BANK OF ENGLAND

Speech

What's the FPC for?

Remarks by

Alastair Clark, Member of the Financial Policy Committee, Bank of England

At the Society of Business Economists Annual Conference

24 May 2012

Introduction

A great deal has been said about the reasons for, the blame for and the lessons to be learned from the recent – and continuing – financial crisis. And there certainly are lessons to learn from an event which has led to such a massive loss of output, estimated for the UK as a cumulative 25% or more of annual GDP. The crisis, as we all know, has prompted a whole raft of responses at the national and international level – in regulation, crisis management and economic policy more broadly. But this morning I will focus on the narrower issue of how the lessons are being reflected in changes to UK regulatory arrangements. And I will talk more about the "whys" than the details of the "whats".

In the UK, three of the main weaknesses exposed by the crisis were:

- the absence of procedures, properly developed in advance, for handling systemic threats and failing individual banks, and the lack of a clear message to practitioners and to the world at large about who was in charge.
- an approach to prudential supervision which relied too heavily on detailed rules and did not require, or give enough room for, the exercise of judgment by the supervisors; and
- a disconnect between front-line micro-regulation and the response to threats to the financial system as a whole.

Over the past three years, actions have been taken to address all of these areas.

So, for example, on the first, crisis management, there is now, following the Banking Act 2009, a much stronger framework for "resolving" – that is, sorting out with minimum collateral disruption – a bank which is failing; and the new Financial Services Bill, with its associated MoUs, spells out more clearly than before the responsibilities of the Treasury and the Bank in handling a crisis.

On the second, splitting the FSA in two, into the PRA and the FCA, and shifting the former into the Bank of England, produces not just a new organisation chart but is also intended to create an environment which will encourage the exercise of regulatory discretion, more sensitive to economic and financial developments "in the round".

That said, in neither of these areas is the job by any means complete. A key challenge for crisis management remains that of joining up the actions of different national authorities into a coherent whole so that serious threats, which today will almost always have an international dimension, can be dealt with effectively. And a key challenge for the line regulators, now as in the past, will be to attract and retain staff who are sufficiently experienced, capable and self-confident to operate a more judgment-based regime.

But that leaves the last of my three weaknesses – the area which has come to be called macroprudential policy – and that is the province of the Financial Policy Committee (although other initiatives, for example from the Independent Commission on Banking, will also have a part to play). I will divide up my comments under three headings: objectives; instruments and powers; and finally a few more general points. But I should make clear straightaway that the FPC is operating for the time being in interim form. What this means is that, although it has been given certain tasks, it has as yet no statutory powers and indeed no statutory existence. These will come with the passing of the Financial Services Bill into law. To date, this "virtual" committee has, nevertheless, completed four rounds of "virtual" meetings and has just embarked on a fifth.

Objectives

The formal objectives of the FPC are spelled out in the draft legislation[1] and I will return to them in a moment. It may be useful to begin, however, by making clear what the FPC is not.

One thing it is not is a vehicle for managing crises. The FPC's goal is to avoid crises. It is the fire prevention officer not the fire brigade. This distinction is not a piece of bureaucratic pedantry; the demands of crisis management – in terms of players, tools, priorities and timescales – differ, in some cases significantly, from those relevant in "peacetime".

And a second thing it is not is a second-guesser of, still less a court of appeal from, micro-regulatory judgments made by the PRA or the FCA. It will be very important to establish clearly and explain clearly the different responsibilities of the FPC and, particularly, the PRA – the more so since both will be housed within the Bank.

So what does the Bill say? [Annex A] The core is a fairly standard statement of a macroprudential objective – to identify and counter threats to the smooth functioning of the UK financial system as a whole. Similar objectives have been adopted more or less explicitly in a number of other countries, although often in a less formal way than in the UK. The key feature of course is the emphasis on the system rather than the individual financial firm.

I am not going to deconstruct the objective in detail – although I can tell you that much deconstruction and reconstruction took place before arriving at the text in the Bill. And Parliament may yet want to propose further changes. But let me mention a couple of issues which have given rise to a lot of debate.

The first stems from the fact that there is still no universally accepted definition of financial stability, and still less agreement on how to translate financial stability, whatever the definition, into a precise operational target for macroprudential policy.

[1] See http://www.publications.parliament.uk/pa/bills/cbill/2012-2013/0002/2013002.i-v.html

More than two years ago, in 2009, the Bank of England published a discussion paper[2] which (non-exhaustively) identified three possible “target variables”: the level and growth of debt in the economy; the level and growth of credit; and financial robustness, represented say by leverage, within the banking sector. Although the three clearly overlap, they have different implications for the focus of policy and for the instruments required to deliver it.

But in any case, these so-called conjunctural measures tell only half the story. Structural weaknesses can be at least as important and can contribute to the build up of conjunctural risks. What do I mean by structural weaknesses? They are things like wonky accounting conventions, inadequate disclosure regimes, badly designed clearing and settlement systems, inappropriate or inadequate regulation, and so on. You could argue that addressing structural weaknesses is a means to an end, not an end in itself – that improving structures is an instrument not an objective. But in practice it makes sense to recognise that systemic stability requires both the curbing of excessive exuberance in the here and now – the conjunctural dimension – and the creation of a system less prone to exuberance in the first place and/or more able to cope with it – the structural dimension.

And that is why the objective proposed in the Bill casts the net wide. The corollary of that approach is, however, that it makes quantitative monitoring of performance and success that much more difficult.

The second key point is that no objective is an island: government policy will always be aiming to achieve several goals at the same time. There will often be tensions between them, and interactions between the instruments used to deliver them. This raises the question of whether, how and how far policy in one area should take account of (“have regard to”) objectives in another.

This is not of course a new point. But in the context of the FPC it has arisen most sharply in relation to possible conflicts between the FPC’s stability objective and the objective of trying to promote economic growth. You will have seen indications of this in the records of recent FPC discussions.

One response – mirroring the Phillips curve debate and the supposed trade-off between inflation and unemployment – would be to say that actually, in the long run, there is no trade off. In the long run financial stability, just like low inflation, is a necessary condition for sustainable growth.

This may well be true but it begs the question of whether you can have too much of a good thing. By over-egging actions to maintain financial stability could the risk-taking capacity and growth potential of the economy be undermined? This has echoes of the debate in the UK two decades ago about formulating inflation targets. Low inflation had been recognised as unequivocally “a good thing”. But to guard against

[2] *The Role of Macroprudential Policy*, Bank of England, November 2009

over-zealous pursuit of that goal, the target was made symmetric - not more than X% per annum, but not less than Y%. A similar "symmetry" issue arises in relation to financial stability.

But the term "symmetry" has been over-used and has come to mean different things.

One – I think the original – version of symmetry was concerned with leaning against any systematic tendency to play super safe. In other words, to avoid a situation where, faced with a potential threat to financial stability, the FPC consistently erred on the side of excessive caution. I think it is widely accepted that there need to be safeguards against any such bias.

The term is now, however, being applied increasingly in a different context – to the idea of using instruments originally directed at financial stability to try to boost credit availability (and thence, hopefully, economic growth). I believe this second version of symmetry potentially gives rise to a number of problems. The Committee has taken very seriously the injunction currently set out in the Bill to pursue a financial stability objective but essentially to "do no harm" to the growth objective. As I have noted, this is reflected in its comments on the question of banks' capital[3]. But to go further and seek to promote credit growth separate from any financial stability considerations is a different matter. Moreover and perhaps more important, even if such an objective were thought desirable, it is not clear that the instruments available to the FPC (or indeed any other instruments) would actually be very effective in delivering a credit growth objective. Having a symmetric objective – not too fast, not too slow – may seem eminently desirable but unfortunately the available instruments do not have a fully symmetric effect. Nonetheless, in the present circumstances, the Committee recognises that there will be a continuing focus on this aspect of its work.

I should mention one further point on objectives. It is intended that, in a loose analogy with the MPC arrangements, the Treasury will periodically – probably annually – provide the FPC with a "remit". The precise form and content of these remits remains to be determined, and they will in any case be by way of elaboration of, not substitution for, the statutory objective. But they will allow some flexibility, within that objective, in focussing the Committee's work.

With these various qualifications and embellishments, I believe the core role of the FPC – to monitor, analyse and respond to risks in the financial system as a whole – nevertheless remains clear enough. What tools does it have for the job?

[3] See, for example, FPC statement, 20.09.11

Instruments and powers

One of the points the Bank has emphasised in its response to the crisis is that, although post-1997 it had responsibility – or at least partial responsibility – for financial stability, it did not have the tools to deliver it. The way the FPC is being set up aims to address this issue.

There seem to me three big questions underlying the debate about what instruments or tools are needed. The first I have already touched on. The necessary instruments depend, at least in some degree, on the precise definition of the objective. But given the FPC's objective is cast widely, I am going to assume that few if any instruments can be ruled out as obviously irrelevant.

A second, much bigger issue is that there is relatively little empirical evidence on the effect which most potentially useful instruments have on financial stability. And much of what there is derives from emerging markets rather than economies with highly-developed financial sectors like the UK. As a result, the transmission mechanism between, say, capital requirements and stability is still not well established. I confess, for example, to being sceptical about some of the analyses which purport to quantify the link between capital requirements and the probability of financial crises.

So how to choose which instruments to use? And how to decide on the calibration? Well, I think we have to recognise that these choices are now, and are likely to remain for some time, partly matters of experiment. We will in most cases have a reasonably good idea about the direction of impact but a much less good idea about the size of the impact and probably less good again about the relative merits of instrument A and instrument B – for example in terms of their effect on other desirable objectives – where both instruments do much the same thing. In addition, there is a risk that operating through a very wide range of instruments would make it more difficult for the market to establish any kind of reaction function.

But there is another and critical point here. I have spoken as if the FPC will have its own set of instruments. This is of course very far from the situation in practice. Virtually all of the instruments it might think relevant are already assigned to other policy goals, notably to the micro-prudential supervision of individual institutions, to monetary policy, to fiscal policy, even maybe to competition policy. In that sense, it is misleading to talk about "macroprudential instruments"; instead there are instruments some of which are relevant to macroprudential objectives but often to other objectives as well. It would be politically and administratively unacceptable and/or unworkable to give the FPC unfettered discretion over all these instruments and thereby effectively power to over-ride the judgments of the bodies already using them.

The approach which has been adopted could perhaps be called "tiered influence". The Committee can intervene at four levels.

The least formal is simply through what appears in the records of its meetings and any general comments it might make in public statements. It can take this further through the Bank's half-yearly Financial Stability Reports, which are discussed and reviewed by the Committee. These informal channels are often dismissed as ineffective, and on their own they may not have much "bite" on behaviour. But I believe they nevertheless have value in flagging issues and conditioning expectations.

Next, and more formally, the Committee can make recommendations – in principle at least to anyone – indicating actions it believes necessary to restore or maintain financial stability. These recommendations would normally be made in public through the Committee's post-meeting statements. I believe the breadth of this power is welcome, especially in the context of what I earlier called structural issues, and I hope it will be used fully.

Beyond that, but only in relation to the two new "front-line" regulators, the PRA and the FCA, the FPC can make recommendations on a "comply or explain" basis – that is the recipient of the recommendation must implement it or explain (again normally publicly) why it hasn't. I suspect that, once the new system is fully up and running, the two kinds of recommendation may be the most frequent form of intervention.

Finally, and subject to much tighter conditions, the FPC can issue directions to the PRA and FCA with which – provided of course they do not cut across any legal obligations or international commitments – the PRA and FCA must comply. But the FPC can issue such directions only in relation to instruments over which it has explicitly been given a power by Treasury order. And even then, the FPC cannot determine the timetable for implementation; that remains at the discretion of the front-line regulator.

Those of you who follow FPC matters closely will know that the Committee was required to provide advice to the Treasury on the set of instruments over which it wanted this power of direction. It did so in March, drawing on responses to a consultation paper published in December[4], and for a variety of reasons felt that, at least initially, it would be best to focus on a narrow set of instruments – the counter-cyclical capital buffer, sectoral capital requirements and bank leverage ratios. The set may well expand over time. But just to be clear, this does not mean that the FPC will be barred from recommending other actions using other instruments – if it does so, however, it will not have the power of direction.

[4] *Instruments of Macroprudential Policy*, Bank of England, December 2011

Some general comments

Let me finish with a few more general comments.

First, to return to an issue I mentioned earlier, I think it is important that the FPC, as well as scanning the scene for immediate risks, should also be looking at structural features of the financial system which may make it more exposed to shocks and less able to withstand them.

I will mention just one example. Financial systems, both national and international, are typically highly interconnected. But the degree of interconnection – as measured, for example, by the proportion of overall balance sheets represented by intra-sector exposures – increased dramatically in the years leading up to 2007. That in turn multiplied both the number and the size of the potential channels for contagion. But it also made it harder for a bank's counterparties to see what their underlying exposures really were; if say 30% of a bank's assets are claims on other banks, and those banks in turn have exposures on a similar scale to a further tier of banks ... and so on... it makes it well nigh impossible to see what is really going on. If then something – eg sub-prime mortgages – appears on the scene and gives rise to widespread concerns about credit quality, the risk is that the lack of effective transparency causes all these interbank relationships to freeze. And that is pretty much, in caricature, what happened in 2007/08. Such issues seem to me very much a legitimate concern for the FPC; and indeed the Committee has already discussed several such structural issues, for example disclosure practices.

Second, those of you who have read the records of the FPC's meetings to date will have seen that one theme has dominated discussion – how to strike the right balance between, on the one hand, encouraging banks to strengthen their financial position and, on the other, avoiding any undue constraint on the availability of credit. This is of course simply the playing out in practice of the conflict of objectives issue I referred to earlier. I think the Committee accepts the need to explain more fully how it is seeking to strike the balance.

But the tension also highlights another important issue, that of sequencing. Given multiple, possibly conflicting, objectives it is not just a question of deciding what instruments to use but also what order to use them in and how hard to pull on the different levers at different times. My own view is that, in our international regulatory initiatives, we may inadvertently have ended up front-loading the regulatory response more than was intended. Even though, for example, extended timetables were set for the implementation of Basel III, once the end point was announced market pressures have tended to foreshorten the effective period of adjustment. But it is a matter of degree not direction: there are clearly still significant vulnerabilities in the international banking system and the environment remains very threatening. And there is always the risk that, if too relaxed a timetable is adopted, the commitment to reform will progressively evaporate.

Third, and in some ways related, is the question of the relationship between the FPC and the MPC. There is no time now to pursue this in a serious way but let me make just one point. The main rationale for creating the FPC was a judgment – I believe a correct judgment – that we had paid insufficient attention to the functioning and stability of the financial system as a whole. Setting up the FPC has been one way of getting that issue on the map. But the process still has some way to go and therefore, whatever the theoretically optimal arangements in the long term, there seems a strong case for maintaining separate identities and Committees each with a mandate to address a distinct objective and with accountability for doing so.

Conclusion

I have tried in these comments, without getting too far down into the weeds, to given an impression of some of the background issues which have arisen in developing a framework for the FPC.   It is, as the Governor has said, in some respects an experiment but an experiment with, I think, a very legitimate and worthwhile objective. The FPC is not, and was never intended to be, the all-singing, all-dancing, one-stop-shop for delivering financial stability. And it is important we make that clear. But it can make an important contribution to achieving that goal.

Annex A: Objectives of the Financial Policy Committee

(1) The Financial Policy Committee is to exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective.

(2) The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

(3) Those systemic risks include, in particular—

.....

(c) unsustainable levels of leverage, debt or credit growth

(4) Subsections (1) and (2) do not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

Financial Services Bill, 2012 Part I: 3, 9(C)