BANK OF ENGLAND

Speech

Reflections on the FPC: the road ahead

Speech given by

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It is a pleasure to be able to speak to the Society of Business Economists. Your Chairman suggested I reflect on my years on the Financial Policy Committee, and I will do that, but I will spend most of my time looking forward – giving my views on some broad priorities for the FPC in coming years.

I have been a member of the Committee since its inception as the interim FPC in the spring of 2011. In that time I believe we have accomplished much to make the UK financial system safer and put in place the foundations for continuing that work in the future.

We have worked with the Prudential Regulation Authority (PRA) to build the resilience of the UK banking system – especially to build its capital cushion against future shocks – so that it can continue to deliver financial services to the real economy in the face of adverse economic and financial developments, and without requiring further taxpayer support. To this end, we phased in the Basel 3 capital risk-weighted capital requirements as quickly as possible for UK banks and instituted a minimum leverage ratio; there is still some work to be done, but major UK banks are now comfortably ahead of the Basel 3 transition timetable. Greater capital supports growth not only by making crises less likely and less severe, but also because well-capitalized banks have been shown to be more willing to lend.

Last year the FPC and the PRA initiated concurrent capital stress tests across large UK banks and are making these tests a regular part of the capital framework. This was a major innovation and strengthens our ability to be explicit about what we see as the important risks to financial stability in the UK and to test the banks' resilience to those risks. Last year we tested banks' resilience against the effects of a substantial rise in UK interest rates and a fall in property prices; this year our stress scenario originates in a major shortfall in growth in the rest of the world. The horizontal comparisons across banks from these tests can be particularly revealing about the relative capital positions, modelling characteristics, and risk management capabilities of each major UK bank.

These tests also importantly increase transparency to the public about the FPC's view of risks to financial stability, the individual bank's ability to withstand those risks, and the actions the FPC and PRA are taking in response to the results. In that regard the stress tests are an important new element in the accountability of the FPC and the PRA. I expect the stress test to play a major role in our execution of macroprudential policy in the future and I expect us to continue to develop our ability to use the information we collect to identify threats to financial stability, such as procyclicality of bank risk models, interconnections among banks that may not be evident on the surface, and crowded and correlated positions that make the system vulnerable to particular asset price movements.

The FPC has also identified various risks to financial stability beyond those posed by potential bank credit losses and made recommendations to deal with them. For example, we highlighted the dangers of cyber attack, and the potential for rising house prices to cause borrowers to become so indebted for the purchase of houses such that they would need to cut back sharply on spending should interest rates spike

unexpectedly or income be temporarily depressed. In both cases we made recommendations that were implemented to counter the perceived risks. And we worked with the banks to enhance their disclosures and thereby strengthen the ability of their private sector counterparties to monitor and price the riskiness of banks through greater bank transparency – especially around capital risk calculations.

Finally we have put in place much of the basic framework required to operate macroprudential policy on an ongoing basis. We worked with HM Treasury and Parliament to get authority for the tools we need – including powers of direction over capital, leverage and key terms of lending against residential real estate. And we issued policy statements outlining how we might use these powers of direction to sustain financial stability.

As a Committee, we have established good working relationships with the PRA, the Financial Conduct Authority (FCA) and the Monetary Policy Committee (MPC). Macroprudential policy is implemented mostly through the PRA and FCA and they and we need to have a good understanding of what each authority is trying to accomplish and how our actions affect the objectives of the others. The chief executives of the PRA and FCA are both members of the FPC and have provided guidance on how to shape our recommendations to accomplish our objectives. Both macroprudential and monetary policy seek to accomplish their separate objectives by affecting aspects of financial conditions, so it is critical that each committee understand what and how the other intends to operate and can weigh the implications for meeting its objectives. The FPC has been asked to provide an independent voice on financial stability – by the MPC and by Treasury (in help-to-buy) to assess the financial stability implications of their policies.

We are not completely finished with establishing the macroprudential framework: we need to complete the capital framework; we have requested powers of direction for buy-to-let lending; and the FPC will always need to be alert to the possibility that preserving financial stability in an evolving financial landscape could require new tools in new areas. But I believe the basic structure is largely in place. Going forward we will be placing more emphasis on how we use the structure; it is a time of transition for the FPC.

Having just begun a new three-year term with the FPC, I would like to use this occasion to look forward, to reflect now on what I hope we can accomplish in the next three years, building on the approach already in place. I will concentrate on two broad challenges: first, how the FPC can continue to build a systematic and disciplined approach to macroprudential policy – to identifying risks and using our powers of direction and recommendation to address them; and second, how the FPC can contribute to fostering safe and resilient market alternatives to bank finance in the UK.

Systematic and disciplined approach to macroprudential policy

A good deal of uncertainty about macroprudential policy is inevitable: policy will need to respond to threats from unexpected developments – possibly from abroad in globally linked markets – interacting in unexpected

ways with complex and only imperfectly understood financial systems. But within that inherently uncertain environment, the FPC can work to make macroprudential policy more systematic and predictable. This will help market participants to plan and to anticipate our policy actions, and those anticipatory actions should help stabilize the system under many circumstances. Systematic and transparent policy-making also facilitates public accountability: for how we intend to identify risks that embody externalities with macroeconomic and financial stability implications; for how we will determine appropriate responses that are targeted and proportionate to the risks and consistent across time and circumstances; and for how we weigh our secondary objective for growth and employment alongside our primary objective for financial stability.

We do need to recognize that there are likely to be some limitations on systematic, predictable, macroprudential policy – say, as compared to monetary policy. Most obviously, we have no ready continuing measure of how we are doing relative to our financial stability objective that is comparable to inflation readings for monetary policy. Financial instability is mostly obvious after it has occurred. Moreover there are multiple kinds and degrees of instability with varying implications for the financial sector and the real economy; for example asset price overshooting with limited leverage like dot-com equities, versus housing price overshooting in the presence of highly leveraged lenders and borrowers. Both can have adverse effects on the economy, but the disruptions to the financial sector in the second case proved a much more potent downward force on employment and economic activity. As I will discuss below, we have developed a set of indicators for financial stability, but refining and testing those indicators is an ongoing challenge.

In addition, we have little experience with using macroprudential tools in a countercyclical way in a highly developed, globally integrated economy like that of UK. These types of tools were more common in the UK and US several decades ago, when markets were less developed and arbitrage opportunities more limited, and they have been more widely used in emerging market economies in recent times. But for the UK today, we have limited information to use to draw inferences in order to gauge calibration and effectiveness.

Nonetheless, I believe we can and should be able to make further progress toward systematic and disciplined macroprudential policy. I see two broad areas for such progress.

First, we can continue to develop a more systematic approach to identifying risks and deciding which tools to use to address them. This should be aided as much as possible through monitoring a set of indicators we and you can have confidence in. Identification of risks and indicators of risks is challenging. We are looking for systemic risks, which generally involve market failures that are not embodied in market prices or captured by institution-by-institution microprudential oversight. Examples would include asset mispricing owing to widespread complacency or over confidence; complex and opaque interconnections among key financial market institutions; crowded trades that might reverse with widespread consequences; broad increases in lender leverage or maturity mismatches that look relatively benign on an individual institution basis; substantial increases in borrower leverage; or a buildup of macroeconomic or macrofinancial imbalances that might hold the potential for sharp changes in asset prices or credit availability when they correct.

In addition, systemic risks often involve the tails of distributions – vulnerabilities to unexpected developments. Financial institutions, investors, households, businesses, do not plan on being unable to meet their obligations, or to have difficulty trading out of a position, or to take a loss that impairs their ability to spend or hire. But they could be vulnerable to unexpected shocks that subject them to extreme events against which they are not adequately prepared. Our job is to identify tail events to which they are vulnerable and that could pose an unacceptable risk to financial stability.

Of course we already look at indicators of the sorts of imbalances and distortions that have preceded past crises. These include the build-up of leverage and maturity mismatch in banks and other intermediaries; the rapid growth of credit to households and businesses relative to income; current account imbalances that might imply a build-up of indebtedness and greater vulnerability to developments elsewhere; and asset pricing, for example for houses or risky bonds, that looks extreme relative to standard metrics.

But the threats next time might well come from a different direction, and problems could be amplified by newer characteristics of financial markets. Among other things, activity and risks are likely to migrate to different parts of the financial system and the consequences of tail events change shape as market participants adapt to the shifting regulatory landscape after the global financial crisis. Identifying indicators for newer types of vulnerabilities – the next problem – is even harder than for the issues we have experience with, but is absolutely necessary.

The FPC has a set of indicators we publish and use as a first step toward deeper analysis of possible emerging threats to stability. I expect us to refine these over coming years. The reactions and inputs of business economists and others knowledgeable about financial markets would be most helpful in this regard. Do you find the FPC indicators helpful? What indicators do you use? What new information would you like to have as you assess vulnerabilities in the financial landscape? The Bank consults regularly with a wide array of business and financial market participants and I reach out regularly myself to help identify risks and assess the effect of our actions.

The analysis of risk in turn should point toward the most appropriate tool to address the risk. Where is the market failure that threatens financial stability? What is the most efficient and effective way to reduce that risk?

A broad increase in credit through the banking sector might be addressed by an increase in the countercyclical capital buffer for banks which would better assure their resilience to a reversal of the cycle to a turn in asset prices whose upward movement had been fueled by credit or an increase in debt servicing problems among borrowers should interest rates rise and growth slacken. An increase in capital requirements, which, if binding, would raise the effective cost of funding loans a little, might help to damp the buildup in credit itself, though I suspect that effect will be quite limited in the face of optimistic expectations fueling strong demand and ample supply of credit; but a rise in capital will unambiguously bolster resilience.

Imbalances and risks that appeared to emanate from particular sectors might call for tools focused on that sector, that could be aimed at reducing exposure/leverage from either the lender or borrower side – or some combination. Higher sectoral capital requirements, for example for bank real estate lending, would make that lending a little less profitable and by potentially increasing bank capital would make banks extending such loans less vulnerable to risk from that lending – help them weather a turn in the market and pick up in defaults. If the market failure arose from households becoming too exposed to certain types of mortgage loans that left them particularly vulnerable to changing economic circumstances, the most effective restrictions might be ones that place limits on the terms of the lending – for example the interest rate stress test and LTI restrictions the FPC recommended for residential real estate lending last June. Experience in other jurisdictions implies that these sorts of product restrictions can be effective at damping credit and price cycles, perhaps more so than actions on bank capital.

Second, we should be able to improve and make more systematic the calibration of our tools by making progress on analysis of the impact – that is the costs and benefits – from changing regulations. As noted, we have limited experience to analyse this in the UK, but the FPC is required to act proportionately and to do a cost-benefit analysis where possible. To some extent, costs may be more obvious, immediate, and easier to quantify than benefits – in terms of raising the price or restricting the availability of credit and imposing compliance costs on institutions. The benefits of reducing the odds on future instability are longer–term and harder to specify. Still, those benefits are considerable, as we have learned so painfully over the past few years.

Refining impact analysis can help us with: policy design and calibration – selecting the tool or combination of tools best suited to address the problem, and the calibration most likely to produce a positive balance of benefits over costs; communication and public accountability – explaining our choice, the reasons for it, and the outcome we anticipate from its use; and evaluating those outcomes relative to expectations.

None of this will come easily and quantification of costs and especially benefits will be subject to considerable uncertainty. But it is important that the FPC's framework and approach to policy weigh what we can determine about the costs and benefits of our recommendations and directions. We will gain experience over time, and will continue to refine our models and techniques.

By establishing a systematic and disciplined policy making approach, the FPC will be better able to achieve its statutory objectives of protecting financial stability and supporting growth. But it is important to be clear and have common expectations of what macroprudential policy and the FPC can achieve. Asset prices will fluctuate and overshoot long-term sustainable levels from time to time. Financial intermediaries will make poor decisions or be hit with unexpected developments, some of which will be serious enough to undermine viability and cause failure. But if the FPC and other authorities do their jobs right, neither of these will threaten financial stability. The system will continue to intermediate between savers and borrowers, offer risk

management services, and deliver payments without interruption and at prices that allow the UK economy to live up to its full potential.

Fostering safe, resilient, efficient market alternatives to bank finance in the UK

The second broad area I expect to make progress on in the next three years is fostering resilient and efficient market alternatives to bank finance in the UK. Developing these alternatives is important for a number of reasons. Intermediation is already shifting to some extent outside banks into securities markets, as evidenced by a large volume of corporate bond issuance in recent years, and we need to identify and address any financial stability concerns resulting from that shift. This shift is partly in response to record low long-term rates resulting from weak economies and the efforts of central banks to stimulate growth and hit inflation targets using unconventional monetary policies. It also reflects some restraint on business lending by banks—as they rebuild balance sheets after the crisis and as their costs reflect tighter regulation and higher capital and liquidity requirements imposed to prevent a repeat of the global financial crisis. So incentives to channel a smaller proportion of intermediation through banks than before the crisis are likely to persist.

At the same time, financial market structures are evolving, partly in response to the increase in the demand from borrowers for market finance, but also reacting to regulatory changes after the global financial crisis and to new technologies, which are changing the nature of risks. Savings have been redirected from banks to funds run by asset managers operating in securities markets. Regulation is moving more derivative transactions onto exchanges and through central counterparties, which increase transparency and clarify interconnections, but also tend to concentrate risk. The spread of "big data" and algorithmic trading may create or at least intensify some feedback loops in asset pricing and have unpredictable effects on market liquidity.

Increased flows through capital markets have the potential to create material benefits for financial stability and for savers and borrowers. Businesses and households (through securitization) will have access to a greater diversity of funding sources. Having financing available through both banks and markets has been characterized as a "spare tyre" approach to intermediation – if one aspect of intermediation is impaired, the other could be available to take up the slack. This possibility helped the US weather a number of financial shocks – until the crisis when both "tyres" were flat, in part because complex and obscure interconnections had developed between them. And a variety of intermediation channels facilitates innovation and competition, reducing costs to household and business borrowers and enhancing returns to lenders.

But there are potential risks to financial stability when market finance is not done right, and the most telling example of that is the US subprime mortgage market in the years leading up to the crisis. In that market, substantial, unwarranted, credit easing was supported by innovations in market-based securitization that entailed a marked increase in leverage and maturity mismatch in securitizations held outside of banks,

though often with bank exposure through implicit or explicit back-up facilities – think SIVs and asset-backed commercial paper conduits. Moreover, the instruments created in the securitization and tranching process were opaque and complex, behaving in unanticipated ways under stress and creating uncertainty about the incidence of losses as real estate prices fell and borrowers defaulted, leading to panics and fire sales when confidence eroded. Other, new types of risks may develop as more funds flow through markets where smooth functioning is dependent on market liquidity and market plumbing being in good order.

Doing it right – fostering safe and resilient market-based finance is a medium term priority for the FPC. The FPC is far from the only player involved promoting this objective – for example the steps to create a capital markets union in the EU will be important. But the FPC has a key role to play in the UK.

We need to make sure that markets develop in ways that protect overall financial stability. Identifying risks, market failures, and externalities in the securities and securitization markets and devising approaches to deal with them have their own special set of challenges, however. These new threats to financial stability are likely to occur in structures and institutions outside, or only indirectly related to, the more heavily and directly regulated sectors. This potential highlights the importance of reviewing the regulatory perimeter (the nature and extent of regulation on different sectors and markets) on a regular basis, trying to identify gaps that regulators and, on occasion Parliament, might need to fill. And we will need to continue to work closely with the FCA and PRA to gather information about how the system and risks are evolving and consider responses.

The risks we should be looking for could be quite different from the leverage or maturity mismatch or poor underwriting standards issues that we are used to dealing with in banks. And the materialization of these risks could disrupt intermediation and damage the real economy. For example our current analyses of risks from securities markets have examined the effects on pricing of the "search for yield"; possible increases in herding behaviour as more funds are administered through asset managers; the effects of perceptions of first-mover advantage by investors in these funds if they fear overshooting of asset prices; and the apparent decline in market liquidity, which could exacerbate the resulting asset price volatility.

Moreover, securities and securitization markets are global in character. That facilitates savings flowing to the most productive capital projects. But it also implies an exposure to risks originating around the world when UK action, by itself, may not be sufficient to assure safe and efficient markets, especially with London a key node in the global financial system. The UK will benefit from a global approach to global markets, and, fortunately, the Financial Stability Board has been formulating such an approach.

A critical element in safe and efficient markets is the "plumbing" of those markets – how securities are traded and financed. As noted, central counterparties and data warehouses will make interconnections and risks more transparent – but they also concentrate risk so we need to get oversight right globally. Securities

financing transactions proved to be a source of instability in the global financial crisis, and the FSB is leading an effort to take a close look at these and address risks through minimum haircuts and other measures.

The FPC's approach to its concerns about market liquidity illustrate the kinds of steps we will need to take to analyse the potential financial stability implications of the shift to market finance and then to determine whether a policy response is required. We set out in a box in the December 2014 FSR our thinking on the causes of market illiquidity in order to delineate and deepen the analysis of this issue. Then in March this year, we asked the Bank and the FCA to encourage and contribute to international work to build an understanding of vulnerabilities. We asked them to explore the channels through which UK financial stability could be affected by a decline in market liquidity. We asked to them to gather information from UK asset managers about how they planned to deal with a potential stressed market liquidity situation. And we asked them to assess how and why liquidity in relevant markets might have become more fragile.

In sum, we have initiated work to deepen analysis and understanding of the risks, in particular to the UK; we have encouraged work in international fora; and we are gathering information what market participants are doing about any developing risks from market illiquidity. Once we get this information – now scheduled for Q3 this year – we will decide whether there is anything we should do to address whatever market failures and vulnerabilities are identified – be that acting in the UK alone or by the Bank advocating positions within the global context.

Conclusion

The FPC has accomplished much, but much remains to be done in building a structure to protect financial stability in the UK. Let me be clear: I don't mean to imply that FPC has not been following a systematic and disciplined approach to fulfilling its mandate; we have, but macroprudential regulation is new and we are climbing a learning curve. The UK has a well-designed system for macroprudential regulation and its interaction with microprudential and monetary policies, and I am honored to be a part of it. We need to continue to develop how it is used.

I have outlined an ambitious agenda for the future, but much work is already underway. Interactions – two-way communication – with informed observers like yourselves will be important to our success. We need to work on enhancing public understanding of what we are trying to do. And we need your perspective on how we are doing and what we could do to meet our objectives.

I am grateful for the opportunity to talk to you today. You can invite me back in three years to hold me to account for how well the FPC has met the ambitious agenda I have laid out tonight.