



BANK OF ENGLAND

Speech

Come with me to the FPC

Speech given by

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I would like to thank Andrew Bailey, Ben Broadbent, Jon Cunliffe, Don Kohn, and especially Csongor Osvay and Caspar Siegert for comments and suggestions on this speech.

Thanks for the invitation. I know many of my colleagues have previously spoken with you and I have heard great things about your group. I am thrilled to be able to be here for my first official speech. I want to start by making clear that what follows are my own views only and are not necessarily shared by my colleagues at the Bank of England.

The title of my remarks is “Come with me to the FPC”. That title is an homage to a speech that has been given a number of times over the years by different Federal Reserve officials to explain what the committee that sets US monetary policy, the Federal Open Market Committee (FOMC), does. My favourite of these is the 1998 version by Larry Meyer, where he claims to have been teased about being a member of the “Fruit of the Month Club” (FOMC) at a luncheon with senior US Treasury staff.

I fear the Financial Policy Committee (FPC) is even less of a household name than the FOMC was then. Most people in the UK know about the Bank’s Monetary Policy Committee (MPC). So when you say you are part of a Bank policy committee they simply assume that it must be the FPC’s cousin – the older and better known MPC.

So today, I want to explain what the FPC does, why we do it and how we do it.¹ I realize for this audience some, perhaps much, of this will be familiar. But I am hoping even amongst this really well-informed group some of what I’m going to talk about might give you insights to the FPC that could help you understand and perhaps even anticipate our decisions.

Where did the committee come from and what’s it supposed to do?

As most of you know, our committee just passed (in April) its official 5th anniversary.² The body was formed in the aftermath of the financial crisis when the UK government, parliament, and regulators were in broad agreement that the supervisory process had let the public down. There are many different estimates of the damage done by the crisis, with different strengths and weaknesses. These estimates all suggest that the damage was very large. For instance, the cost of the taxpayer assistance to the banks that were bailed out is estimated to be more than £2,500 per household,³ and my colleague Richard Sharp argued that the lost growth has meant that the economy is 14% smaller than if we had been able to grow as expected prior to the crisis (Sharp, 2017).

The focus of financial supervision prior to the crisis was looking at individual firms or markets; different regulators were responsible for different bits of the system, but no one in the official sector that was responsible for looking at the system as a whole, including to check for fault-lines in different parts of the system that may reinforce each other. The FPC was set up to fill this gap. We are supposed to look at the

¹ I am not going to touch on some of the interesting philosophic questions about how the committee interacts with the rest of the government, see e.g. Tucker (2018) or Balls et al (2016) for some alternative views on this.

² Before the Bank of England Act was amended to form the FPC, there was an interim committee that operated for two years.

³ Source: National Audit Office and Office for National Statistics.

entire financial system. We are charged with spotting risks as they are emerging and to make sure that the system is resilient enough to support the economy if the risks crystalize. Put this way it seems like no one could oppose this goal. In fact, I guess most people would say how could someone not have always been responsible for this objective? Remarkably, before the crisis such committees were missing in all the major countries in the world.⁴ And even the extent that such bodies have been set up today, they still differ significantly in their mandates, personnel and powers. (Aikman et al (2018)).

Who is on this committee?

Who is actually on this committee? The first answer is that the committee respects a fundamental insight from finance, that diversification pays. We have a group of 12 people with very different backgrounds and areas of expertise. Half of the committee (including the chair) are from the Bank of England. The head of the Financial Conduct Authority (FCA) is a member and then there are 5 externally appointed members. The Treasury also has a non-voting member who attends the meetings.

Let's start with the Bank members. The Governor is our chair and leads the committee discussions with the goal of finding consensus on our decisions to the extent possible. This is critically important in two respects. Because many of the decisions we take involve structural decisions that will have lasting consequences, this rule helps avoid flip-flopping and delivers an appropriate degree of certainty to our decisions. In addition, because so much of what we do is not binary, and once you are acting on multi-dimensional problems, trying to proceed via up and down votes would be very complicated. In fact, Arrow (1951) has taught us that no electoral system can reliably summarize a committee's views on a large set of options. In such an environment, our consensus oriented approach works well.

The four deputy governors of the Bank of England and the executive director for financial stability strategy and risk, Alex Brazier, are the five other 'internal members' of the FPC. Jon Cunliffe is the deputy governor responsible for Financial Stability, and Sir Jon serves as chair if the Governor is not able to attend a meeting. The Bank's remaining three deputy governors (Ben Broadbent, Dave Ramsden, and Sam Woods) are responsible for Monetary Policy, Markets and Banking, and Prudential Regulation. Alex Brazier leads a staff of the around 140 staff whose work most directly feeds into the FPC work. All the internals bring their own expertise, and ensure that the perspectives of other parts of the Bank can be taken into account.

This group also brings wealth of experiences from the rest of their careers, with the various members having served in high ranking roles at the Treasury, the Cabinet Office, the Foreign Office, the private sector, and an alphabet soup of international committees. It is hard to think of an issue that comes before us where one of them does not have some specific expertise on the topic. Because the governors also sit on one or two of

⁴ Eg, between 1997 and the financial crisis, the Bank of England had a financial stability objective, but lacked the powers that would have been necessary to achieve this objective.

the other two main Bank committees, the MPC and Prudential Regulation Committee (PRC), we also benefit from the insights of those bodies.

Andrew Bailey is the head of the FCA. The FCA is the other primary financial regulator in the UK, and having him on the Committee means that we can be assured of being kept abreast of their efforts and can coordinate effectively on areas of shared interest. He too brings a wealth of experience in different official positions.

Finally, we have the 5 external members. We are appointed by the Treasury and it seems that HMT strives to find people with complementary backgrounds and areas of expertise. Three of our members, Richard Sharp, Elisabeth Steeman, and Martin Taylor, have worked mostly in the private sector. They have been at the highest levels in major financial services firms and bring that orientation and perspective. I routinely have an “aha moment” when one of them explains how they think about some of the issues that we face (or how they think the market will think about them), because they bring such a different approach and set of experiences than me to our deliberations.

Don Kohn is a central banker’s central banker. He served in various roles at the Federal Reserve, including as Vice Chair during the crisis, and knows virtually every important central banker of the last 30 years. His wisdom is irreplaceable. He lives in Washington DC, so he is the other commuter on the committee.

I am the token academic on the team. I have spent most of the last 25 years teaching and writing about banking and financial regulation, with a particular interest in Japanese financial crisis. I am not sure how much value I add, but I do think I sometimes approach issues in a way that others may not have considered. I am also using my expertise to inform/assist the Bank’s research program on financial stability issues.

How do we operate?

First, let me say a bit about the process, before I turn to the substance.⁵

We are by law required to meet at least 4 times each year and to make some decisions at each of these meetings. Twice a year we publish the Financial Stability Report (FSR), which is our flagship publication, describing the risks we see to financial stability, and any actions we are taking to address them. In addition, in quarters in which we do not publish an FSR, we publish a statement containing our main decisions. A summary of our deliberations is published after each round of meetings in the FPC’s “Record”.

Ahead of each of these four policy meetings there are a series of briefings and preliminary meetings.

⁵ See also Tucker, Hall and Pattani (2013) for many additional details of how a typical ‘FPC Round’ works.

This process starts with a big staff briefing that covers all the major financial indicators that we monitor, as well as any other developments that are judged to merit the Committee's attention. That briefing happens in the Bank's amphitheatre and you have over 100 staff sitting in the stands watching as different colleagues run through the data. This format reverses the usual norm where I suspect the staff doing the briefings are nervous; in this meeting, the FPC members are sitting under spot lights and being watched by the masses. After that briefing, the FPC will have a more private conversation about which risks we believe deserve most attention this round. Staff will take this away and work up additional analysis, and sometimes policy options, on these risks. And in quarters where the Financial Stability Report (FSR) will be published, they will start drafting material for the FSR that reflects our views.

In addition, we have smaller, less structured discussions around different issues before we need to make decisions at our policy meeting. These preliminary meetings have the glamorous name of the "FPC Issues Meetings". In many cases, this helps ensure that we have a common understanding of the key judgements that the Committee is required to make before having to take a decision. We often instruct the staff to do some additional background work on particular policy options for us to choose among at our Policy Meeting. A few of the issues we discuss in these meetings are recurring. For example,

- Each quarter, we must make a decision on how to set the UK counter cyclical capital buffer rate (CCyB) for banks – I will say more on that in a bit.
- At the start of each year, we discuss the annual stress test that will be conducted on the banking system that year. Stress tests are one of the great supervisory tools that were created after the crisis to make sure we understand if the banking system is sufficiently resilient to withstand a given 'severe but plausible' shock. We work with the PRC to help design those tests.
- We also have authority to set leverage ratios for banks, loan to value requirements and debt to income limits for borrowers (among other things). There are ongoing discussions about these tools, and we review their intended and unintended effects in regular intervals.
- We periodically scan the horizon for risks that might emerge in areas of the financial system outside the highly regulated sectors.
- At the moment, we are also regularly assessing the various risks of disruption to UK financial services arising from Brexit. This includes reviewing progress against a checklist of actions that would mitigate risks of disruption associated with Brexit to important financial services used by households and businesses, and we update progress against the checklist and publish the results each quarter. The Brexit-related issues that dominate the headlines are not necessarily related to financial stability. But our committee is still doing its job and making sure that there will not be any surprise disruptions to UK financial stability from Brexit.

There are also a number of other topics that an academic economist might not necessarily think of when thinking about "financial stability", but that we find ourselves coming back to in more or less regular intervals.

For instance, the risk of cyber attack causing disruption to critical financial services is something that the FPC takes very seriously. The FPC has already catalysed a range of actions in this area – for example by instigating a program to test and enhance the resilience of major UK financial firms to cyber attacks (via so-called ‘CBEST tests’). In June 2017, we have also set out the elements of the framework of regulation for the UK financial system’s cyber resilience that are necessary to mitigate systemic risk. The FPC’s future role will be to check that each element is being fulfilled by the relevant authorities. These elements include (i) Clear baseline expectations for firms’ resilience that reflect their importance for the financial system; (ii) Regular testing of resilience by firms and supervisors; (iii) Identification of firms that are outside of the financial regulatory perimeter, but which may be important for regulated firms; (iii) Clear and tested arrangements to respond to cyber attacks when they occur.

It is only after we have had an opportunity to discuss this wide range of issues, and identify the key judgements that we will be required to make, that we hold our quarterly policy meeting. This meeting takes place in a grand and elegant Committee Room inside the Parlours of the Bank of England. The room dates back over 250 years (having been moved and preserved during the various renovations). Appropriately, the governor sits beneath a portrait of Montagu Norman, who you recall was in charge of the Bank between 1920 and 1944.

What do we do?

In terms of substance, we have already developed various analytical frameworks that we use to make our decisions. We arrive at these by considering potential financial stability risks and discussing whether we might be able to improve outcomes - recognizing that acting involves potential costs as well as potential benefits.

We are guided by the idea that the private sector does not always get things completely right. There will be times when privately optimal arrangements will involve what economists call “externalities” – loosely speaking where a cost or benefit affects a party who did not choose to incur that cost or benefit.

A good example is the stress tests that I mentioned. We look for banks to be adequately capitalised not just to withstand a hypothetical adverse shock, but also to be able to support the real economy if a stress does materialise. We have published a detailed description of our approach to stress testing (Bank of England, 2015). These stress-tests are “counter-cyclical” in nature and are meant to become more severe as financial conditions get looser and the scope for macro-economic downside news becomes bigger.

The stress tests are a key input into our decision about the setting of the Countercyclical Capital Buffer rate. The CCyB is another post crisis tool that we believe can be an important source of strength for the financial system. It amounts to adding extra capital for banks when we judge that risks are building. We do this in part by looking at the losses that banks would face in the stress test that captures the current risk environment.

The CCyB will make the banks more resilient should those risks crystallize. We can then release the buffer to give banks added lending capacity to make sure that they continue supporting the economy in a downturn (Bank of England, 2016).

Perhaps the most unique thing about the FPC's operation is that we are instructed to worry about risks from and to all parts of the financial system, including the resilience of both lenders and borrowers. Most people understand that if the economy slows down and banks start making losses, things get much worse if banks cannot continue supporting the economy by providing credit to businesses and households. So the idea that we want to avoid what is often referred to as a "credit crunch" is generally accepted. Consequently, explaining that we use tools like the CCyB to limit this risk is not hard and there is broad support with the public and parliament for doing this.

The statute setting up the FPC also makes the committee responsible for taking steps (here I am paraphrasing) to reduce the risks associated with unsustainable build-ups of debt for households and businesses. This means that the FPC is obliged to monitor credit developments and if necessary be prepared to advocate for policies that may lead some borrowers and lenders to change the terms of a deal that they were otherwise willing to consummate. The rationale for doing this is that if borrowers become too heavily indebted, they may have to cut spending or investment sharply in order to continue servicing their debts as the economy slows down. This decline in spending reduces the income to others in the economy, who must then cut back on their own spending. In this way, excessive debt can amplify a shock even if banks remain resilient.

This mechanism has operated at various times including during the last crisis when homeowners decide to de-lever. The Bank has published research trying to quantify the extent of this problem (eg, Bunn and Rostom, 2014). And the FPC has made recommendations that led to requirements that banks check whether new borrowers can afford a mortgage if interest rates rise sharply, and to limits on the percentage of new residential mortgages to people seeking to borrow at or above 4.5 times their income. These policies can reduce the losses that banks and other lenders are likely to make in a downturn. But more importantly, they tackle the risk of pro-cyclical de-leveraging by households. Given painful memories of the crisis, these policies have not been very controversial. However, counterparts to the FPC in other countries rarely have this kind of mandate or authority.

More generally, in the UK we are fortunate to have the tools that are necessary for achieving our objectives. During the 7 years including the interim committee, we have made 38 recommendations to other regulators, all of which have been implemented. On top of that, we have asked for extra authority on several occasions to attend to risks for which we did not have appropriate tools or authority. These requests have also been granted. We have come pretty far in a short-time. If we succeed in continuing to build our frameworks and processes, I hope we can lead the way internationally in establishing the prototype financial stability committee, much like the MPC did regarding monetary policy.

Finally, let me close with an attempt to explain why I find being a member of the committee so interesting. This is the question I am asked the most. Exhibit 1 is my attempt to answer this question. The top half of the exhibit (Panel A) shows a subset of questions that I was asked at my first appearance in front of the Treasury Select Committee. The second half of the exhibit (Panel B) shows some additional questions that I had guessed I might be asked based on some of the prior TSC hearings, FPC statements and member speeches. It turned out that these questions did not come up, but I felt they would have been fair game.

I believe the exhibit shows the range of issues which we confront on the FPC in the most concise possible way. Preparing for my first appearance at the TSC was like studying for my qualifying exams in graduate school, and it brought back all the terrifying fears about flunking, along with the excitement of seeing connections behind ideas and concepts and the satisfaction of mastering interesting material. If you care about public policy, I cannot imagine a job that has a better combination of important responsibilities, interesting tools, and an ever changing set of issues.

If I had to try to summarize all the issues we consider, I would say *“we look across the financial system and try to identify situations where the private sector left to its own will not deliver the kind of stability that society wants. And upon finding such cases we try to remedy them.”* This may not be very punchy, but it is the most concise description of our remit that I can think of.

Let me close by circling back to Larry’s Meyer speech that inspired this one. Larry said of the FOMC *“Each member appreciates the heavy responsibility the Committee has for the economic well-being of the country and the importance of their personal participation in this process”*. I can tell you the same is true for the FPC. Right now when you look up FPC in the Urban Dictionary (urbandictionary.com) you are told that FPC stands for Fetal Position Cry. The definition is *“it is what happens when life is getting too much and the only way to cope is to sit in a fetal position and cry. This is known as 'having an FPC'”*. Let’s hope that by our 10th anniversary that won’t be what people think of when they hear FPC.

Thanks, I would be delighted to take some questions.

EXHIBIT 1

Panel A: Some of the things I was asked at my appointment hearing in 2016

- Do you have any thoughts on the recent flash crash in sterling - including what caused it and whether it matters when things bounce back quickly?
- Is the flash crash attributed to computer generated algorithms?
- Overall, do you think algorithm trading leads to more or less volatility?
- Overall, looking at the sterling market, do you think that we are better off having algorithmic trading or not? If it is not, what policy implications, if any, lie behind that?
- In response to the crisis, we have had the introduction of a heap of new banking rules, both through Basel and in efforts to combat conduct risk. Are those increasing financial stability or reducing it?
- You have spoken about potential contagion from European banks. Do you agree that one key problem for European banks is the American regulatory system with its multiplicity of regulators?
- The popular consensus is that there are about €360 billion of non-performing loans in the Italian banking system. Some sources suggest that in reality, the number is much lower (€80 billion). Do you have a view on this?
- Given the fall in sterling of 15% since 23 June, how likely is a further major depreciation, and what are the associated financial stability risks during the period of Article 50?
- If I were to paraphrase, let us say we went for a hard Brexit, how does that impact your thinking?
- I am interested in the relationship between how the Financial Policy Committee works and the MPC. Can you envisage situations where there might be a policy divergence between the two?
- In the last 12 months, the aggregate deficits on pension funds in the UK, pension funds to which the pension authorities are liable to step in if there is a problem, have doubled. In the month of August alone, they shot up by 22%. Does that not ring alarm bells?
- One of the issues that we have been discussing with the Bank since the FPC's inception is that that consensus should not preclude the expression of views and the demonstration of the independence of mind to challenge current orthodoxies. Are you intending to participate in that in public forums?

Panel B: Some additional questions that I had prepared for

- Is unconventional monetary policy and low-for-long interest rates having a financial stability impact?
- Are monetary policy and financial stability policy working together or against each other?
- The CCyB has been held at 0% after its reduction earlier in the year. Was the reduction of the CCyB earlier in the year necessary?
- Have movements in markets since the referendum been less severe/more severe or in line with your fears or expectations?
- Following the Prime Minister's announcements that Article 50 will be triggered in March 2017, what has been the financial market reaction? Has market reaction been more or less severe than expected?

- How will the forthcoming Brexit negotiations affect the Bank's ability to meet its financial stability objectives?
- Following the Warsh Review, the MPC now publishes full minutes of its meeting. Do you believe the FPC should do something similar?
- Do you agree with consensus building nature of the FPC?

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