BANK OF ENGLAND

Speech

Citizens in service, not people in power

Speech given by

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I'd like to express my thanks to Allen & Overy for hosting this event and for bringing together such a formidable crowd to discuss these issues.

More than a decade on from the financial crisis, memories can begin to fade.

They must not. Because the crisis was a disaster: leaving a legacy economic cost equivalent to about £20,000 per person.[1]

Like all disasters, it should be memorialised so that future generations are not destined to repeat the past.

It's sometimes argued that the crisis happened because nobody spotted that the system was heading for the rocks.

I think the causes run deeper than that. They centre on a collective failure to take the long view. The financial system lived for the moment.

Those that reaped profits and bonus today but would be bailed out tomorrow had every incentive to live for the moment and figure out the rest later.

That may not have mattered so much if regulation of that system had taken the long view and had prepared it for bad times, whenever they came and whatever caused them.

But it didn't.

The report into the failure of the Royal Bank of Scotland, describes a pre-crisis regulator – the Financial Services Authority – responding to political demands from all sides of the debate for 'light touch' regulation[2].

The result was a financial system that lived for the moment. It relied on the economic good times continuing to roll.

And so, like a city built with no building standards on a fault line, it crumpled dangerously with the first economic tremors.

It wasn't the failure to spot the particular coming earthquake that was the real problem. It was the failure to think about the long term.

A failure to acknowledge that a quake could happen at some point and set standards accordingly.

[1] Based on the net present value of the difference between the path of income since 2007 and a simple extrapolation of its pre-2007 path.
[2] See Financial Services Authority Board Report on "The failure of the Royal Bank of Scotland", page 10.

A failure to think about failure.

And so, when the downturn came along, it was turned into disaster as the financial system collapsed.

A taxpayer bailout and a million more people unemployed up and down the country. Financial instability is something for which everyone, and especially the most vulnerable, pays the price.

An independent committee to take the long view

Against that backdrop, few would disagree with an intention to build a stable, resilient, financial system.

But the road to disaster is paved with good intentions.

There will always be pressure to live for the moment. A little loosening of standards can bring many years of small gains before the big price is paid.

So in the aftermath of the crisis, Parliament did not just declare its intention to build a stable financial system. It chose also to commit to sticking to that intention.

And there was, of course, a model for how to commit not to live for the moment in economic policy.

In 1997, the Monetary Policy Committee of the Bank of England was established to deliver the clear intent of sustained low inflation.

Successive governments had lived for the moment by pushing the economy to expand beyond its potential. Each time, that worked in the short term. But ultimately it brought no benefit and only a price: inflation and recession to get inflation back down again.

Recognising that the pressure to live for the moment had resulted in serious costs, government and Parliament sought to entrench the long view in economic management.

The results have been impressive. In the 20 years since the Monetary Policy Committee was created, inflation has averaged pretty much exactly 2%. In the preceding 25 years, it averaged 8%.

In financial stability, the benefit of committing to take the long view can be even greater than in monetary policy.

In monetary policy, the upside of living for the moment is enjoyed only for as long as inflation remains a surprise. And inflation is not something easily hidden.

In financial stability, the benefits of being underinsured can be enjoyed for a long time before the costs are felt.

And the complexity of the system means it can be easy to let good intentions slip without notice.

The consequences of today's actions for tomorrow's crisis can be hidden away, just as they were in the run up to the financial crisis.

So in the aftermath of the crisis, Parliament created the Financial Policy Committee in the Bank of England – the institutional memory of the financial crisis and its costs.[3]

An independent committee, free of short-term political considerations, and with members drawn from inside and outside the Bank, its job is to take the long view.[4]

Its aim: to ensure the UK financial system has the resilience to serve households and businesses in bad times, as well as good.

The Committee has considerable powers with which to deliver that. And it has used them to build a more resilient financial system.

Through stress testing of major banks, it has boosted the resilience of the banking system.

It has used those tests to deal with specific threats from pockets of credit growth in consumer credit and leveraged loans to companies.

It has introduced measures to cap high loan-to-income mortgage lending.

It has, through new tests, built greater resilience in the financial system to cyber attacks.

And it has examined risks in the growing non-bank financial system so that they can be addressed if they become material, if necessary by changing the scope of regulation.

[3] The post-crisis regulatory infrastructure also included a new Prudential Regulator for banks, insurance companies and designated investment companies (the Prudential Regulatory Authority of the Bank of England) and a resolution regime for failing banks, overseen by the Bank of England. For a full description of these functions, see the Bank of England's Financial Stability Strategy.
[4] The committee comprises the Bank's Governor, 4 deputy Governors, the Executive Director for Financial Stability, the Chief Executive of the FCA, 5 external members appointed by the Chancellor and a representative of HM Treasury.

Legitimacy & accountability

It will be important that those in Parliament continue to recall the misery that prompted their predecessors to grant us our powers and the independence to use them. To abandon their predecessors' good intent could inflict the same misery on some future generation.

But of course, the handing of such powers to an unelected group of people raises serious issues and challenges.

How can such a group be trusted to implement what our society wants when it cannot be sent packing through the ballot box? How can it be legitimate that unelected technocrats take decisions that affect people's lives?

These are understandable, real concerns. And they must be addressed.

Those of us to whom a degree of independence has been granted must remember that we have no natural right to it.

We are citizens in service, not people in power.

Two important features of the way power has been delegated to us make that so.

First, Parliament delegates to us a clear mandate. We cannot pursue whatever our own preferences may be.

That's why we have, as it's known in the trade, instrument independence, but not goal independence. We do not have the independence to decide what the instruments are used to achieve.[5]

Second, our performance against Parliament's mandate must be able to be assessed.

This means we can be held to account for delivering what we've been told to deliver.

These two features were central to the creation of the Monetary Policy Committee in 1997.

It has a clear remit from Parliament: a target of 2% consumer price inflation. There is no danger of the committee being able to impose any other standard.

[5] Guy Debelle and Stanley Fischer. "How independent should a central bank be?". Federal Reserve Bank of Boston, 1994.

And its performance against that remit can be assessed month in month out with published inflation numbers. It can be held to account easily for delivering Parliament's good intentions.

If only it were quite so simple in financial stability.

The creation of the Financial Policy Committee required two major challenges to be overcome to ensure we remained citizens in service.

But overcome them we have. Let me describe how.

Challenge 1: the difficulty of specifying a clear mandate

At the heart of this difficulty is a trade-off between stability and growth.

A stable financial system is resilient to a range of bad shocks. It doesn't respond to them by causing further material economic harm.

But beyond a point at least, raising that resilience hampers the ability of finance to take risks and drive investment and growth in the good times.

It's possible to over-insure.

So there is a balance to be struck. And it is right that Parliament should decide where it should be struck.

However, a target like: "make sure the system can withstand a repeat of the 2008 recession and no more" wouldn't work.

Such a target wouldn't be fit for purpose all the time or for all of the financial system.

For some parts of the system, whose failure might not cause much economic damage, such a target might be too severe.

At some times, such as after a credit boom, such a target might be too loose.

And what if the bad shock the system might need to deal with is fundamentally different to the 2008 recession? What if, for example, it's a cyber attack?

The general point is that it isn't possible to specify a target for how resilient the system should be that is appropriate for all forms of threat, across all forms of finance.

And even if one day it were possible to specify a complete set of resilience targets, that would be proved quickly out of date as the financial system evolved and the circumstances in which it operated changed.

Any operational target must be flexible so that it can keep up with events. Hardwiring into legislation isn't a recipe for flexibility.

So the challenge was how to specify a clear mandate. Parliament's secret sauce for doing so had three ingredients.

The first was to specify the mandate not as a single target but as a set of preferences.

Put simply, Parliament's intent, enshrined in law, is that we should build as much resilience in the financial system as possible, without harming the expected growth of the economy over the medium to long run [6].

We must aim for a level of resilience that involves short-run sacrifices only insofar as they are outweighed by long-run gains.

This is our rule for constructing a resilience target for each area of the system at each point in time and for each threat. It hardwires flexibility, allowing us to adapt as new threats emerge and the system evolves.

The second ingredient was to mandate that we must show our handiwork in translating these preferences into operational goals.

For each of our powers we must maintain a policy statement, setting out our approach to their use. Our actions must be supported by cost-benefit analysis. And we must report regularly on how our policies contribute to financial stability.

This ensures that, when we set targets for how resilient each part of the system should be, we can be held to account for following the preferences we've been told to follow.

And the third ingredient is a process to challenge our handiwork and force us to act on that challenge.

If the targets don't look to be delivering Parliament's preferences, as enshrined in law, we can be called out transparently. The Government may at any time make public recommendations to us about our financial stability objectives but must do so at least annually. [7]

[6] Details of the FPC's objectives and primary responsibilities are set out in section 9C of the Bank of England Act 1998. In particular, the FPC is charged with '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', but this does 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'.

[7] This approach, of proposing and testing, is similar to the notion of 'discursive governance' proposed for independent regulatory agencies by Gehring (2004) and discussed in the financial stability context by Demekas (2019).

Together, these three ingredients mean we have a clear mandate to follow but, at the same time, we have the flexibility that's needed to manage financial stability efficiently and effectively.

An example – resilience of major banks

Our approach to how resilient major banks should be to economic shocks captures all of these ingredients.

We started with Parliament's preferences: resilience but not at the expense of growth over the medium to long term.

Using all the evidence available, we've balanced the benefits and costs. On the benefit side of the ledger: the fact that the system will not magnify severe downturns.

On the cost side of the ledger: the drag on growth that comes the rest of the time from forcing banks to fund more of their lending with capital rather than deposits.

The result of this careful cost-benefit analysis is a goal for how resilient the largest part of the banking system should ordinarily be.

It's expressed in the severity of the economic scenario we expect banks to be resilient to. So great are the costs of not having enough capital in the banking system that the scenario is of a rare level of severity, akin to the financial crisis.

That means a scenario in which: unemployment rises to over 9%; the output of the economy falls by nearly 5%, the global economy enters a recession deeper than the financial crisis and house prices fall by one third.

To ensure they can keep lending through such a scenario, the major banks typically need to fund around 13.5% of their risk-weighted assets with their own (Tier 1) capital.

We're clear that if, in the future, the economy becomes a more fragile place (as, for example, debt levels rise) our stress scenarios will get tougher and the capital levels needed to pass them will increase.

And if a downturn materialises, we're clear that capital buffers that have been built up should be run down to absorb losses without cutting lending.

Our resilience target will flex to the circumstances in a way that it could not had it been hardwired into legislation.

By presenting our handiwork, we started a debate. It has brought us criticism and comment on all sides.

Uncomfortable though that may be, the debate is positive. Over time it is important in establishing a consensus behind our targets.

And in its annual public letter to us regarding our financial stability objectives, the Government has welcomed the level of resilience we have built in the banking system.[8]

With clear preferences in law, a requirement to show our handiwork to establish our goals, and a framework to debate those goals, there is little danger of us following something other than the mandate we've been given.

The first condition for being citizens in service is met.

However, a second challenge remains.

Challenge 2: monitoring that the intent is being delivered

Having established a target for resilience in some part of the system, how can we be held to account for then meeting it?

There's no financial stability equivalent of measuring inflation each month to see if it's close to 2%.

The real test comes only when a bad shock happens and the resilience of the system is tested. It will be clear then whether we had built in too little, or too much, resilience.

But such events are rare.

So we have a duty to give Parliament the means to check in real time that we're delivering the levels of resilience that we've said we're targeting.

The solution is to simulate – to stress test – bad shocks before they happen.

That's why, every year, we subject Britain's major banks to a *public* stress test.

The scenario reflects the target for resilience of major banks that I discussed earlier.

The test shows whether major banks would, in fact, be resilient to it. When they show they're not, it can be corrected before any real-life test comes along.

We can be held to account every year for continuing to ensure that our resilience targets are met.

[8] See Remit and recommendations for the Financial Policy Committee: Budget 2018

Taking transparency and accountability to the next level

So with a clear mandate from Parliament, transparency and discussion about how its translated into resilience targets, and transparent stress tests to show those targets are being met, we can be held to account for delivering Parliament's intent and no other.

It's a framework that ensures we are citizens in service and not people in power.

But we're always looking for ways to reinforce that.

We are, for example, working to display more of the handiwork in translating our objective into levels of resilience in other parts of the system, such as the mortgage market.

We're working on ways to measure in a disciplined way how, if debt rises, it should make our stress test scenarios tougher.

And above all, we're helping to widen the net of our accountability.

We are accountable directly to Parliament through regular public testimony to the Treasury Committee of the House of Commons.

Policymakers in few other countries are called before Parliament as often as we are.

We have a duty to make ourselves accessible, and to explain ourselves, not just to Parliament but also to people up and down the country.

Their trust in us to do the job we've been given will not arise from trying to sound clever or from obfuscating with acronyms.

Their trust in us rests on having it proved that we're doing what we've been asked to do in the way we've been asked to do it.

That's why there's a web version of our 100-page financial stability report that's just eighty three words and three pictures.

The whole report is captured in six tweets.

It's why a phrase such as "The 2018 stress test shows the UK banking system is are resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis and that are combined with large falls in asset prices and a separate stress of misconduct costs" has become…

… "banks can lend to households and businesses in bad times as well as good".

And it's why those of us who make the decisions are hosting Citizens Panels around the country.

These are groups of 20-30 citizens from all walks of life and a diverse range of backgrounds.

We're very grateful to those in the North East, Northern Ireland, Yorkshire & the Humber, London, Scotland, the West Midlands, and the South West who, in recent months, have spent an evening with me or my colleagues.

They've given us much to chew on about how the economy and the financial system really look from where they sit in different parts of the country and society.

They've challenged us on the financial crisis, quantitative easing, interest rates, living costs and more.

And most importantly, they've held us to account, forcing us to explain every aspect of our work. And some.

While that's not easy, it's essential. Because it's their economy, their financial system and their lives that we influence.

We are simply citizens in their service.