BANK OF ENGLAND

Speech

Remarks to the BBA Strategy Group

Speech given by
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Based on remarks given to the British Bankers Association, London
on 10 September 2014

I appreciate this opportunity to talk with the strategy group of the British Bankers' Association. The FPC and the UK banking sector share a strategic goal for preserving financial stability, and it is in our mutual interest to help each other meet that objective. As we've seen all too vividly over the past seven years, unstable financial and economic environments impede the growth of jobs and incomes, and efforts to mitigate financial instability have required taxpayer resources to shore up private businesses. Unstable conditions do not allow you, the banks, to deliver the financial intermediation services to your customers that you are in business to provide and that are essential for modern market economies. As you know, the FPC was established – as part of a wide set of financial sector reforms – to preserve financial stability – to work with you to build a system that will keep the flow of services going, even in the face of major unexpected developments. We need your help and advice to do this as efficiently and effectively as possible, giving as much scope as possible for you to innovate and compete, and yes sometimes to fail, to the benefit of the UK and global economies.

For you to help us, it's important that you understand what we are trying to do and why, and I will begin with a broad overview of the challenges facing macroprudential policy and how you can help us accomplish our objective. Then I will focus on two current issues within that broad stability objective. One is enhancing transparency about firms' approaches to risk – a subject the Bank and FPC have worked closely with the BBA on – to improve the ability of markets to contribute to financial stability. The second is on managing the financial stability risks that could arise as global policy makers exit from unconventional monetary policies; to be clear, I will comment on the financial stability aspects of exit, not the techniques or timing and other strategic issues best left to the Bank and MPC (and monetary policy makers in other jurisdictions).

<u>1. What we are trying to do.</u> I see the primary objective of macroprudential policy as reducing financial vulnerabilities, so that the financial and economic systems are more resilient to unexpected events. For example, the effects of an unexpected rise in interest rates should not be amplified by an outsized retrenchment by highly indebted business and household borrowers or by disruption in the ability of the financial system to intermediate between savers and borrowers, to redistribute risk, or to process payments.

Critically, market discipline by itself won't give us an acceptable level of financial stability. Market prices have been distorted by the moral hazard of the implicit promise of government capital in a crisis (although good progress is being made in resolving some of that problem[1]). In addition, even other useful and necessary backstops, like liquidity insurance provided by the Bank of England, may also affect market pricing.

Moreover, the threat of contagion from one troubled institution to other, perhaps fundamentally sound, lenders, through fire sales of assets or uncertainty about who else is in a similar situation, means that there are externalities – social costs in addition to private costs – to the problems one institution might suffer. So regulation on an institution-by-institution basis won't suffice either; someone needs to be looking at the whole

[1] As recently discussed by Sir Jon Cunliffe http://www.bankofengland.co.uk/publications/Pages/speeches/2014/727.aspx

system to determine its collective vulnerabilities. That includes considering the entire system's leverage, maturity mismatch, interconnections, complexity, the valuation of assets, and level and growth of credit relative to the ability to service it. That is how the FPC begins its deliberations; and, depending on what we find, we determine what actions need to be taken to build adequate resilience. One challenge is that the important externalities and disruptive behaviour tend to emerge only in some states of the world – and often that state is not seen as the most likely path for asset prices or economic activity. So the FPC must look to identify those especially consequential tail outcomes. Further, in general, these vulnerabilities tend to build in periods when the environment appears benign and is expected to remain that way.

The FPC – as a macroprudential authority – is part of the collective effort, alongside our colleagues on the PRA Board and at the FCA, as well as international bodies and counterparts, in improving the regulatory regimes. For our part, as we attempt to build resilience against tail risks, you can expect us to require:

More capital at every stage of the business cycle. More than you held before the crisis and more than you might hold if left to your own devices and the discipline of the market. We and the authorities in Europe and around the globe have already made considerable progress in determining how much more and what form this capital should take over the next few years, but that process isn't finished. For example, as you know, there are active ongoing discussions about the types, level, and distribution of capital within firms to aid in resolution, as well as ongoing analysis on the quantity and quality of capital overall.

Diversified measures of capital adequacy. Like any good investor, regulators will not want to put all their eggs in one basket when it comes to assessing the adequacy of a firm's and the system's capital, given its critical importance for financial stability. No one measure captures all the important aspects of a bank's risk position, or gives an unambiguous read on the ability of individual banks or the system as a whole to survive and continue to perform its role after unexpected developments. The Basel Committee has recommended that a leverage ratio sit side by side with risk-weighted measures. This is a position the FPC has embraced, requiring UK banks for the past several years to publish leverage ratios, and we are currently reviewing the role for a leverage ratio within the capital framework in the UK.[2]

Another key aspect of the capital framework is the process of evaluating capital positions by subjecting UK banks to regular, concurrent stress tests. These tests allow us to consider the resilience of the UK banking system to particular scenarios that we can tailor to capture the risks of most concern to us; for example, for the 2014 tests the FPC, alongside the PRA, has put out a scenario that will test banks to risks such as a sharp rise in interest rates and a large decline in the UK housing market. [3]

No doubt, being subject to multiple capital measures complicates your business decisions, but I also have no doubt that it makes the system safer, to the benefit of UK citizens using it.

[2] See the FPC's consultation paper on the review of the leverage ratio
http://www.bankofengland.co.uk/financialstability/Pages/fpc/fscp.aspx
[3] http://www.bankofengland.co.uk/financialstability/Documents/fpc/keyelements.pdf

Measures of capital adequacy that vary over types of institutions and over the cycle. Not all institutions pose the same threat to financial stability, and vulnerabilities of the whole system tend to be procyclical – building up in good times when profits and overconfidence fuel taking on leverage and accepting greater risk. We already have the authority to tailor requirements for RWA measures to the degree of danger in the counter cyclical capital buffer and the capital buffers for systemically important banks. In my view, the logic that supports diversified measures of capital also support varying all those measures over the cycle and across institutions according to the threat to overall stability. We have asked for comment on the use of the leverage ratio in this way, and I look forward to reading your views on this issue. I also expect that we will be able to introduce countercyclical and other macroprudential elements into the annual stress tests over time. Asset price cycles are driven by many factors, so we wouldn't expect the variation of capital alone to be able to prevent asset price cycles altogether, though some damping would be welcome. I do expect, however, that it can reduce the level of vulnerabilities that tends to build up in good times and it can release regulatory capital constraints to support lending in bad times.

Constraints and limits on maturity transformation through required liquidity ratios. Reliance on runnable wholesale funding was a major weakness of the system leading up to 2007, but liquidity requirements were not a part of the internationally agreed regulatory system. Limiting – or imposing costs on – such reliance is an important aspect of building resilience. As you know, a liquidity coverage ratio that addresses short-term funding vulnerabilities already is being implemented, and the Basel committee is getting comments on a net stable funding ratio that addresses the longer-term balance between the maturity of obligations and the maturity of sources of funds.

Narrower measures targeted to specifically identified problems. An advantage of macroprudential policies is that they can be targeted to problem areas that might be emerging. We don't need to use broad-based capital and liquidity measures that raise the cost of a wide array of lending when the vulnerabilities appear to be narrowly based. We can approach these issues by building lender resilience to particular sectors through, for example, changes in sectoral capital requirements or, as we did with mortgage markets, address potential borrower vulnerabilities.

Both you and we should keep in mind that experience in implementing macroprudential policies in a global financial centre with free movement of capital across institutions, across markets, and across international boundaries is quite limited. For the most part, macroprudential type polices have been implemented in the past in the UK and in the US when regulation and less complete markets made arbitrage difficult and hence restrictions harder to get around and more effective. And they have been used in recent years most frequently in emerging market economies, where less developed financial systems and capital controls impede the ability to avoid the effects of regulation.

In this context, I see three broad areas where you can help us reach our shared objective for financial stability as we develop and propose policies. First is in identifying risks and vulnerabilities. Almost by definition, tail risks are difficult to spot and difficult to gauge in importance. One needs to have some judgment about asset prices relative to fundamentals; about growing vulnerabilities in crowded trades and in leverage and maturity mismatch that may not be evident in the very limited and aggregated data we have, especially outside the banking sector; about credit standards that may be deteriorating in ways not picked up on by surveys or by the usual measures, and about building vulnerabilities among the households and businesses that borrow from you. You are in the credit markets and can see what is happening; the Bank has an extensive effort to gather your insights; I can only emphasize how important it is to you and to us that we have an accurate picture of what is going on.

Second is in assessing the effectiveness and potential benefits of policies to deal with vulnerabilities to tail risks. Given the lack of experience, devising and calibrating policies will be challenging, especially if activity migrates to less regulated markets. It is in our mutual strategic interest to understand how policies may work as they are implemented in financial markets, and how they can be made more effective or less disruptive while we still accomplish our objectives.

And third, we recognize that these policies have costs. Indeed, a major objective of macroprudential policy is to impose costs that take account of the externalities associated with financial instability. Risk will be more expensive and intermediation will be more expensive as a consequence of these policies when compared to costs without regulation. This is especially the case in good times when the price of risk and of intermediation tends to be driven too low, contributing to the procyclical character of financial markets. The near-term costs themselves should incent behaviours and generate the benefits that reduce the frequency and potential costs of any bouts of financial instability. But just as with the benefit side of the equation, we need your help in gauging the costs, so that we can weigh them against the benefits. We are obligated by law, but also by the standards of good policy making, to act proportionately – to ensure as best we can that costs are proportionate to benefits.

<u>2. Enhancing transparency about firms' approaches to risk.</u> One area in which the FPC and Bank have a good productive relationship with the BBA is in enhancing the transparency of UK banks – particularly to help investors better understand the risks that banks are taking and their approach to managing those risks. This has been an important priority for the FPC as we try to enlist the market discipline of private counterparties in preserving financial stability. As I noted before, even far-sighted, well-informed market discipline by itself can't replace regulation and supervision, given the challenges of externalities and moral hazard arising from financial instability and the government's efforts to contain it. Moreover, in the lead up to the crisis, the pendulum had swung too far away from regulation and supervision, in favour of reliance on the banks and their counterparties to asses risk and impose discipline. But as I also discussed, part of our regulatory effort should have the effect of helping those externalities to be better priced, for example though higher capital and liquidity requirements. But the effectiveness of these policies and of finding the right cost-benefit balance will depend on having things like equity, debt, liquidity priced well. The better markets work, the better they price risk and vulnerabilities, the less intrusive our regulation will need to be.

Two prerequisites for market discipline to be helpful are: providers of credit and equity need to see their funds potentially at risk, and not be expecting tax-payers to step in; and they need the information to judge those risks well. The first criterion requires that Too Big to Fail be eliminated. That's a priority of the Government, the Bank and the FPC, but I'm not going to deal with it in this talk.

The transparency piece itself is not easy. Market participants must judge the appropriate risk and return for advances of various sorts to highly complex organizations dealing in complicated, often global markets and with balance sheets filled with opaque assets, including loans to businesses and households. The challenge is how to help outsiders reach good judgments – and especially help them reach good judgments early, be able to see problems coming, and send market signals that induce the banks and other market participants to fix those problems before they become systemic.

The FPC has undertaken several efforts to help investors assess bank counterparties. We recommended that leverage ratios be published beside capital ratios based on risk-weighted assets beginning with your reports on end-2012 results. We endorsed the EDTF recommendations, which should give investors a better window into how you measure and manage risks, and asked that they be implemented by UK banks for their end 2013 reports. And we recommended that you modify your pillar 3 Basel capital reports to enhance comparability across banks and across the various reports banks issue – over time and between regulatory and accounting capital.

I expect to get an update on progress on these recommendations in the current round of FPC meetings. My preliminary impression is that significant progress has been made in recent annual reports, and that importantly that information is easier to compare and interpret for outsiders.

It is difficult to evaluate whether these disclosures are having their intended effect. Whether investors are looking at banks in a more nuanced and differentiated way than before the crisis; whether they are better at judging strengths and weaknesses. But in this area again, I would argue that we have a common strategic interest. Accurate market assessments are in your interests and those of the system as a whole.

<u>3. Exit from unconventional monetary policies.</u> The final issue I wanted to cover, is how we can work together to try and manage the risks that could arise as globally policy makers begin to prepare their exit from unconventional monetary policies. I will give you the financial stability perspective of the FPC; the how, when, and under what circumstances are the purview of the MPC.

The first thing to note is that exit is likely to be a positive event for the UK economy and financial markets. It will probably occur in the context of continued good gains in output and employment, so your customers will be borrowing more but at the same time better able to repay. The MPC expects that the rise in policy rates will likely be limited and gradual. Some market participants would gain and others would lose, depending on how they positioned themselves for rising interest rates, but probably without threatening financial stability.

In these circumstances, the behaviour of financial markets would be no impediment to the MPC adjusting rates in the usual fashion to achieve its inflation target in the medium term.

But exit is not without its risks and dangers, especially after a long period of very low interest rates and low market volatility. And exit is likely to occur at different times in different jurisdictions globally, adding to the complexity and potential complications. As I emphasized earlier, it's the tail risks – the unusual developments – that often pose the greatest threats to financial stability. The question is whether the long period of low rates and low volatility has led to a mispricing of risks through reaching for yield, herding, or other types of behaviours. If it has, the potential for very sharp adjustments would be higher, with possible unanticipated consequences for both borrowers and lenders. The FPC has had these risks in focus in our recent meetings and Financial Stability Reports, and we have included some in our stress test scenario for the banks.

We've pointed to a number of types of risk that could be mispriced. One is *credit risk*. Current spreads in a few credit market segments are low by historic standards, and covenants on some types of business loans have been eased. Some businesses that have been able to service their loans when rates are historically low may encounter difficulties as rates rise, even as the overall UK economy prospers.

Although levels of household debt have declined relative to household incomes, they remain quite high by historic standards, and a surge in interest rates would put pressure on spendable – post debt-servicing – income, with the potential for greater defaults and for substantial downward adjustments in spending by highly indebted households. It was concerns about the financial stability aspects of household debt servicing burdens as both mortgage borrowing and rates rise that led the FPC to limit very high debt-to-income mortgages and to impose higher minimum standards for the rise in mortgage rates used in assessing mortgage affordability.

Market developments over the summer suggest some greater caution on the part of lenders and investors as exit grows closer in some countries, but spreads remain narrow and terms on loans to larger businesses generally easy.

In addition, banks and other market participants may have taken on more *interest rate risk* than they will be easily able to cope with as rates rise. The rate risk can come from several sources. The prolonged upward slope of the yield curve and assurance that short-term rates will remain low for long could have induced some to take on carry trades that will lose money as short-term rates rise and long-term rates also move higher. Central bank purchases of longer-term assets, including gilts, have driven down term premia embedded in yield curves, suggesting the adjustment at the long end of the curve could be especially sharp, combining rising rate expectations and higher term premia. A sudden surge in longer-term rates – snap-back risk – could cause bond investors to pull back, exacerbating the rise in long-term interest rates. To be sure, because many of your loans are tied to Bank rate, your exposure to changes in yield curve slope may be limited, but I suspect they aren't negligible, you do have some longer duration assets on your balance sheets, and many of your customers will be exposed to shifts in the level or shape of the yield curve.

If market participants were able to get out of exposed trades and positions in a timely and predictable way, the risks might not be so high. But a third type of risk we highlighted in the most recent Financial Stability Report (FSR) is *liquidity risk* – whether market participants are counting on more market liquidity than will be there in a period of adjustment. We now see that assumptions about market liquidity going into the summer of 2007 were too optimistic and liquidity risk was not priced correctly. The governmental and regulatory response to the crisis, by requiring more capital and funding liquidity, by limiting or restructuring the business of market making and speculation, may have itself had the effect of reducing market liquidity.

One source of concern is the liquidity transformation implied by bond and other mutual funds. Retail investors have greatly increased their holdings of bond mutual funds in recent years, most especially funds investing in corporate bonds and emerging market debt where underlying market liquidity has not been as good historically as for sovereigns or equity. These investors may be counting on a greater ability to redeem their shares than will be available if a substantial proportion of them attempt to shift direction at the same time. We can't be sure how they would react to changing perceptions of liquidity in an extreme situation.

Coping with all these risks is complicated by the potential disparity of global economic positions and monetary policies. From the fall of 2008 on, monetary authorities in most developed market economies have been pursuing highly accommodative policies in an effort to speed the economic rebound and boost actual or projected inflation from too-low levels. Funds were flowing not only into higher yielding investments in developed markets, but also across borders into the capital markets of emerging market economies. The convergence of policy stances in industrial economies and the expectation that they will be sustained for quite a while not only reduced longer-term interest rates globally, but also damped volatility in many asset markets.

Market expectations and statements of various central bankers suggest we are returning to more normal circumstances, marked by greater differences among economic circumstances in industrial economies and the resulting monetary policies. As the monetary policy authorities have emphasized, the process of exit in each jurisdiction will be governed by incoming information bearing on the prospects for achieving policy goals. The differences in policy stance and uncertainty about the pace of interest rate increases could increase volatility and complicate risk management after a long period of damped volatility across a wide array of markets.

As I noted, the FPC has had these issues under close scrutiny. In our FSRs, we have highlighted the information we are using from historic relationships, from surveys, and from conversations with market participants to judge whether some of these risks are appropriately priced. Through these *Reports*, parliamentary testimony, and talks such as this one, we are trying to alert market participants to factor the potential effects of rising rates on an array of asset prices into their risk management considerations.

In addition, in the summer of 2013 we asked the PRA and FCA to evaluate the exposure of banks and other market participants to a rise in longer-term interest rates. We recognized that the answers we received were based on partial information, taken in isolation from each respondent. With respect to nonbanks, we have asked the FCA to gather more information and look in greater depth.

For banks, we have incorporated a number of these risks into our stress scenario for the bank stress tests now being conducted. In particular we wanted to be sure that we tested against a substantial rise in interest rates across the yield curve, and to have these rates rise in an adverse economic context so we could judge the resilience of the banking system in a severely adverse tail that featured pressure on both households and businesses to meet their debt obligations.

You have a strategic interest in managing any unusual events well enough to preserve your ability to function fully and serve the needs of the UK economy, and to be forward looking in your planning to give the PRA, FCA, FPC, and MPC confidence that you will be able to do so. That will help the MPC concentrate on price and economic stability over the medium term.

These are extraordinary circumstances. Never before have the monetary authorities engaged in the sorts of unconventional policies that have been widely utilized over the past six years. So, none of us has any experience with the asset price movements associated with the policies, or those that could occur as they are exited. As noted, the complexity of forward planning and risk management is heightened by diverging economic prospects around the globe. Most likely all will go well; unconventional policies will be unwound with only the sorts of gains and losses that usually accompany policy shifts and don't threaten financial stability. But this is an unusual challenge for both the authorities – including new macroprudential authorities like the FPC – and the private sector. One that we must get right.