BANK OF ENGLAND

Speech

Opening statement at the European Parliament's ECON Committee

Speech given by

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Mr Chair,

Honourable Members of the Economic and Monetary Affairs Committee,

It is a pleasure to address you in my capacity as Vice-Chair of the European Systemic Risk Board.

Maintaining financial stability requires strong policy frameworks, a dynamic understanding of risks, and, when appropriate, co-ordination of individual macro-prudential policies.

The need for a coordinating authority within the EU is particularly important, given the unique nature of the single market and its high degree of integration. In fulfilling this role, the ESRB is making financial stability policy more effective across the EU.

1. On openness in the EU

The openness of European member states supports economic dynamism by facilitating trade and specialisation, by enhancing competition, and by encouraging more diversification and risk-sharing.

Larger markets mean wider choice, bigger incentives for innovation, and greater scope to realise economies of scale.

While openness boosts dynamism, it also increases exposure to shocks from abroad. Financial linkages in particular can create new vulnerabilities and the potential to deepen shocks.

The ESRB can help build the resilience to maximise the benefits from openness and minimise the risks it entails. In this spirit, I would like to outline three specific contributions of the ESRB during my time as Vice Chair.

2. Building stronger macroprudential frameworks

The ESRB has promoted stronger macroprudential frameworks across the Union.

Specifically the ESRB has issued recommendations to encourage national legislators to establish macroprudential authorities within their jurisdictions.

Its Handbook on *Operationalising Macroprudential Policy in the Banking Sector* embodies practical information on how to set policy using the newly-established powers.

The Handbook sets out best practice on an instrument by instrument basis, suggests indicators to guide their use, and outlines the legal framework governing them. It also details potential spillovers.

Where it judges that best practice is not being followed, the ESRB can use "soft law" to issue recommendations on an "act or explain" basis to mitigate financial stability risks and curb spillovers. For example, last year the ESRB gave guidance to national macroprudential authorities on how to set countercyclical capital buffer rates. The ESRB will follow up that guidance with a published assessment of implementation in 2016 Q3.

With macroprudential policy still in its adolescence, the ESRB is helping it to mature.

Recent ESRB studies have evaluated the case for using margining to counteract pro-cyclical behaviour in derivatives and securities financing transactions.

And this year, the ESRB assessed the value of including macroprudential buffers within the leverage ratio framework. The Bank of England has followed this approach to ensure that the leverage ratio complements the risk-weighted capital framework in a way that makes it robust to cyclical and structural risks.

One of the strengths of the ESRB is its ability to harness data and conduct analysis across all EU Member States.

In its work on the leverage ratio, the ESRB collected new empirical evidence showing banking sector leverage has been pro-cyclical at an aggregate level in almost all Member States. Average risk weights tend to fall in credit booms and rise in downturns.

Working with EBA data, the ESRB found that systemically important banks in Europe typically have lower risk weights and leverage ratios than other types of banks.

Taken together, theory and evidence demonstrate the importance of a dynamic leverage ratio to a robust macroprudential framework.

Another way that the ESRB has led in identifying best practice and influencing the international agenda has been to take a macroprudential perspective on how elements of the financial system can support long-term prosperity.

For example, in its examination of Solvency II, the ESRB has considered how long-term investors like insurers can bring diversity and stability to the system.

In my view, more can be done to ensure that Solvency II creates the right framework for long-term investment. The ESRB can provide a constructive and objective macroprudential perspective as an input to Parliament's review in 2018 of aspects of the operation of Solvency II.

Openness puts a premium on shared understanding of risks. The ESRB plays a vital role for the EU, enhancing members' assessment of new and evolving risks.

The structure of the financial system has changed significantly since the crisis. Virtually all of the net credit growth since then has been from the bond markets. In tandem, the assets under management have risen by 60% globally and 80% in the EU. These trends will continue as the Capital Markets Union is developed.

The ESRB is currently contributing in two ways to more resilient capital markets.

First, it is promoting a shared understanding of the fundamental drivers of market liquidity.

Second, it is gathering consistent information on the nature and size of the risks associated with market-based finance.

The ESRB has unique powers in this regard given its ability to collect information from financial participants from across the EU.[1]

The ESRB is currently surveying market makers and asset managers as part of a broader study into the risks from a reduction in market liquidity. This work should be completed by mid-2016.

The survey will draw out the implications for liquidity conditions, including whether open-ended funds have liquidity sufficient to meet redemptions in the event of market stress.

In a similar survey of 143 investment funds, the Bank of England found that, in aggregate, these funds expected to be able to liquidate in one day roughly three times estimated dollar corporate bond market turnover; clearly a fallacy of composition. The ESRB survey will provide a valuable wider perspective.

Armed with such insights, the ESRB can help design appropriate policy responses. Stress testing of the investment fund sector can be expected in the future, complementing existing stress tests of banks, insurers and pension funds.

[1] Of course, the ESRB must exercise this power with care and precision. And the case for doing so must be compelling. But the rapid growth of market-based finance satisfies these tests.

The ESRB is also beginning to access detailed derivative trade reports from trade repositories across the Union.

By pooling national expertise and leveraging the ESRB's unique access to the entire set of trades, authorities can better understand the complex webs of derivative transactions and how they could propagate and dampen risk across the system.

It can also assess the impact of mandatory central clearing and whether it shifts risks to other parts of the system such as direct clearing banks.

3. <u>Greater openness can require shared approaches to managing risks</u>

In some cases, shared understanding is not sufficient; authorities also need shared ways of managing risks. The ESRB is the only hub where all the relevant authorities are present, including central banks, bank supervisors, and securities authorities. Through our regular dialogue we can establish and update best practice.

Consider residential real estate. This year ESRB's work emphasised how these markets were influenced by structural differences, from Loan-to-Value restrictions to tax treatments, across the EU.

Its analysis identified the tools authorities may use to respond to different vulnerabilities, ranging from capital measures to restrictions on debt-to-income ratios and collateral.

Key lessons of the analysis include that:

- flexibility is needed in both design and calibration of macroprudential tools;
- no single tool can combat all property risks;
- tools need to be appropriate to domestic circumstances; and
- domestic policies are more effective for both domestic and EU financial stability if their spillovers are managed.

The ESRB has built a framework to assess and manage such spillovers, which should be agreed soon and be operationalised early next year. Its central feature is reciprocity – eliminating regulatory arbitrage to give domestic policy greater traction. It will be member led, but, importantly, backed by ESRB recommendations. Compliance will be on an "act or explain" basis but the presumption will be that many exposure-based measures (e.g. LTV, LTI and maturity) will be reciprocated.

This is significant. The ESRB has been notified of macroprudential actions 69 times this year, and 173 times since the introduction of the CRR/CRD in 2014. Although many notices are procedural, they show the direction of travel. More countries are using macroprudential tools, creating an increasing need for a "clearing house" that is both comprehensive and timely.

The ESRB will also evaluate the ways national macroprudential authorities might apply countercyclical capital buffers against financial exposures from countries outside the EEA – a tool given to the ESRB under Union law. That will further bolster collective resilience against the global financial cycle and spillovers from outside the Union.

While risks in property markets reflect national differences, other risks such as misconduct have more common determinants.

In the past five years, misconduct penalties imposed on EU banks have totalled €50bn.

Those costs have direct implications for the real economy. At 5% leverage, that capital could have supported €1 trillion of lending capacity.

More fundamentally, repeated episodes of misconduct undercut public trust in the system.[2]

The ESRB's work has helped catalyse sensible actions to begin the process to rebuild that trust.

First, it has proposed capturing misconduct costs in stress tests to ensure banks remain resilient even under severe outcomes.

The Bank of England has followed this approach in its most recent stress test which included and additional £40bn of misconduct costs. These costs were calibrated to have a low likelihood of being exceeded and are therefore, by design, much larger than the amounts already provided for by banks.

Second, the ESRB has also proposed tackling misconduct at source by increasing individual accountability. This can be done by reforming remuneration - using variable pay, combined with Malus and Clawback, to hard-wire stronger incentives for good behaviour within firms. The UK is committed to this approach with the toughest remuneration regime in the EU, including the longest deferrals and claw backs.

However, the effectiveness of such measures across the EU is being tempered by the bonus cap. For example, in 2013, the ratio between fixed and variable for material risk takers at major UK banks was around

[2] Bank of England survey results. Respondents were asked for their views on the statement 'I believe that financial markets work in the interest of society'. Possible responses were: strongly agree, agree, neutral, disagree, strongly disagree. Only one third agreed or strongly agreed.

1:3 – meaning three quarters of remuneration was at risk from individual misconduct. The next year, when firms first had to apply the bonus cap, that ratio had fallen to around 1:1, with the overall level of remuneration unaffected.
Prompted by the ESRB, the FSB is now examining the impact of various compensation tools on misconduct, and if appropriate, it will recommend improvements to next year's G20 summit.

Reforms to compensation are necessary but not sufficient. ESRB reports have rightly stressed that more should be done to hold senior individuals to account.

Prompted in part by the ESRB, the FSB members will share experiences on the role of bank regulatory powers to address misconduct and on approaches to enhancing individual accountability.

In the UK, we are implementing a new regime to ensure senior managers right across the financial system are held directly accountable for failures in their areas of responsibility. That will be buttressed by clear code of conduct, designed by practitioners, to ensure high standards are understood by all.

4. *Conclusion*

All member states, and more fundamentally all EU citizens, have a stake in EU financial stability. The ESRB helps deliver this foundation of prosperity.

The financial crisis starkly illustrated how quickly risks could spill across borders, the need for wide-ranging reforms, and a new approach to addressing risks.

With your leadership, the reform programme is substantially complete, and authorities are now implementing it to maximise its effectiveness.

But durable financial stability requires more than microprudential standards that bolster the resilience of individual firms.

It also requires a macroprudential perspective, with flexibility to respond to shocks wherever they occur; with higher standards for systemically important firms; and to increase levels of resilience when risks increase.

The ESRB has been helping Member states fulfil these roles, and it remains alert to emerging vulnerabilities. As President Draghi recently described to this Committee, over the coming year, the ESRB will develop assessments of the macroprudential stances of Member States to complement its existing risk monitoring and focus on the risks of low interest rates on financial stability and an abrupt transition to a low-carbon economy.

Thank you for your attention. I look forward to your comments and questions.