

# Central Banking and the Credit Crunch

Howard Davies
Director
LSE

Sheikh Zayed Theatre
30 October 2008



"There have been three great inventions since the beginning of time: fire, the wheel and central banking"

Will Rogers



- 1. Is it the Fed wot done it?
- 2. Should central banks take more account of asset prices in setting interest rates?
- 3. Is there a case for a macro-prudential overlay on bank capital requirements?
- 4. Do central banks need to play a hands-on role in the supervision of individual banks?
- 5. Does the 'social contract' between banks and the finance authorities need to be renegotiated?



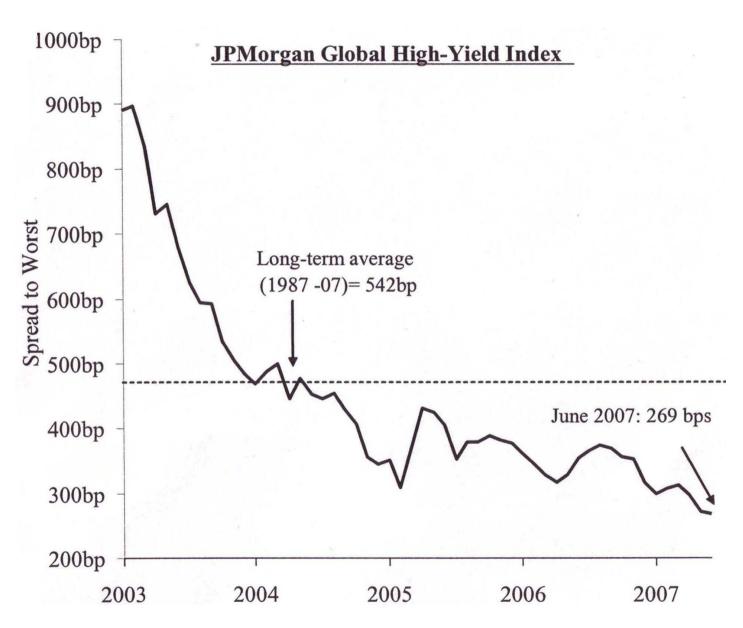
1. Is it the Fed wot done it?



"Central banks were asleep at the switch. The lack of monetary discipline has become the hallmark of an unfettered globalisation. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy"

Steve Roach, Morgan Stanley August 2007





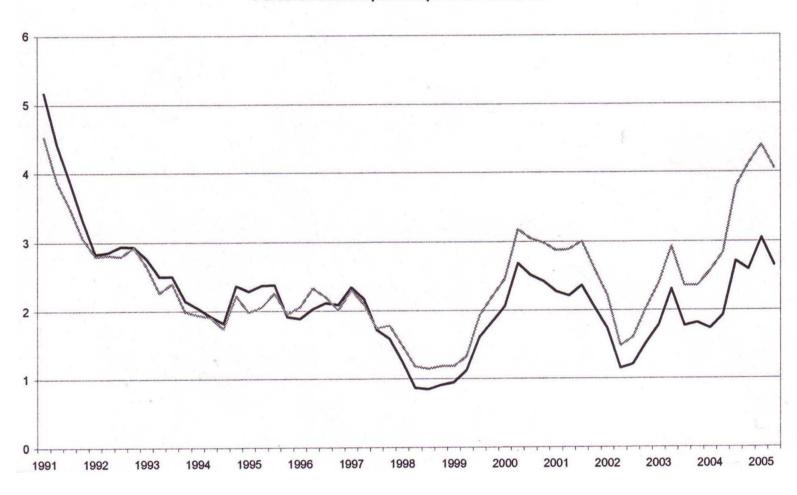


2. Should central banks take more account of asset prices in setting interest rates?

### Including House Prices in the US Inflation Measure

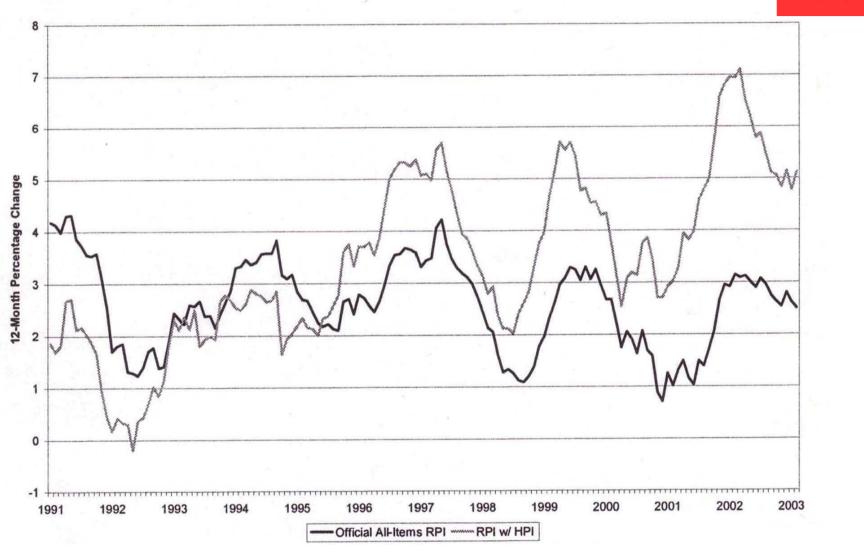


#### **Personal Consumption Expenditure Inflation**



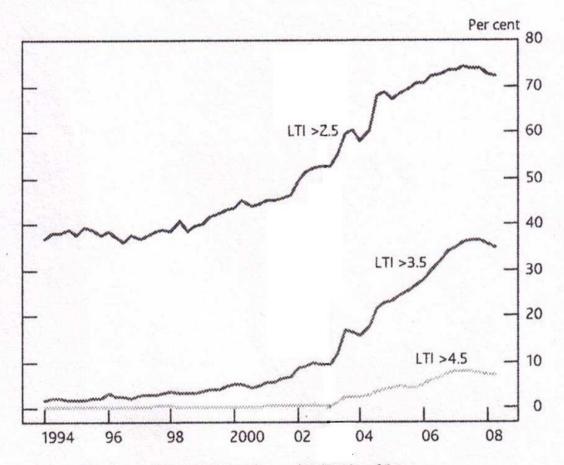
#### The UK Retail Price Index





Source: UK all-items Retail Price Index, RPI housing component with Nationwide UK-wide HPI.

### Loan to income ratios for house purchases in the United Kingdom<sup>(a)(b)</sup>

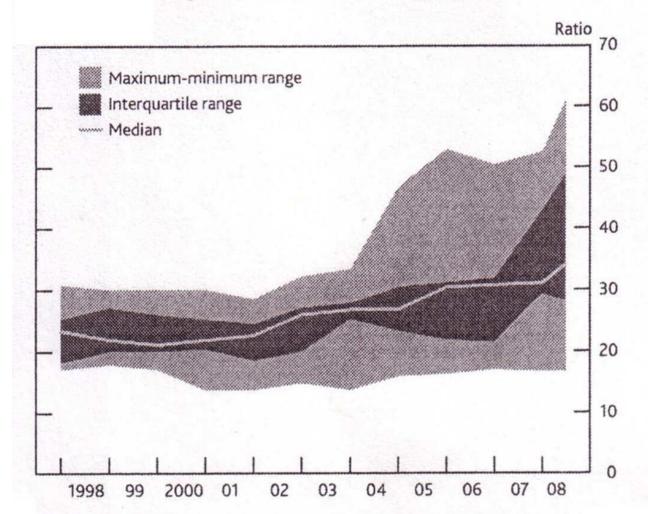


Sources: FSA, Survey of Mortgage Lenders and University of Essex.

- (a) Chart shows the proportion of mortgages with loan to income ratios greater than 2.5, 3.5 and 4.5.
- (b) FSA data are used from 2005 Q2 onwards. The back-run has been constructed using the changes in the series from the Survey of Mortgage Lenders data set.



#### Major UK banks' leverage ratio(a)(b)



Sources: Published accounts and Bank calculations.

- (a) Leverage ratio defined as total assets divided by total equity excluding minority interest.
- (b) Excludes Nationwide due to lack of interim data.





3. Is there a case for a macroprudential overlay on bank capital requirements?

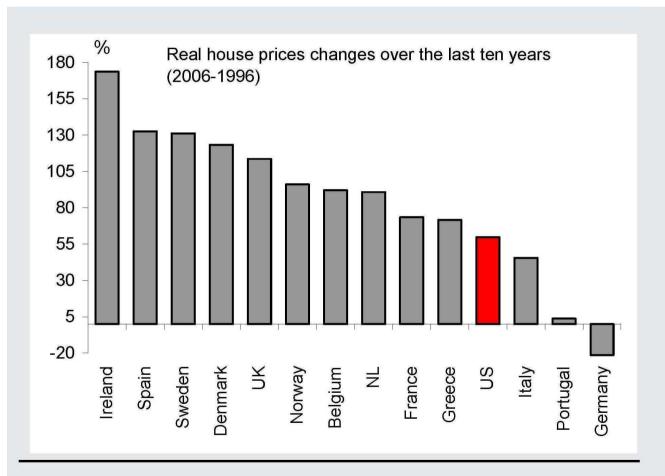


"Bank failures are caused by depositors who don't deposit enough money to cover the losses due to mismanagement".

Dan Quayle

## Real increase in house prices over the last decade





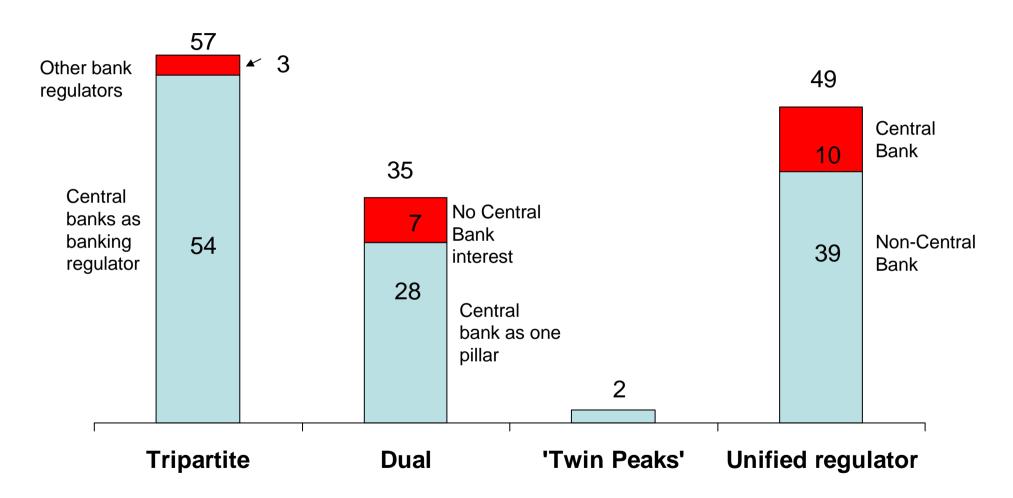
Source. ECB, National Statistical Offices, IMF, EMF, Italian Ministry of Infrastructure, Morgan Stanley Research



4. Do central banks need to play a hands-on role in the supervision of individual banks?

#### National Regulatory Structures

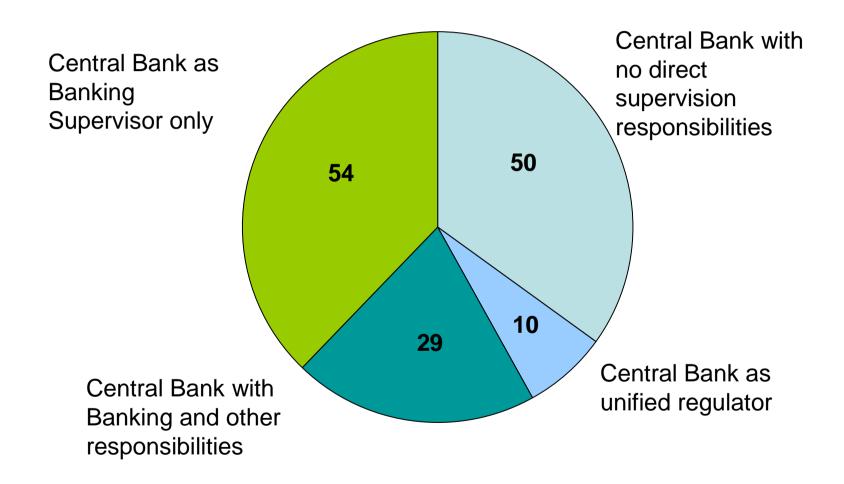




Source: How Countries Supervise their Banks, Insurers and Securities Markets 2007: Central Bank Publications

#### **Central Banks in Regulation**

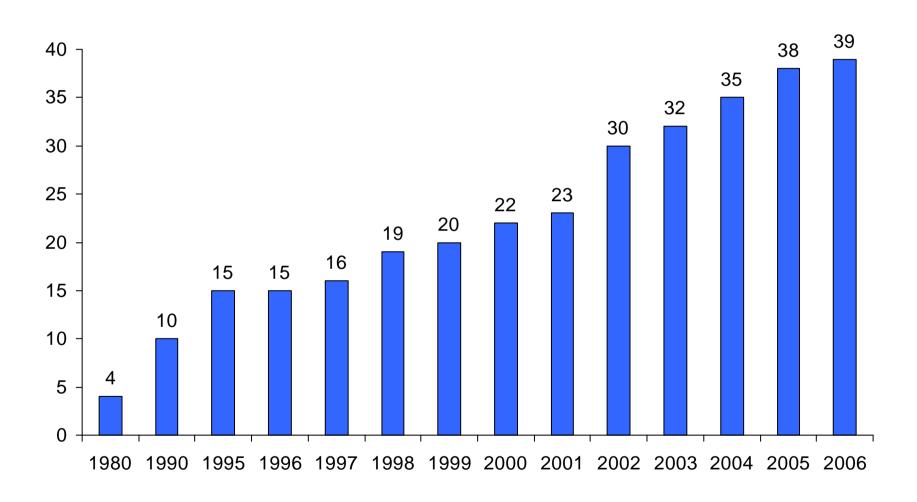




Source: How Countries Supervise their Banks, Insurers and Securities Markets 2007: Central Bank Publications







Source: How Countries Supervise their Banks, Insurers and Securities Markets 2007: Central Bank Publications



'Global Financial Regulation is a timely review of a subject which engages the attention of both national and international authorities. Howard Davies and David Green bring substantive experience and a strong point of view to the needed debate.' Paul Volcker, former Chairman of the Federal Reserve Board

'Financial regulation has leapt to the top of the international economic agenda. Seldom can there have been such a well-timed book. The authors are very distinguished experts and practitioners in the field. Davies and Green achieve the almost impossible feat of making "regulation" interesting.' William Keegan, Senior Economics Commentator, The Observer

As international financial markets have become more complex, so has the regulatory system which oversees them. The Basel Committee is just one of a plethera of international bodies and groupings which now set standards for financial activity around the world, in the interests of protecting savers and investors and maintaining financial stability. These groupings, and their decisions, have a major impact on markets in developed and developing countries, and on competition between financial firms. Yet their workings are shrouded in mystery, and their legitimacy is uncertain.

Here, for the first time, two men who have worked within the system describe its origins and development in clear and accessible terms. Howard Davies was the first Chairman of the UK's Financial Services Authority and the single regulator for the whole of Britain's financial sector. David Green was Head of International Policy at the FSA, after spending thirty years in the Bank of England, and has been closely associated with the development of the current European reculatory arraneoments.

This guide to the international system will be invaluable for regulators, financial market practitioners and for students of the global financial system, wherever they are located. The book identifies weaknesses in a system faced with new types of institutions such as hedge funds and private equity, as well as the growth in importance of major developing countries, who have been excluded so far from the key decision-making fora. It will be essential reading for all those interested in the development of financial markets and the way they are regulated.

Howard Davies is Director of the London School of Economics and Political Science David Green is Advisor on International Affairs at the Financial Reporting Council

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The Essential Guide Howard Davies & David Green

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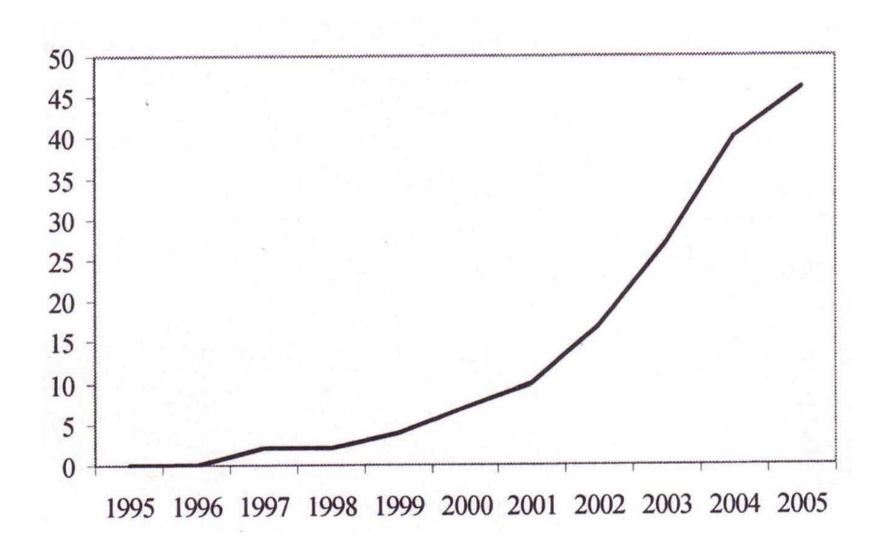


"Financial stability assessment as currently practiced by central banks and international organisations probably compares with the way monetary policy assessment was practiced by central banks three or four decades ago – before there was a widely accepted, rigorous framework"

ECB 2005

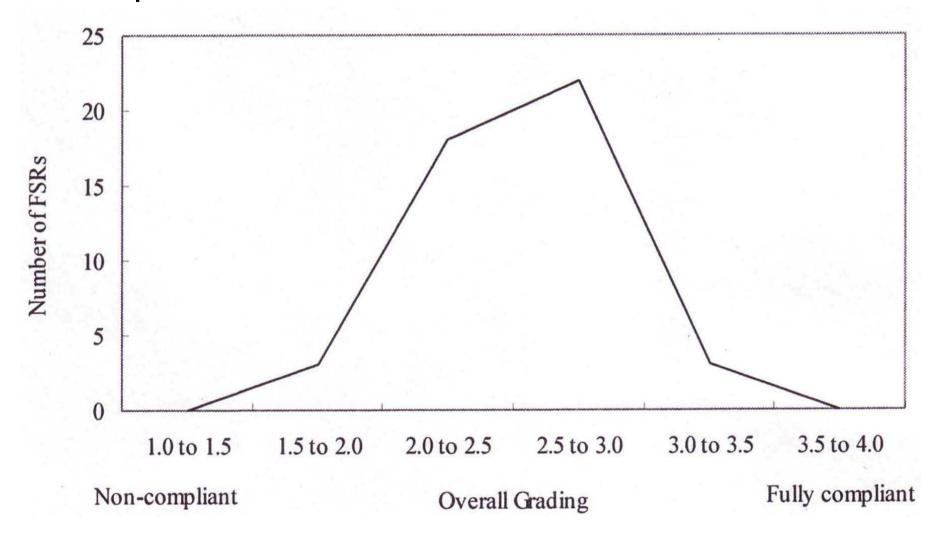
## The Number of Countries Publishing FSR's 1995-2005





## How Do Existing FSRs Compare to the Proposed Criteria?







"Interestingly, gradings are on average higher for central banks not directly involved in day-to-day supervision, partly reflecting that the overall assessments in these reports are more candid"

Martin Cihak IMF December 2006



"The Fed's ability to deal with diverse and hard to predict threats to financial stability depends critically on the information, expertise and powers that it holds by virtue of being a bank supervisor and a central bank"

> Chairman Ben Bernanke January 2007



"The US system is at odds with the increasing convergence of financial service providers and products...(in future) the Fed's role would continue through traditional channels of implementing monetary policy and providing liquidity to the financial system...(this role)... would replace the Fed's more limited role of Bank Holding Company supervision"

> U.S. Treasury March 2008



5. Does the 'social contract' between banks and the financial authorities need to be renegotiated?

#### **The Social Contract**



#### **Banks**

#### <u>Government</u>

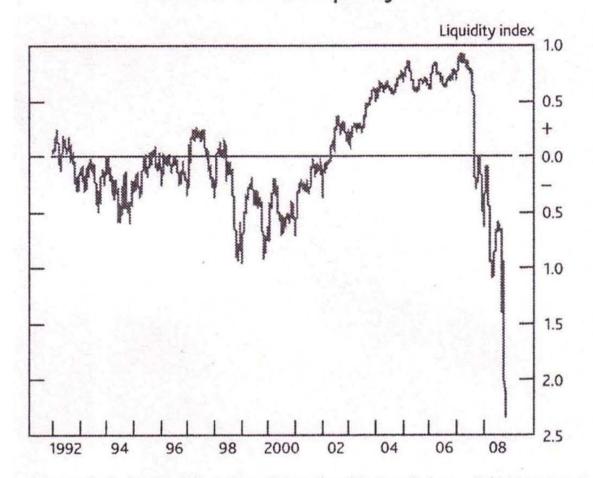
Maturity transformation

**Deposit Insurance** 

**Prudential Regulation** 

Central Bank Liquidity (lender of last resort)

#### Financial market liquidity(a)

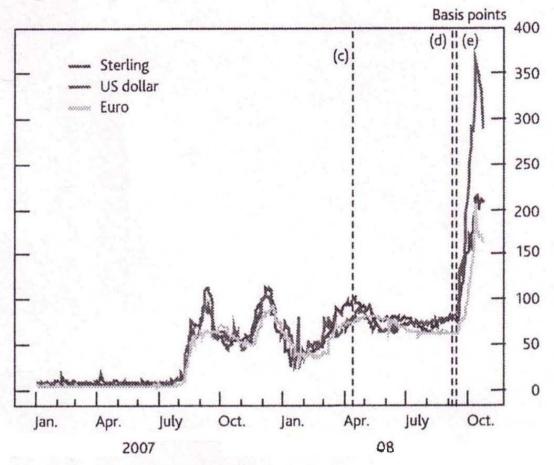


Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thomson Datastream and Bank calculations.

(a) The liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised on the period 1999–2004. The series shown is an exponentially weighted moving average. The indicator is more reliable after 1997 as it is based on a greater number of underlying measures. The recent fall in the indicator is largely due to a sharp decline in the interbank market liquidity measure.



### Three-month interbank rates relative to expected policy rates(a)(b)



Sources: Bloomberg and Bank calculations.

- (a) Spread of three-month Libor to three-month overnight indexed swap rates.
- (b) Data to close of business on 20 October 2008.
- (c) April 2008 Report.
- (d) Fannie Mae and Freddie Mac taken into conservatorship.
- (e) Lehman Brothers Holdings files for Chapter 11 bankruptcy protection.





"If the fundamental evolutionary criterion of success is that an organisation should reproduce and multiply over the world, and successfully mutate to meet the emerging challenges of time, then central bodies have been conspicuously successful".

Capie, Goodhart and Schnadt The Future of Central Banking



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