – the Royal Institute of Chartered Surveyors, no less, suggested that the FPC should act to cap house price inflation at 5% per annum. Just as I told you, we're the fashionable backstop! Once again I find myself in two minds – pleased that people see the point of having a body like the FPC around to stop things getting out of hand, but concerned that expectations both of the scope of our role and of our ability to achieve an outcome are expanding so fast.

I don't know what, if anything, the FPC will decide at its future meetings to do about housing, though we made it very clear in the Record of our September meeting that we have our eye on developments. I don't think, personally, that it should be the FPC's job to stop house prices going up. Indeed, if you have an economic recovery, rising numbers of households and very tight supply – all of which we seem to have at the moment – it would be surprising if they didn't. But then add to that low official interest rates, and a government scheme in Help to Buy 2 that – and, in isolation, this feels like quite a desirable objective – will give access to the

market to those potential buyers who have enough income to service a mortgage but not enough capital to put down a deposit, and you certainly have some vigorous facilitation of demand.

What might the FPC be looking out for under these circumstances, and why might it worry? We are watching for signs of over-extension on the part of the banks and the public, especially signs that borrowers were not in a position to withstand an eventual rise in interest rates, signs in general that a more speculative market might be developing: these might be expected to attract our attention. Housing boom and bust and financial stability make uneasy bedfellows.

The FPC is new, and still finding its way. For it to be effective, it will need to enjoy broad public support and understanding, even or especially when its interventions are, as they are bound to be, unpopular, or perhaps I should say counter-popular. I find it encouraging that underneath the rather frenzied debate about housing, and about the FPC's potential role, lies the grown-up idea that financial stability is a public good which it may be worth making sacrifices to attain. In the end our legitimacy as a committee will rest both on our doing a good job and on people believing that the job needs to be done. Let's not forget that the biggest mistakes in this area in the past have not come when the job was badly done. They have arisen when it was not done at all.

Thank you so much for your attention.