BANK OF ENGLAND

Speech

Crisis and crash: lessons for regulation

Speech given by

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At a gathering jointly hosted by the Bank's Agency for Scotland and Scottish Financial Enterprise

23 March 2012

The financial crisis of 2008 took the world by surprise, as events on a scale seemingly inconceivable unfolded before our eyes. Everybody in the industry was gripped by it. As the (then) co-head of corporate and investment banking at Deutsche Bank, I had a front row seat. I saw how extraordinary market movements were affecting individual institutions and their clients, and how governments moved to try to deal with the contagion that was spreading through the financial system like a bush fire. This contagion threatened to wreak havoc on the world economy. While the extent of the panic in the financial markets has subsided, we are far from 'business as usual'. The need to draw meaningful lessons from what happened in the fourth quarter of 2008 continues to be urgent, although a friend who happens to be a Professor of History tells me it probably takes about 50 years to put dramatic events into a truly appropriate context.

Through the looking glass

I would like to address a number of issues tonight: A bit about the run up to 2008, a bit about what happened in 2008, as well as how the authorities reacted to these events and how the Bank of England (Bank) is responding to its evolving mandate. At a time when policymakers across the world are grappling with the deep questions thrown up by the crisis, you might say that I have swapped a front row seat for something of a role on the stage – as a member of the Bank's Court (its governing body) and the interim Financial Policy Committee. I would like to share insights from both experiences with you tonight.

It is clear (in hindsight) that the premise of 'efficient' market behaviour, the structure of the banking industry and the regulatory framework were unsuitable prior to 2008. During the era of 'Great Moderation' there was a widespread belief that markets were self-correcting and the regulatory mantra was 'light touch'. As Alan Greenspan has noted - "All of the sophisticated mathematics and computer wizardry essentially rested on one central premise: that enlightened self interest of owners and managers of financial institutions would lead them to maintain a sufficient buffer against insolvency by actively monitoring and managing their firms' capital and risk positions."[1]

Not only is this view of market behaviour wrong, so was the structure of regulation. In the UK, responsibility for the regulation of individual firms was transferred in 1997 from the Bank to the newly formed Financial Services Authority (FSA). The Bank, for its part, concentrated on its two core purposes of setting monetary policy and maintaining a broad overview of the system as a whole. As part of this latter responsibility it published a Financial Stability Report twice a year, giving voice to its analysis in this area. Meanwhile, Her Majesty's Treasury (HMT) was responsible for the overall structure of financial regulation, and as the controller of the public purse strings had a key role to play in crisis decisions. This tri-partite system is widely criticised today as there was no single institution mandated with the responsibility, and powers, to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted actions.

[1] Greenspan (2009)

As such there was a degree of, what Paul Tucker has called “under lap”[2] within the system. Lord Turner has noted “In the years running up to the crisis, there was an insufficiently close relationship...The two institutions (Bank and FSA) were so keen to concentrate on their own specific responsibility—the Bank on monetary policy defined around the inflation rate objective, the FSA on the supervision of institutions on an individual case-by-case basis that, (as Paul Tucker … has expressed it) – we left an under lap between us”.[3]

If one reads the Financial Stability Report, or other speeches made by Executives at the Bank from before the crisis, there are ample warnings about the build up of many of the risks in the financial system that caused the banking industry to break apart in 2008. In fact there were perhaps too many such warnings – it’s like the ‘risk factors’ which are inserted by lawyers in documents to cover all conceivable risks of a new issue of securities that are generally ignored by the consumer.

To get a sense of the build up of risk consider the metrics shown in **Table 1** which were cited by the Governor of the Bank recently in evidence he gave to the House of Commons Treasury Select Committee (TSC). Clearly the leverage in banks and indebtedness of households jump out as concerns. But in **Table 2** I look at another metric, one that was widely used to judge the health of the banking sector, the major UK banks’ Tier 1 capital ratios. Using this metric the problem isn’t nearly as clear. The regulatory community were fixated with the ratio of capital and risk weighted assets as prescribed by Basel I & II. But perhaps they didn’t spend enough time worrying about the quality of the capital, the way in which banks were calculating their risk weighted assets or the type of metrics highlighted more recently by the Bank. More importantly few regulators, public commentators or government entities gave thought to the financial system as a whole. Attention was myopically, and (as it happened) dangerously, focussed on individual institutions.

Given its lack of levers, even when the Bank pointed out its growing concern about what was going on it had little effect. As Mervyn King pointed out in 2009, “The Bank finds itself in a position rather like that of a church whose congregation attends weddings and burials but ignores the sermons in between....it is not entirely clear how the Bank will be able to discharge its new statutory responsibility if we can do no more than issue sermons or organise burials.”[4]

Panic

There are certain dates in history that stick in the mind. Dates when something so significant happened that we stopped whatever we were doing and focused on the event in question. For those in the financial community, September 15, 2008 was such a date. Nobody anticipated how catastrophic the bankruptcy of Lehman Brothers would be. Capital markets simply stopped functioning. Asset prices went to surreal levels. Although bankers would shout that asset prices during that time period were so distorted that marking them

[2] Tucker (2009).
[3] Turner (2009).
[4] King (2009).

to market was wrong, virtually every bank in Europe, and many worldwide, would have been insolvent if properly marked to market in the latter part of the fourth quarter of 2008. Contagion set in and trust evaporated: "At first, incipient panic amounts to a kind of vague conversation: Is A. B. as good as he used to be? Has not C. D. lost money? And a thousand such questions. A hundred people are talked about, and a thousand think, 'Am I talked about, or am I not?' 'Is my credit as good as it used to be, or is it less?' And every day, as a panic grows, this floating suspicion becomes both more intense and more diffused; it attacks more persons; and attacks them all more virulently than at first." This apt description of what happened within the financial community as 2008 came to a close happens to have been written by Walter Bagehot in 1873.[5]

There are many accounts of who did what to whom during this period. My clear recollection is that the immediate response in the USA was to find a way to buy toxic assets to lift the banks out of trouble. Those in the financial community knew this approach would not be quick enough or practical. It was in the UK where an approach of capital injections was formulated and this became the tool used to prevent a collapse of the banking system in most of the G20 countries. In the UK a total of almost £125bn was directly injected into banks.[6] In my view the UK government had no alternative – if money had not been injected into the UK banks they would have collapsed taking many other banks outside the UK down as well. The economic issues we face today would be multiplied many times over.

A new approach

Gradually, the financial system emerged from the very depths of the crisis – though few would claim that, coming up on four years after Lehman's demise, we have escaped it completely. In June 2010 the (new) government outlined substantial changes to the regulation of the financial sector in the UK. HMT would continue in its role as the body which would determine whether and how to use public funds. But the 'tri-partite' system was changed to a 'twin peaks system'. A Financial Conduct Authority will look after consumers, with the microprudential regulation arm of the FSA becoming part of the Bank and renamed the Prudential Regulation Authority (PRA). In addition, the Bank will be given responsibility for 'macroprudential' regulation of the UK financial system, via a new Financial Policy Committee – more of which below. Within the Bank a Special Resolution Unit was also formed to improve the resolvability of banks in the UK through an improved resolution regime and work on living wills,[7] although we still lack adequate powers to act in complex cross border cases. The government also assembled a very able group to look at the structure of banking – the Independent Commission on Banking (ICB) which published a report,[8] which is a must read for those interested in UK banking.

[5] Bagehot (1873).
[6] See Figure 3 (page 97) HM Treasury Annual Report and Accounts 2010 -11.
[7] See, for example, Tucker (2010) for a more in depth explanation of the efforts of the international community in this area over the last few years.
[8] See Independent Commission on Banking, 'Final Report and Recommendations' September 2011.

These measures are substantial and there are good reasons to believe that this new system will work better than the system that it replaces. However, we shouldn't be under any illusion that a change in the structure of regulation in itself will rule out another financial crisis or indeed that this new system will prevent the collapse of individual banks or other financial services companies. The fact is that in 2008 countries that had a twin peaks structure, such as the Netherlands, experienced similar problems to everybody else. The structural changes recommended by the ICB are logical. But, if one examines the list of banks that failed in 2008 it is clear that pretty much all possible banking structures are represented. In other words, whilst the type of regulation and the structure of the financial system matter, getting these two ingredients correct (if that is possible) will not ensure there are no problems. We should be clear that banks of every structure failed and countries with most of the common regulatory structures had problems. Ultimately it is the culture within individual banks and the incentive systems that drive risk taking which need to be changed. The good news is that I see evidence that banks are changing incentive systems and this will lead to a different culture within the banks which society will prefer.

In addition, the interim FPC, on which I sit, is an important part of the new regulatory environment. It is currently meeting on an interim basis pending the passage of legislation, the Financial Services Bill, which will enshrine it in law. The FPC's mandate is to conduct macroprudential oversight – that is, it is looking to reduce systemic risk across the entire financial system in the UK. The FPC will have two main powers. The first is a power to make 'comply or explain' recommendations to the microprudential authorities. It will also have the stronger power to direct the PRA to adjust specific macroprudential tools which are requested by the FPC once these tools are approved by Parliament. I discuss more about this later, but an early example of the type of actions that could be undertaken by the FPC is shown by an FPC recommendation that UK banks reveal their leverage ratios on a Basel 3 basis so that investors and customers get a better sense of overall enterprise risk.

The Financial Policy Committee

The interim FPC has 11 voting members: the Governor and Deputy Governors of the Bank, the Executives responsible for Financial Stability and Markets at the Bank, the Chairman and CEO of the FSA and four members who are called 'externals' (of which I am one). A representative of HMT and the head of the proposed FCA attend the meetings as well in a non-voting capacity. The FPC holds formal meetings on a quarterly basis as well as various preparatory discussions – in fact since it was established in Spring 2011 it has met 22 times (four of which were formal policy meetings with a published Record).

The FPC has a meeting cycle that lasts about a week. We begin with a Briefing Meeting that involves staff members from across the Bank and FSA giving the Committee written and oral briefings on the current market, economic, and regulatory conditions. We also have a meeting where we discuss the key issues and themes raised by this briefing process in more depth. Several days after this the FPC has a final set of meetings where policy is debated and agreed. Because the FPC doesn't have numerical guidelines to work towards, the debates cover a wide range of topics – for example how might sovereign defaults elsewhere impact the UK banking sector, or how might problems in a specific sector such as commercial real estate affect UK banks, or how can we encourage banks to provide more support to the real economy to lessen a downward spiral. The debates tend to be rigorous and members speak their mind – I have seen little evidence of the much talked about 'group think'. Most of the time, the Governor, as Chairman of the Committee, seeks to form a consensus amongst FPC members on any given policy issue. However as the dynamic of the Group evolves and the debates become sharper we have needed to formally vote on some policy matters and I suspect that going forward voting will become the norm. The FPC also has frequent teleconferences to deal with urgent issues or to conclude debate on a given topic.

To date, the Committee's recommendations have fallen into two broad categories: first, recommendations to build additional resilience into the banking system in view of current threats to stability but without impairing its willingness and ability to perform key intermediary functions, in particular the supply of credit to the UK real economy and, second, acquiring information to help the FPC and the public monitor risks to financial stability more effectively.

Promoting greater transparency has been an important theme of the initial discussions of the FPC and the need for better transparency among financial institutions is clear. But transparency in accountability is also extremely important for the FPC itself. Building trust with the public will help the FPC to take seemingly unpopular measures further down the line while still retaining public support. Overall, a lot of time is spent ensuring that the public understand the macro-financial context for decisions, the thinking of the FPC and its recommendations. For example, a statement and a record of the deliberations of each FPC policy meeting is made public promptly after meetings. The FPC also now publishes the Financial Stability Report (FSR) twice a year and includes a full assessment of the outlook for the financial sector and a summary of the systemic risks, vulnerabilities and potential imbalances. The FSR and FPC policy recommendations are discussed in a twice-yearly press conference. Members of the FPC give speeches, write Op-Eds and give interviews. To ensure further public accountability, members of the FPC appear in front of the TSC to answer questions on FPC matters.

As set out in the draft Financial Services Bill, the FPC's mandate will focus on protecting and enhancing the resilience of the UK financial system as a whole. But we should not, however, take actions that are 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. In good times we have to decide when to 'take away the punch bowl' and in bad times we have to decide how to treat a 'hang-over' to ensure we minimise systemic risk within the UK financial sector. While it might seem easy to decide it's time to take away the punch bowl, this is likely to mean curbing an electorally popular credit boom. The howls one will inevitably hear when doing it make it hard unless the FPC (and the Bank) have a strong degree of independence. It certainly won't be easy, but in my view establishing widespread awareness of these problems and building trust through the accountability measures I previously discussed, along with the memory of the very tough times we are now experiencing because of past excesses, will help to build support for such actions in the future.

Directive policy instruments

In order to determine when it's time to take away the punch bowl the interim FPC is tasked with developing a set of metrics and a tool-kit to ensure that, in the future, the Bank can do more than give sermons. The FPC has been asked by the Government to provide advice on the tools for which it needs directive powers in secondary legislation. The FPC had an initial discussion at its September meetings on such tools, and a paper was published in December outlining the pros and cons of the tools which we might need.

In our FPC meeting last week we reached conclusions that were published this morning and include: the countercyclical capital buffer, sectoral capital requirements; and a leverage ratio.

We have also noted that we would like the statutory FPC to have powers of Direction over a time-varying liquidity tool, but we could not yet define this tool as the international microprudential standards have not yet been agreed. The FPC agreed that it might be useful for the statutory Committee to have powers of Direction in respect of the terms of collateralised transactions by financial institutions but again this should happen after international debate on this topic further progress. The FPC would like powers of Direction over disclosure requirements but it is difficult to be specific on what exactly we would like, so we have asked HMT to advise how we might proceed on this topic. Finally, we as a group believe that powers of Direction over loan to value and loan to income restrictions on mortgage lending could be beneficial to promote financial stability but given the sensitivity of the use of tools such as this we believe there needs to be more public debate on whether to give the FPC such powers.

Thus far debate has focused on whether giving a body like the FPC the power to have such tools makes sense. Now that we have made a specific recommendation, the debate can also focus on the specific tools we have chosen. Generally we have chosen to recommend a small tool kit that contains those tools with which there is more familiarity within the regulatory community. As I have outlined, the need for transparency and accountability in the final allocation of such powers is clear. However, the need for suitable tools is also clear if the Bank is to do something meaningful when it next determines that there is systemic risk building dangerously within the financial system or indeed if it wants to allow financial institutions in bad times to utilise a countercyclical capital buffer built up in good times.

The FPC is in a tricky position as it faces a difficult balancing act between public accountability and the need for independence. Certainly some of the decisions it will have to make will be contentious in the short run and won't be popular in the Houses of Commons. In my view the FPC must learn from the Monetary Policy Committee, which is widely admired in terms of the process it utilises. Many of the same issues on accountability existed when it was formulated. However, the nature of conducting monetary policy is different from that of conducting policies for financial stability. For example, most of the relevant data needed to conduct monetary policy can be made public and decisions can be measured against a specific target formulated by the Chancellor. When targets are not met, letters explaining why can be made public.

Things are more complicated for the FPC. The type of data needed for financial policy is often sensitive and needs to be kept confidential. The type of mandate (i.e. similar to the inflation target given to the MPC) the Chancellor gives the FPC is not straightforward, and arguably not as easy to grasp for an uninitiated audience. More thought is being given to the remit the Chancellor gives the FPC (it turns out that defining “financial stability” is not straight forward) and what type of public interaction takes place between HM Treasury and the FPC (i.e. similar to the MPC process when an exchange of letters occurs when the inflation target is more than 1% from the target set by the Chancellor).

So where next?

Avoiding a repeat of the current crisis will undoubtedly be difficult and the process to get macroprudential regulation up and running will be long and complex. But the prize for succeeding will be huge. It has been estimated that the current crisis has cost the UK up to 10% in lost output or, in money terms, £130bn. And this is expected to persist over time.[9] To make a success of financial policy the FPC must be empowered to take decisions which are enforceable and which will have a real impact. Creating a FPC that is only able to provide advice or give sermons won’t move us very far from where we were when the financial world broke apart in 2008.

Looking forward there is much to do in 2012. The new Financial Services Bill is currently being debated and once enacted the organisational changes I described before will come into statutory force. The Special Resolution Unit within the Bank needs to have appropriate statutes that allow for the unwinding of a failed financial institution across national boundaries. There are still gaps about how any cross border institution would be resolved. Regulators are national but banks are global. More work needs to be done to give us confidence that we can deal with the failure of a large or important financial institution, while avoiding the chaos that enveloped us after Lehman. This is absolutely critical – if we are not able to solve the ‘too big/important to fail’ issue, society will not be being served as it should be. Finally, there needs to be an agreed implementation timetable for the new global rules for regulating the safety of banks (Basel III). The current timetable states that banks must adhere to the new guidelines by 2019. I think implementation by 2019 is too distant.

Against the backdrop of all these changes the economic environment is pretty uninviting. Amongst the items which worry the FPC are the enduring risks and possible fall-out from events on the continent, the state of

[9] Haldane (2010).

the UK economy and how that impacts UK banks, the complexity of many financial instruments, the way financial firms are interconnected and we worry about a bank failure abroad.

We have clearly moved into an environment where the notion of self-correcting markets and light touch regulation is a distant memory. However, care must be taken to ensure that regulators don't go too far and stifle legitimate risk taking which creates value in the real economy. The wisdom of hindsight, from which we benefit in considering the 'light-touch' approach, will not be available to us to evaluate the post-crash regulatory mantra of "intensive and intrusive" for some time yet. But even at this early stage it seems clear that the correct balance needs to be struck.

Some changes can happen remarkably quickly. Other changes take much longer to come into effect. I fear analysing and trying to correct many of the deep-rooted issues exposed by the financial crisis fall into this latter camp. We must be honest about the fact that time is required to heal much of what's broken. The time needed goes beyond normal cycles that businesspeople and politicians work to. There will be temptations to apply quick fixes or jump quickly into new regulatory regimes. As Chris Salmon (Chief Cashier at the Bank) recently warned[10] we should avoid this temptation as we create new regulatory policy. Many of the fixes that have been put in place or proposed will make a difference but it will be many years before the changes are evident. A notion that markets don't work at all or that we need draconian regulation will lead us to a bad place. Striking the right balance between too little and too much regulation is perhaps the most difficult judgement financial policymakers face at the moment. But it is also one of the most important.

[10] Salmon (2012).

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ANNEX

Table 1: Table of financial stability indicators

	Average 1997 [1]	Average 2002[1]	Average 2007[1]	Latest value
Simple aggregate leverage ratio of major UK banks [2]	23.9[3]	21.3[4]	35.6[5]	23.7 (June 2011)
Aggregate leverage ratio of major UK banks [6]	n/a	n/a	33.3[5]	20.3 (June 2011)
Household debt to income ratio [7]	102%	123%	169%	152% (Q3 2011)
12m growth in lending to UK non-financial sector [8]	n/a	10.23%	11.90%	-0.04% (Dec 2011)
UK long term real interest rate [9]	3.38%	2.41%	1.40%	0.1% (Dec 2011)

Source: Bank calculations

(1) Unless otherwise stated.

(2) Total peer group assets (adjusted for cash items, tax assets, goodwill and intangibles and with derivatives netted according to USGAAP rules) divided by total peer group capital (including total shareholders' equity adjusted for minority interest, preference shares, goodwill and intangibles). Not available for 1997-2007.

(3) Figure as at 1997 year-end.

(4) Figure as at 2002 year-end.

(5) Figure as at 2007 year-end.

(6) Total peer group assets over total peer group equity. This measure is available over longer time periods, however there is a discontinuity due to the introduction from 2005 of IFRS accounting standards, which tends to increase reported leverage ratios thereafter.

(7) Households' gross debt as a percentage of a four-quarter moving sum of their disposable income.

(8) UK resident monetary financial institutions' sterling lending to UK households and private non-financial corporates (excluding the effect of securitisations and loan transfers). Average is for September 1998 to 2007.

(9) 5 yr real interest rates 5 yrs forward, derived from the Bank's index-linked government liabilities curve.

Table 2: Major UK banks' tier 1 capital ratios

	1997	2002	2007	H1 2011
Median	8.4%	8.5%	8.1%	11.6%
Minimum	6.4%	7.3%	6.9%	9.6%
Maximum	14.1%	12.3%	9.7%	16.1%

Source: Published accounts and Bank calculations.