BANK OF ENGLAND

Speech

The Financial Policy Committee of the Bank of England; an experiment in macroprudential management – the view of an external member

Speech given by

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Thank you for the introduction.

I would like to stress that these remarks represent my own views and not necessarily those of my Bank of England colleagues. My role within the structure of the Bank of England is that of an external member of the newly created Financial Policy Committee (FPC). I am one of four such external members who are expected to bring an independent as well as an external perspective to FPC deliberations. For my part I have had approximately 30 years of a broad based investment banking experience and I am seeking to utilise my experience to help the Committee fulfill its primary task of maintaining financial stability in the UK.

Tonight I will touch on some of the background issues concerning macroprudential policy leading to the creation of the FPC. I will discuss some of the FPC's powers and objectives, and share with you some of the challenges we face as we seek to fulfill our mandate.

The creation of macroprudential policy and the FPC

Crises, of any nature, cause people to reconsider their beliefs and their actions and policies. Looking back through history, we find that it is common for major financial crises to be followed by innovations or changes in regulation. For example, there was a wave of regulations, including the creation of Glass-Steagall and deposit insurance, in the US in response to the Great Depression, and the initial Basel Committee on Banking Supervision was created in 1974 in response to the failures of Bankhaus Hersatt and the Franklin National Bank of New York.

The recent financial crisis has had a profound effect on people and economies across the globe. And it has caused governments and regulators to rethink and redesign much of the global regulatory framework, including capital, liquidity and leverage requirements (through Basel III), structural reform of banking groups (e.g. the Independent Commission on Banking proposals in the UK and the Volcker rule in the US), market reforms (e.g. of over-the-counter derivative markets) and the regulation of shadow banks.

Critically, it is now understood that effective macroprudential policy sits at the heart of interconnected policies which all touch on financial stability. And, moreover, that financial stability is of absolute importance and needs to take account of this interconnectedness in design and implementation. Hence the importance in creating an appropriate structural response which has a singular entity charged with financial stability. In the UK that is the FPC.

Changes to financial regulatory structure in the UK

Before the crisis the UK's system of ensuring financial stability was vested in an infamous tri-partite system. The Financial Services Authority (FSA) conducted microprudential and conduct supervision of over 25,000 financial institutions, the separate Bank of England was responsible for monetary stability, regulating payment systems, and providing liquidity to the financial system, and HM Treasury oversaw the institutional structures and ultimately footed much of the bill associated with resolving problems in failing banks.

To manage the intersection of these responsibilities, in 1997 a Memorandum of Understanding was signed between HM Treasury, the Bank of England and the Financial Services Authority. It said that Parliament, the markets and the public must know the responsibilities of each authority, there should be no overlap between those authorities and that each authority must be accountable for their responsibilities. And each authority sat on a Standing Committee which met monthly to discuss financial stability issues which was supposed to encourage meaningful coordination. The agreement seemed clear and had all the right words, but it just did not work. When they set up this tri-partite system they focused too much on structure and not enough on matters which were necessary for effective outcomes.

As one of my favorite philosophers, and baseball legend, Yogi Berra, said: “if you don’t know where you are going, you may end up somewhere else”.

In 2011 the Government said “the decision to divide responsibility for assessing systemic financial risks between [the] three institutions meant that in reality no one took responsibility”. It was generally agreed that the FSA was insufficiently focused on systemically important institutions and failed to manage against correlated risks across the system. The Bank of England was responsible for the broad overview but it could and should have done more to elevate awareness of the risks, and lack of resilience, in the financial system and to press for action to be taken. And the Treasury had been content with the light touch regulation which had done so much to contribute to the apparent successful development of the City and its financial institutions; it was blissfully ignorant of the failure of the FSA to ensure that the light touch regulation was effective.

The architecture is now vastly different: roles and responsibilities are more clearly defined and accountability is clearly allocated. The most visible change was to split the FSA into (i) the Prudential Regulation Authority (PRA), which is a part of the Bank of England and is responsible for microprudential regulation of banks, insurers and large investment firms, and (ii) the Financial Conduct Authority (FCA), which is responsible for conduct regulation of all regulated financial institutions and microprudential regulation of regulated financial institutions not covered by the PRA. In this way it is expected that the extensive consumer protection activities will not diminish resources or focus expended on effective microprudential regulation of key financial institutions.

But a more subtle and, I’d argue, equally important change was to give responsibility for macroprudential policy to the Bank of England, in particular to the FPC.

The FPC

There are 11 members of the FPC. The Committee is populated to ensure the best possible coordination between the Bank of England, the PRA, the MPC and the FCA. The FPC has five Bank of England staff members: the Governor who chairs the FPC, as well as the PRA Board and the Monetary Policy Committee (MPC); 3 Deputy Governors; and the Executive Director for Financial Stability. One of the Deputy Governors is the Chief Executive of the PRA. In addition, there is the Chief Executive of the FCA, one non-voting member from the Treasury, and the four of us as independent external members: Don Kohn, the former Vice Chairman of the US Fed and an expert in central banking standards and global capital flows; Clara Furse, former Chief Executive of the London Stock Exchange; Martin Taylor, former Chief Executive of Barclays; and myself.

The importance of the independent external members is to bring a different range of knowledge and insights to the FPC, which should help guard against the risk of groupthink.

The statutory objectives of the Financial Policy Committee are twofold. First, to contribute to the achievement of the Bank of England's Financial Stability Objective and, second, subject to that, to support the economic policy of HM Government, including its objectives for growth and employment.

The FPC has powers to give directions to the PRA and the FCA in relation to the use of certain specified macroprudential instruments – which are currently the sectoral capital requirements and countercyclical capital buffer; it can make recommendations to anybody, including to the PRA and the FCA on a "comply or explain" basis; and it is able to make recommendations to HM Treasury, including on the boundaries within and around the perimeter of the PRA and FCA regulatory regimes.

The FPC's tools will form the first line of defence against financial stability risks. This includes financial stability risks that may be indirectly created by the actions of other committees (as the MPC recognised in its use of forward guidance). When using its tools, the FPC aims to take graduated and proportionate action, where possible. The Committee has stressed this approach, for example, when considering risks stemming from the housing market and the set of tools that it could deploy to manage these risks as, and if, they emerge.

In addition to risks, like those in the housing market, which vary over the course of the business cycle or credit cycle, the FPC is responsible for addressing risks that emanate from the structure of financial institutions, financial markets or the financial system as a whole. As these structural risks are broad and varied, the Committee has decided to focus over the next 12-18 months on three key medium-term priorities: establishing the medium-term capital framework for banks; ending 'too big to fail'; and ensuring diverse and resilient sources of market-based finance. Work in these areas will involve extensive interaction with authorities internationally, as well as domestically with the PRA, FCA and HM Treasury.

Challenges facing the FPC

The conduct of macroprudential policy is vitally important but is unfortunately particularly challenging, not just for the FPC but macroprudential authorities and academics throughout the world. This is for a number of reasons, including:

- Challenges in identifying the build-up of systemic risks, including the build-up of time-varying risks and cross-sectional risks;
- The current lack of definitive empirical evidence on the impact of many of the tools available to the macroprudential bodies;
- The need to balance objectives e.g. financial stability v economic growth (although, in the UK, the law is explicit that the FPC's primary objective is to contribute to financial stability and, subject to that, it should support the government's economic policy);
- We do not really know how time-varying tools, e.g. the countercyclical capital buffer, should be set during a downturn given the possible trade-off between the balance sheet resilience of the financial system and credit supply – which is when the difficulty of balancing objectives is likely to be most acute;
- Challenges in understanding the potentially imprecise interaction between macroprudential, monetary, and microprudential policy;
- And the potential for unintended consequences when communicating policies to the public and financial industry; for example, if anticipation of action by the FPC stimulates market participants to change their behaviour in an unhelpful way.

Uncertainty is a common theme behind each of these challenges. I will focus on some of the types of uncertainty that create challenges for macroprudential policy makers when deciding to act.

Objectives

There is currently no clear international consensus on the objectives of macroprudential policy (Galati & Moessner (2013)). Whilst the overall objective of reducing systemic risks in the financial system is clear, what is not clear is the extent to which this should be balanced against a broader macroeconomic growth objective. One area of significant debate is on whether macroprudential policy should act to mitigate the growth of asset 'bubbles'. If a bubble is funded by bank debt I think the answer is likely to be yes, but it is unfortunately less clear cut if the links between a bubble and financial stability are less obvious.

Identification of risks

We should remember that it is always easy to see bubbles in hindsight, but it is not always as easy to see them when they are developing. Certainly my experience has led me to be all too well aware that to seek to forecast future market directions or developments is invariably an extremely hazardous exercise. It is worth reminding ourselves that by some measures somewhere between 75% and 98% of the world's finest minds in finance consistently underperform passive market indices even though they are well informed, experienced and supposed experts. Hence, a central belief of mine is that macroprudential regulation and policy making should always prioritise protecting the robustness and resilience of the financial system and not act on the expectation that significant systemic risk can always be appropriately anticipated and thereby be securely avoided.

Indeed the history of central banking across the globe demonstrates a consistent failure to anticipate or mitigate significant shocks. For example, the Latin American Sovereign crisis, the US savings and loans crisis, the tech bubble of the 1990s and, devastatingly, the real estate bubble of the last decade. None of these risks were appropriately anticipated by central banks in a way that managed to prevent or mitigate severe shocks to stability.

The risks associated with seeking to be effective in this area are highlighted not just by the fact of the crash but also by the perspectives of some of the most intelligent operators in this area before the crash took place. In a notable speech delivered a few years before the recent crisis, Ben Bernanke said that "one of the most striking features in the economic landscape over the past 20 years or so has been a substantial decline of macro volatility". He was so confident that substantial volatility had been eliminated that the speech was not focused on whether this issue was true, but instead focused on why volatility had declined. The implicit message was that severe volatility had been eliminated. Indeed this period was actually described at the time as "the Great Moderation".

Bernanke had identified three types of explanation. First, structural change had taken place such that changes in economic institutions, technology, business practices or other structural features of the economy had improved to such an extent that there was a greater capacity for the economy to absorb shocks. This view, by the way, was a widely held consensus. Unfortunately not only was it wrong, it was precisely wrong. In fact, correlated risk taking and structural changes had taken place which led to the amplification, and not the absorption, of shocks.

The second class of explanation for the "Great Moderation" focused on the benign effects of macroeconomic policy and, in particular, monetary policy. We now know that, although monetary policy had benign effects on inflation, there were devastating effects on the accumulation of leverage in financial institutions and the wider economy, and on asset inflation.

His third explanation was good luck, i.e. that the world had experienced smaller and more infrequent shocks. His explanation puts in my mind the need to coin the phrase:

"You never hear the shock that kills you".

My point in reminding us of this perspective from Ben Bernanke is not to single him out, but more to remind ourselves that, at any given point in time, the most intelligent central bankers in the world can be wrong. Indeed, the forecasting ability of the Bank of England itself has been under scrutiny. A review of the MPC's forecasting ability, conducted by David Stockton in 2012 at the request of the Court of the Bank of England, showed that the MPC's central forecasts for annual GDP growth one year ahead were consistently above actual GDP growth for much of the period since the crisis began.

As Yogi Berra said, "making predictions is difficult, especially about the future".

So when it comes to evaluating the FPC, please do not expect an omniscient Committee which, by their collective capabilities, can always successfully anticipate shocks. Whilst we will do our best to anticipate shocks and minimize the possibility of them arising, it is better that the FPC should be viewed as unequivocally accountable for ensuring that, when such shocks do occur – and indeed they will – the system has built up sufficient strength and resilience so that such events can be effectively managed.

Response to uncertainty about systemic risks

Predicting crises is difficult and I don't believe one can rely on academics or central bankers developing any robust predictive models in the near future (Hansen (2013)). However, I do not believe that perfect models for predicting financial stability threats are necessary in order for macroprudential authorities to take important action before significant threats build-up. Instead, what is necessary are frameworks and processes that enable macroprudential authorities to identify emerging signs of threats or lack of resilience in the financial system so that they can act at an early enough stage to address the risk effectively (especially given the implementation periods for some policy actions). A particular challenge is "fat tail risk", where ensuring against an unlikely event happening may have more visible tangible short term costs.

There is a growing body of research in this area. For instance, research suggests that the difference between the credit-to-GDP ratio and its long-run trend (the 'credit-to-GDP gap') is a good signal of the build-up of potential time-varying risks to financial stability (Giese et al (2014)). On an intuitive level this makes sense if you believe that the financial sector provides credit to increasingly risky borrowers the further the level of credit exceeds its historic trend.

Despite this, the credit-to-GDP gap is not a perfect indicator and no such indicator, or even a set of indicators, is likely to exist. When it sets the countercyclical capital buffer (CCB), which is one of the FPC's main tools to address time-varying risks, the FPC considers a number of indicators. These 'core indicators' are published on the Bank of England's website. But the FPC also considers other sources of information, including supervisory and market intelligence. It would be wrong for the FPC to set its tools mechanistically purely on the basis of models or indicators.

Not only can models be imperfect but data can be imprecise or missing. For example, it is fair to say that the structure of the financial system is not fully understood due to data gaps, for example on correlations between firms' assets and financial interlinkages more generally.

And it is possible that these challenges are particularly acute for the FPC, given the macroeconomic and financial environment in the UK. Each nation has idiosyncratic sources of risk. In the UK now, we are alert to risks represented by the acceleration of asset prices, particularly property, in part arising from the low interest rate environment. In addition, we have a worrying level of national debt to GDP which is below but flirting with the tipping point, suggested by Rogoff and Reinhart, whereby for certain countries excessive national debt can compress economic growth.

In addition to idiosyncratic national risks, we have to be mindful of the risks arising from the spill-over effects from other markets. We saw last year, for example, the tremor to credit markets arising from the risk of US tapering. We have potential risks in the financial systems in China and Japan to contemplate. And we have to assess continuing risks which could emerge from sovereign indebtedness in Europe.

Although the UK is a geographical island, it is not a financial one. It is highly open in terms of trade: the sum of nominal exports and imports and goods and services exceeds 60% of GDP. To put that in perspective, the figure is a little over 30% for the US and Japan. This means that foreign developments can transmit strongly to the UK through trade linkages.

The UK's financial openness is even more striking, with the sum of the UK's external assets and liabilities exceeding 14 times nominal GDP. For many advanced economies, this figure is less than 5 times nominal GDP. So the UK's financial linkages are also a key channel by which foreign developments can affect the domestic economy.

The correlation between annual UK GDP growth and PPP-weighted world GDP growth since 1988 is around 0.6, confirming that UK activity displays a high amount of co-movement with wider global activity.

Using several structural VAR models, previously used in a speech by Ben Broadbent, so-called world shocks can account for around two-thirds of the weakness in the level of UK GDP relative to pre-crisis trend since 2007**.** Hence we also need to be realistic that the FPC has to take account of unpredictable external events which it is not in a position to manage but which may have a profound effect on UK financial stability.

The choice and calibration of tools

The FPC's powers are considerable. However, we must acknowledge uncertainty about the effectiveness of the tools available to macroprudential policy makers and the possibility of unintended consequences arising from their application. Moreover, models which describe the transmission channels through which tools operate are unfortunately imprecise due to the complexity of the structure of the financial system, especially given the swathe of recent regulatory reforms, and the magnitude of the channels. As the FPC and its tools are relatively new, we will need to be careful to assess the effectiveness of our actions. This will be done publically, as the FPC is legally required to conduct cost-benefit analysis, where practicable, when deciding to take policy action.

At times, the choice of instruments may be particularly challenging. There may be a broad range of instruments available to the FPC and it is possible that multiple tools can address the same risks in very different ways. For example, cyclical risks developing in the banking system could potentially be addressed by use of system-wide or targeted capital requirements, liquidity requirements, requirements relating to the terms of bank lending, and many others.

In addition, calibration of the tools is particularly difficult, not least because other committees and authorities have instruments at their disposal which could amplify or dampen the effect of the FPC's tools. The FPC needs to take account of monetary policy, microprudential policy, competition policy, fiscal and structural policy, and resolution policy, among others. And we need to recognize that macroprudential policy, although generally synergistic with other policies, may from time to time be in conflict with them and that any tensions need to be recognised and managed carefully.

Has the UK got the set-up right?

I have briefly described the many significant challenges facing macroprudential policy. Clearly it is a difficult thing to get right but it is vitally important that we do so. So it is fair to ask whether we have the right set-up in the UK.

The IMF usefully offers guidance with respect to the efficient operational organisation of macroprudential policy. The FPC is following these processes. There is a need to develop the capacity to assess systemic risk; there needs to be the selection of a macroprudential tool kit and powers. Tools need to be calibrated and there needs to be effective communication with the public and markets, hence my presence here today. In addition, there needs to be constant vigilance with respect to monitoring regulatory gaps and timely action needs to be taken to close them. Similarly if data gaps create risks and uncertainty this needs to be addressed.

In my view, the set-up of macroprudential policy in the UK is right – now it's about the execution.

Whilst Yogi Berra is one of my favourite philosophers, a man who has lectured here in the past – Hayek – is someone who I have enormous respect for. He pointed out "that the failure of economists to guide policy more successfully is closely connected with the propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences – an attempt which may lead to outright error". He described it as “scientistic” and said that, “unlike the position that exists in the physical sciences, in economics and other disciplines that deal with essentially complex phenomena, the aspects of the events to be accounted for about which we can get quantitative data are necessarily limited and may not include the important ones”.

Central bankers – and their critics – need to constantly remind themselves that if it was acceptable for Hayek, the 1974 Nobel prize winner, to acknowledge massive uncertainty in economics, then we too need to recognise that there are limits to the certainty with which we can rely upon central bankers’ vision and the consequences of their actions.

Current challenges

So what worries me?

First, that the last crash occurred partly as a result of central bank and regulators’ failure to appropriately assess risks to the system and the resilience of the systems – and that I now find myself accountable to make sure this does not happen again.

Second, the UKs economic position is still fragile.

Third, we have a banking system that is still somewhat undercapitalised, although it is on an agreed transition path to a higher level of capitalisation.

Fourth, global quantitative easing has led to asset price inflation which may involve some fragility in markets, in particular if there is a sharp snap-back in rates.

Fifth, our economy is vulnerable to external shocks. There is some fragility in Asia, both with respect to potential growth and the financial system, and of particular concern our biggest trading partner – Europe – is flirting with deflation.

In addition, there is a vigorous debate taking place as to whether: (i) there is a shortfall of demand in the global economy that requires the demand-boosting strategies which we are currently experiencing; or whether, (ii) there is a balance sheet effect which is reducing economic activity, and that incurring more debt in the system will not ultimately be a successful recipe for economic growth – putting me in mind of one of Yogi’s other phrases:

“If you come to a fork in the road take it”.

There is no doubt that the zero bound regime within which we operate is a clear indication of significant macroeconomic difficulty and therefore – although presently we must feel that the last year has seen a tremendous move towards more economic stability – it is perfectly conceivable that new shocks or difficulties are just around the corner.

So with respect to the economy and financial crisis, I’ll turn to Yogi one last time: “it aint over till it’s over.”

But fortunately for you this talk is.

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