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Disclaimer: These are my personal views and do not represent the official views and policies of the Bank of England.

I am going to talk this morning about the approach to macro-prudential policy in the UK. I will describe the institutional framework, the toolkit and, importantly, the challenges.

Aside from micro-prudential failures, prior to the global financial crisis, the system of regulation in the UK did not take sufficient regard for the overall stability and resilience of the financial system, nor was there clear responsibility for it, and this contributed to the severity of the crisis in the UK. The balance sheets of many of the major UK banks and much of the UK population were massively overstretched and the UK government finances were based on a wholly unsustainable model.

The journey back to a strong and stable financial sector and sustainable government and personal balance sheets would not, ideally, start from here, but it must start anyway.

So what is the institutional framework?

Under new legislation, that is currently being introduced, financial stability becomes the explicit mandate of the Bank of England, with the creation of the Financial Policy Committee, or FPC as I shall refer to it, as the macro-prudential supervisor. The FPC will be made up of Bank of England executives and independent members.

The FPC's main responsibility will be to take action to remove <u>systemic</u> risks with a view to protecting and enhancing the resilience of the UK financial system – that includes both faultlines in the structure of the system and its connections and cyclical threats from unsustainable levels of debt or leverage. This is the first time any body in the UK has had such a mandate for macro-prudential supervision. The new legislation will provide the FPC with the tools to do their job.

Parliament has oversight through the Treasury Select Committee

So how will the FPC form its judgement and what are the tools available to successfully conduct its macro-prudential role?

Firstly, the role of the FPC is to look broadly. And thus market intelligence is vital. The Bank of England already had a substantial market intelligence effort but this has been broadened to include more scrutiny of market infrastructure, regulation and policy as well as markets and market participants. That market intelligence then has to be combined with risk assessment to identify, and attempt to quantify, the risks to the resilience of the UK financial system. The point of this is to help frame the thinking for the FPC as much as to provide specifics and help them take a holistic view.

A key element of that holistic view is to monitor the regulatory perimeter for leakage – the role of the FPC is not the resilience of the UK banks but the resilience of the UK financial system as a whole.

Having identified any areas of risk the FPC will need tools to intervene.

Without going into any specifics, the tools must have some general characteristics:
Targeted and proportionate – they should be able to address the specific risks and their impact needs to be proportionate to the risk. It is not just about loading capital on banks.
Symmetric – ideally they should be able to both tighten and loosen policy
Transparent and simple – they need to be both clearly understood and implementation must be clearly visible

And perhaps most importantly: Broad and flexible.

To elaborate on this.

Macro-prudential regulators must take a holistic view and are operating in a complex, and changing environment. Innovative approaches will be required as new problems arise. Interventions may not work. Mistakes will, almost certainly be made. Responsiveness will be required in implementation. Creativity will required in the choice of tools. In the UK this is somewhat recognised as the legislation allows for an initial set of defined tools but also a mechanism for swiftly implementing new tools where appropriate. This is important.

And what are the key challenges?

The FPC must co-exist with the Monetary Policy Committee, which is responsible for managing overall demand and achieving an inflation target, as the decisions they make can affect the credit cycle and levels of economic activity. Conflicts should be minimised by both being part of the bank of England and having an overlapping (but minority) membership.

Just to make things a bit more complicated, the FPC also needs to have an eye on economic growth. Explicitly the FPC is not authorised to "exercise its functions in a way that would in its opinion be likely to have 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".

And of course, probably the biggest challenge is 'starting from here'. Ideally we would have started all this well before the crisis, leant against the credit cycle, encourage banks to build up their capital and liquidity, but we didn't.

And this leads into the unintended consequences. There is a huge amount of change going on in financial regulation against a weak economic background and still over-leveraged banks, governments and households. We have to be very careful as macro-prudential regulators that we don't kill the patient while we try to heal it.

Thank you