

THE FUTURE OF FINANCE

And the theory that underpins it



7 What framework is best for systemic (macroprudential) policy?

Adair Turner
Andrew Haldane
Paul Woolley
Sushil Wadhvani
Charles Goodhart
Andrew Smithers
Andrew Large
John Kay
Martin Wolf
Peter Boone
Simon Johnson
Richard Layard



The Paul Woolley Centre for the Study of
Capital Market Dysfunctionality

futureoffinance.org.uk

Copyright © by the Authors. All Rights Reserved. 2010.

Adair Turner and others (2010), *The Future of Finance: The LSE Report*,
London School of Economics and Political Science.

Cover Design: LSE Design Unit

For further information, contact Harriet Ogborn

Email: H.Ogborn@lse.ac.uk

Tel: 020 7955 7048

Chapter 7

What framework is best for systemic (macroprudential) policy?

Andrew Large¹

This chapter identifies a significant gap in today's economic/financial policy framework and suggests for debate an approach to fill it. It addresses systemic financial failure which, as recent events have amply demonstrated, can give rise to significant fiscal and welfare costs.

Seeking to prevent such failures has encouraged a plethora of regulatory initiatives. This chapter suggests that, important though they may be, they will not on their own prevent crises. It proposes a policy framework for containing systemic dangers but recognises that there are a number of significant and difficult issues on which at present there is no clear-cut conclusion. Important interfaces with other policy areas – such as monetary and regulatory – are considered. Encouragingly the policy debate and increasingly political intentions in both Europe and the US do now seem to be focussing on these issues and the new UK government has announced its plans to move in this direction.

Executive summary

The policy framework needs to comprise a number of elements. It must provide for assessing the systemic conjuncture on a regular basis and identifying emerging risks. Crucially, it must ensure that the diagnosis is translated into effective pre-emptive action, which in turn means ensuring that appropriate policy instruments are available and that the relevant bodies have full authority to use them. In addition, the framework must set out clear mechanisms for disclosure and accountability. Despite the difficulty of formal cost benefit analysis, the chapter suggests that the welfare benefits of success would justify the deployment of significant resource and effort.

The need to monitor a range of indicators of financial stability (or instability) is emphasised, of which it is suggested that leverage and overall indebtedness are especially important. The question of targets is addressed noting that, in contrast to monetary policy/inflation, the choice is more open and quantification is more difficult.

The questions of policy instruments and of governance arrangements associated with their use are raised. The former remains a subject of debate although the chapter

¹ I am extremely grateful to Alastair Clark for his substantial input.

suggests that overall capital ratios should be a candidate. There remain however uncertainties about just how effective they would prove to be and about the interaction with micro-prudential policy (whose principal goal is the avoidance of individual firm failure). Questions are also raised about calibration and about automaticity versus discretion in deployment. On policy governance, it is suggested that the systemic authority, should take decisions about the deployment of its “own” instrument. It should however also be mandated to make observations or recommendations to other policymakers whose areas of activity have a systemic stability dimension. This includes monetary policy, regulatory policy, competition issues and fiscal policy.

The relationship with monetary policy is specifically recognised but it is argued that, for reasons of accountability and effectiveness, it would be preferable to keep the policy areas apart.

The complex institutional issues for the successful delivery of policy are next examined. These include clarity of objectives, independence from the political process, and requisite skills and experience. The importance of transparency of process is noted.

The institutional structure might vary from jurisdiction to jurisdiction, but might focus on a “Systemic Policy Committee” receiving inputs from diverse areas which may be located in different existing authorities. However the case is made for housing the Committee itself within (or attached to) the central bank. Questions of the implied concentration of power are noted.

Although policy delivery should ideally be on an international basis, the lack of global government makes this impractical to achieve. This chapter leaves to others the debate on how best this vital dimension should be developed. Accordingly, and ideally with clear guidance from and coordination by international authorities, the chapter suggests that individual jurisdictions will need to implement their own policy frameworks. It emphasises that such frameworks need to be pragmatic and operationally practical as well as addressing the difficult areas of analysis.

Finally to provide a concrete example, an outline of how such a framework might be constructed in practice is put forward, taking the case of the UK.

Introduction

The previous chapter “Can we identify bubbles and stabilise the system?” by Andrew Smithers discussed various indicators of systemic risk, notably “over-exuberant” asset prices and credit bubbles, and pointed out that we did not have an adequate institutional structure for monitoring these risks and taking, or even recommending, action to forestall them.

Although the current environment, with continuing economic and financial strains, may complicate implementation and introduction of any new policy approach, the experience of the past three years demonstrates very clearly the need to reinforce policy in this area. That experience has also called into serious question several of the principles which, explicitly or implicitly, underpinned the approach to financial regulation (and indeed other aspects of financial and economic policy), notably the Efficient Markets Hypothesis and Rational Expectations. It has in addition raised the issue of whether the range of “conventional” policy instruments – short-term interest rates, the fiscal stance, regulatory capital requirements and so on – are adequate to deliver not only low inflation and sustained growth but also continuing financial stability. And if the conclusion is that they are not, the corollary is a need to establish a policy framework and identify instruments which will “plug the gap”.

This chapter responds to that challenge and considers a possible framework for delivering such policies. It identifies a number of significant and difficult issues on which at present there is no clear-cut conclusion, but suggests some possible approaches for debate. The challenge is the greater because of the need on the one hand to address the complex analytical issues while on the other to find a practical operational structure to ensure that policy is both developed and then actually delivered.

Encouragingly the intellectual debate and increasingly political intentions do now seem to be focussing on creating such policy frameworks. Examples of this are emerging with the intended European Systemic Risk Board which the ECB will chair; in the US as outlined in the recent draft Senate bill; and in the UK.

Questions which arise include:

Is it feasible/legitimate to try to turn financial stability into an executive responsibility along the lines of monetary stability, certainly at this stage of the debate (it took a very long time to get there with monetary policy)?

What should the mandate for this policy area actually be?

What instruments would help in delivering the mandate, and who has or should have the ownership and power to deploy them?

How will the interaction of supervisory/microprudential and systemic/macroprudential policy be handled without confusing and/or excessively complicating governance and accountability arrangements?

Would capital requirements actually be effective as an instrument for controlling credit/gearing? If not are there better candidates?

How will/should systemic/macroprudential and monetary policy interact? To what extent should they be separated or handled together?

It may be helpful to make a few introductory points.

1. Global issues. In what is essentially a global financial marketplace, a global approach would be the ideal. But as in so many other areas, this runs up against the tension between global commercial models and national legislative and legal frameworks. This tension is all the more acute in the context of financial stability because at present only national governments have the discretion to apply fiscal resources to the resolution of crises, and in taking such action they are accountable to national electorates.

This of course raises the question of whether supra-national bodies – most plausibly perhaps the IMF in conjunction with the FSB and Basel committees – should have a bigger role to play, going beyond any current contribution as standard setter, source of experience and provider of assessment capability. Whilst acknowledging the importance of the global issue, it is not the subject of this chapter.

In the absence, however, of such a global – or even regional - authority [other than that which is perhaps emerging in the EU], the delivery of policy will fall mainly to individual countries, who will need to implement measures in a way which commands legitimacy with all relevant stakeholders.

It would nevertheless be helpful if each jurisdiction adopted a similar conceptual framework and addressed the basic issues in a consistent way. This should ensure broad similarity of approach while accommodating the particular features of each jurisdiction. In addition we have to start somewhere! If one or several jurisdictions put their toes in the water, others are likely to follow encouraged by a mixture of pressure from the global authorities and their peer group.

2. Microprudential/regulatory initiatives. There may be some who feel that, with the multitude of micro measures in place or in prospect, we should rest there for a moment and not attempt to develop a new area of policy involving difficult judgements and complex political issues. The counter-argument is that, whatever the merits of these micro- measures, there are serious doubts about their collective capacity to deal with emerging systemic pressures.

Many would argue that, historically, systemic oversight and policy were the preserve of central banks and that this area of policy is not therefore new. What is new, however, apart from having to deal with vastly more complex markets and global interactions, is the need for such policies to respect modern approaches to law and accountability. Monetary policy has in many countries now been given the statutory backing needed to confer 'legitimacy'. Financial stability objectives, on the other hand, have been imprecisely specified or left in the too difficult box. Financial authorities were left with the alternatives of acting presumptively i.e. as though they did have the requisite powers, or of deciding that they could not take the risks of so doing.

3. Nomenclature. A key underpinning for today's typical monetary policy frameworks is that people accept the benefits of price stability. In present circumstances, it seems plausible that they might also increasingly see the need for financial or systemic stability. The term 'macro-prudential' policy, which is often used in much the same sense, whilst clear to policymakers, may appear to many rather technical and discourage a wider audience from engaging in the debate. So this chapter uses the term 'systemic policy' which describes the oversight, assessment and delivery of policy and can be seen as a complement to 'monetary policy'.

4. Timing. The timing of any move to put systemic policy frameworks into effect is complicated by the fact that we are far from the steady state which the framework is designed to maintain. On the other hand, the backdrop and aftermath of the crisis may provide a favourable time to think hard about how to implement a policy framework to reduce the probability of crises of this magnitude happening again.

5. Cost. Clearly there would be no point in trying to reinforce the systemic policy framework unless the welfare costs of doing so were demonstrably less than those which might arise from failing to do so.

Recent evidence is that the fiscal costs of financial bailouts, and even more the overall welfare costs of dealing with the results of acute financial instability, are extremely high. It would seem therefore that, despite the absence of a formal cost benefit analysis there should be a large constituency for policies to mitigate the risks and costs of future financial crises.

This nevertheless leaves open the question of whether such policies might themselves impose a cost in terms of long term growth. Growth in the mature economies may well have been slower in the decade up to 2007 if policy had leaned against the build-up of indebtedness. But there is no clear evidence that, over the longer term, average growth rates consistent with a sustainable level of leverage would be lower than those in the 'leverage unconstrained' world (when higher growth in upswing has to be combined with reduced or negative growth in busts). They may even be higher. Moreover, lower volatility in the growth rate might provide additional welfare benefit.

1. Mandate

Proposal

The proposal for debate is that an overarching mandate be given to policymakers in some public body [hereafter referred to as the Systemic Policy Committee (SPC): but see section 5 below] on the following lines.

‘To review and assess the systemic conjuncture, to identify actual or incipient threats to financial stability, to apply the policy instruments available to it directly and, where necessary, to recommend policy actions to be taken by other relevant policymakers, so as to secure and maintain financial stability.’

Financial instability and the crises to which it can give rise, occur when there is a sudden and general collapse in confidence in the soundness of the financial system. This is likely to be associated with doubts about the ability of one or more participants in that system to meet their obligations, in turn precipitating the familiar pattern of herd behaviour, a drying-up of liquidity and the fire-sale of assets by banks or others. The question is what are the circumstances which can create such doubts? Assessing the probability that a crisis may occur requires complex judgements in relation to a number of interrelated factors. So do decisions about when and how to signal concerns and/or to use the available policy instruments. [Excellent analyses are provided inter alia in recent publications by the de Larosiere group on Financial Supervision in the EU [Feb 2009], G-30 on Financial Reform [2009], Bank of England on Macroprudential Policy [Nov 2009] as well as significant literature from the IMF, FSB and Basel institutions].

Leverage and the systemic conjuncture

Previous financial crises demonstrate that confidence is likely to be more fragile the greater the degree of leverage in the system. (The term ‘leverage’ is used here in a broad sense to cover ‘balance-sheet-relevant’ items [ie including SPVs, SIVs, etc] as well as the embedded leverage in derivatives and other related products and is not confined to the banking system.) The term ‘systemic conjuncture’ covers the level of leverage in the economy, the robustness of both the system as a whole and individual institutions to shocks, the fiscal and monetary environment and the state of confidence in the system’s ability to repay debt in full and on time.

Executing the mandate and its evolution

Assessing the systemic conjuncture as outlined above will mean reviewing a range of indicators. There is no single indicator of either leverage, or confidence. Instead the SPC will need to consider the relevance of a number of indicators, both levels and where relevant rates of change over time, including:

- national and international imbalances;
- the overall level of leverage within the system;
- the level/rates of change of indebtedness of different sectors and of the economy as a whole (i.e. external indebtedness);
- the asset exposures and potential dynamic and behaviour of non-leveraged [long only] as well as leveraged asset managers;
- the level of asset prices, for example equity prices, house and commercial property prices, etc relative to their long-term trend or their relationship with other economic variables;
- market measures of uncertainty and risk, for example asset price volatility, credit spreads on bonds of various types, CDS prices, etc;
- new products and securitisation techniques which may be manifestations of arbitrage to avoid measures taken to mitigate systemic dangers;
- the outcome of stress testing of financial institutions and the system as a whole;
- trends in external measures of confidence and risk appetite.

Such reviews will need to be set against judgements about the resilience of the system and about the potential effectiveness of policy measures and sanctions available to the authorities, including the techniques for the resolution of problems affecting individual financial firms.

Depending on the conclusions, decisions will then need to be taken about deployment both of the instruments available directly to the SPC and on what advice, recommendation or “encouragement” the SPC should give to other policymakers on issues deemed relevant to financial stability.

Targets

It is not proposed that the SPC should be given any single target variable, bearing in mind the untested nature of policy in this area, nor at this stage does it seem sensible to determine whether targets should be hard or soft. As part of its remit, however, the systemic/ macroprudential authority should be asked to consider, in the light of experience, whether any particular target or set of targets should in due course be formalised. It is widely recognised that identification of such a target or targets is likely to be materially more difficult than for monetary policy where the main focus has been on the delivery of low and stable inflation.

Issues arising

Given the difficulty of defining a precise objective, there is a legitimate question about the feasibility of constructing any satisfactory policy framework. Is it achievable in

practice and can it be effective? It is worth noting however that other areas of public policy, notably monetary policy, have faced similar issues at early stages in their development which have in many cases now been overcome. The view expressed by some, that it is all too complicated to justify the attempt, seems excessively negative, particularly given the substantial real cost of the recent crisis and the widely-held view that, in the absence of additional measures to address this gap in policy, a similar or even more severe crisis might well occur within a generation. Furthermore, it seems doubtful whether, on their own, the multitude of microprudential and resolution measures introduced recently with the goal of mitigating systemic risks will actually achieve the desired result.

2. Policy Instrument

Proposal

The SPC would be mandated to act in two ways.

Firstly it would have the authority to deploy its “own” policy instrument. This is discussed below with the proposition that the instrument should be based on capital ratios. Secondly it should assess the impact of other policy areas on systemic stability, and be mandated to make recommendations to the authorities responsible for these policies, to which the authorities would be expected to, respond perhaps on a comply-or-explain basis.

‘Own’ policy instrument

This should be capable of deployment on a regular and continuing basis and will need to satisfy a number of criteria, including:

- it should address the root causes rather than merely the symptoms of instability.
- it should ideally be independent of the instruments used in other areas of public policy; without that, there is a risk of confusion and unclear accountability.

Accordingly, so long as they continue to be assigned to delivering an inflation target, short-term interest rates would seem to be disqualified as the ‘own’ instrument even though they are certainly likely to have a bearing on financial stability conditions, and in some circumstances may indeed be the subject of recommendation by the SPC.

The candidate proposed for discussion would be a capital or gearing ratio [perhaps in conjunction with reserve requirements]. This would have its principal impact on banks, the main agents for extending credit. Furthermore, given the effect on the cost of providing this credit, the impact would extend indirectly to credit users such as investment banks and hedge funds.

This of course could also fall foul of the problem of ‘single instrument two policy objectives’ [because capital ratios are at present assigned to microprudential supervisors, with the prime objective of achieving an acceptably low probability of individual-firm failure]. However capital ratios would meet the first criterion above in that they would bear directly on the cost both of creating credit and of increasing leverage.

In relation to the second criterion, it might be argued that the two objectives are in fact not genuinely distinct – that systemic and individual firm stability are *de facto* highly correlated. Although there must be some merit in this point it is hardly borne out by recent experience.

So assuming that capital ratios were indeed the chosen instrument, it would be necessary to define a hierarchy, or at least some clear relationship, between the two policy areas. This could be to assign to the systemic/macro-prudential policymaker ‘ownership’ of the overall Risk Asset Ratio [the Basel “8%”]. This would give the SPC a way to influence the cost of creating, and thence the overall growth of, credit.

Meanwhile the microprudential supervisor - focussed on the strength of individual firms - would be able to assign relative weights to different classes of assets in the RAR computation, also taking into account judgments on a firm’s individual risk characteristics.

Policy areas with systemic relevance

Separately the SPC might also be mandated to make recommendations to other policy makers, including the micro-prudential supervisor, in relation to policy instruments under their control such as liquidity policies etc. The latter would be expected to respond, perhaps on a comply-or-explain basis.

Breadth of mandate

Other policy areas relevant to systemic policy include monetary policy, fiscal policy, competition policy and microprudential policy, the latter including, for example, capital and liquidity standards but also incentives and remuneration policies. This raises the question of exactly what powers and responsibilities the SPC should have in relation to these other areas. For which should it have a remit/duty to make recommendations and for which should it merely take the relevant policy stance into account in making its own decisions? Microprudential and monetary policy might fall into the former category whilst fiscal policy might fall into the latter.

Other instruments

It would be necessary to consider also what might be equivalent instruments to contain systemic pressures arising independently from and outside the banking sector. Instruments such as the solvency ratio, in relation to the insurance sector, might be considered here. As more generally, it would be important to avoid measures which made

sense at the individual firm level but which could prove destabilising for the system as a whole.

Role of interest rates

Finally, putting to one side the issue of multiple targets for a single instrument, there is debate as to whether interest rates would be more effective than capital ratios in containing leverage growth. The balance is hard to predict; general interest rates levels impact banks' cost of funds whereas capital ratios influence the cost of intermediation and therefore affect the willingness of intermediaries to supply credit.

Granularity issues

Our proposal is that it would be preferable for the SPC to 'own', and direct the use of, a single policy instrument, following the model of monetary policy. It would be possible in principle for the SPC to adopt a more granular approach to influencing the growth of credit, for example by setting different and/or variable capital ratios for different classes of assets (say mortgages or commercial real estate loans or loans to SMEs).

Although in some circumstances such measures might seem attractive, they involve a number of serious downsides:

- First it would complicate the conduct of systemic policy and potentially make it more difficult to reach clear conclusions or establish behavioural expectations and reaction functions as regards the SPC [see below 'Calibration']
- Second it could potentially confuse or undermine the legitimacy and governance structure of the other authorities already charged with particular areas of policy
- Third use of micro instruments could lay the SPC process open to a greater degree of political pressure given the differential impact on different segments of the economy. [Note however that, it may sometimes be easier politically to justify raising capital requirements for lending to a particular sector or sectors where credit growth has been "excessive" and that in some circumstances a more granular approach could also alleviate tension with monetary policy goals.]
- Fourth, however, and perhaps most important, it is not clear that a granular approach could be made to work satisfactorily in practice. If the objective is to contain overall leverage and credit growth, applying constraints only to particular sectors is likely to generate a "squeezed balloon" effect.
- And finally, micro-intervention seems inconsistent in principle with what is intended to be an overarching macro dimension to financial policy. This might be regarded as philosophically unacceptable in some jurisdictions.

Calibration

There is at present no reliable estimate of what effect a given adjustment of overall capital ratios would have on credit growth. Again, however, this is not a new challenge

for policy: in the context of monetary policy, the impact of alterations in interest rates on inflation is also hard to judge.

Two factors are relevant in considering this problem:

- First, a regular and reasonably frequent process of assessment would allow “course corrections” to be made if credit growth seemed not to be adequately restrained. Such assessments, as in monetary policy, would clearly need to take account of significant lags in the response to capital ratio changes.
- Second, as the policymakers’ reaction function becomes more stable and better understood, so pre-emptive behaviour is likely to become more common and the degree of adjustment of the policy instrument needed to achieve a given impact is likely to be less. (Facilitating understanding of this reaction function is a further reason for keeping the instrument environment simple and avoiding multiple instruments.)

Discretionary or automatic

An obvious further question is whether the instrument should be deployed on an automatic or a discretionary basis.

Automatic countercyclical adjustment of capital requirements is under discussion as part of the FSB and Basel Committee processes. It is perceived to be of value both in reducing credit cyclicality and in countering the danger of regulatory or supervisory forbearance or political interference. It seems probable, however, that discretionary use of the instrument will also be needed – and in any case wise to make provision for such use – given the many factors which influence credit conditions and the overall systemic conjuncture. In effect the deployment of such adjustment by national systemic policymakers would be constrained by such globally set, and transparent, adjustments, but not overruled by them.

3. Relationship with Monetary Policy

Interplay of policy areas

As proposed above, interest rates and capital ratios would be designated as the prime instruments to impact the root causes respectively of, inflation and credit/leverage. But the two instruments interact: movements in interest rates will affect the evolution of credit and leverage and capital ratios will affect the monetary transmission mechanism. And both may have an impact on growth. The question is whether this matters and, if so, what can be done about it.

At a minimum, it seems clear that policy assessment in each area should take into account policy actions in the other. This follows precedent in a number of jurisdictions

where monetary policy takes fiscal policy into account. In a similar way, monetary policymakers might be formally enjoined to have regard to systemic stability issues and vice versa for the SPC, although there is clearly a critical question about what “taking into account” would mean in practice. Over time, the two sets of policymakers may well develop expectations about each other’s likely policy actions.

This raises the question of whether an ‘equilibrium’ delivering both price stability and financial stability objectives could be reached, or whether the set of actions and counteractions would be recursively self-defeating and potentially destabilising. In practice, this seems unlikely to be the result any more than it is in relation to fiscal policy, although the outcome would depend on precisely how the systemic/macro-prudential target came to be specified.

The additional credit/leverage constraint could of course have an impact on growth. But a possible criticism of the current policy framework is precisely that the growth rate compatible with the inflation target alone has in recent years been higher than was compatible with the maintenance of financial stability.

So arguably the following equilibrium might emerge. Higher capital ratios and slower credit expansion would allow price stability to be delivered with slightly lower interest rates. And while growth in the short to medium term might be slightly slower, the threat of financial instability as a result of rising leverage would be reduced and long-term growth might actually be enhanced.

Combine monetary policy and systemic stability?

Alternatively it is argued by some that, if there is indeed a case for a policy initiative in relation to systemic stability, it might be better to extend the remit of the relevant monetary policymaker. Although there are significant and possibly decisive contrary arguments, this is an important point to address.

- Experience suggests that introducing more policy goals increases the risk of **suboptimal implementation**. For example monetary policy in the UK already has price stability as its goal, albeit with a subordinate objective of supporting the Government’s wider economic objectives. Jurisdictions which attempt to deliver several goals (e.g. price stability and growth) with the single instrument of short-term interest rates face *inter alia* greater difficulties in explaining policy decisions, in creating a reaction function and in managing inflationary expectations. This arises for the obvious reason that there are often tensions between the actions indicated by the different objectives.
- The **experience and capabilities** required of those involved in formulating and executing monetary and financial stability policies differ in important respects. Experience of supervision and financial market dynamics are

essential in the context of financial stability, just as an understanding of macroeconomic and monetary theory and practice are needed for monetary policy. It would be preferable to ensure that each area is fit for purpose rather than trying to embrace all the needs of both policy areas in a single committee.

- **Accountability**, on both the monetary and financial stability sides, is likely to be more effective if each is accountable for a single rather than multiple area of policy. Moreover, from the point of view of individuals it could be uncomfortable to be accountable for quasi-political judgements about the relative weight to be accorded to different policy objectives, especially since political perceptions of relative importance are likely to change over time.
- The nature of the **assessment process** is different. Monetary policy assessment is about stability within a band or around a target over time. And there is regular and reasonably clear-cut evidence on whether that is being achieved. In the case of financial stability policy, while instability is also obvious, by the time that point is reached policy has failed. Instead policy has to be based on unobservable probabilities that a state of instability might arise. Trying to combine both approaches in a single process could risk compromising the integrity of both.
- Finally, policy in the two areas is at **different stages of development**. There is still a great deal to learn in the area of financial stability policy. It needs to find its own place in the thinking and expectations not just of the authorities but of the public and industry. It is vital that the public sees systemic policy issues as part of everyday life and not just during a crisis!

There are no doubt countries, particularly where the liberalisation of the financial sector is not complete or the capital account remains partially controlled, where the two areas of policy are satisfactorily carried out together. Such countries may feel the absence of an explicit financial stability regime less strongly. In practice they accommodate systemic issues within their monetary policy regime. India is one such example. In the case of mature and fully open economies with existing monetary policy frameworks however the issues set out above become more important.

Finally it is certainly the case that someone must in the end make the overall assessment of the combined impact of systemic and monetary policy measures. This will require careful thought. It would probably be assisted by housing the two areas of policy at or close to a single institution [the Central Bank], but that may raise in turn issues about concentration of power (see 5 below).

4. Institutional features: Qualities necessary for the success of systemic policy

More than for monetary policy, which is better understood, systemic policy decisions could at this stage be unpopular. The impact, for example, of constraining credit growth/leverage would be felt by many different groups - politicians, bankers, industrialists and consumers. So, however ill-advised, resistance to constraining the ‘fuel’ of credit growth can be expected from politicians whose ‘growth story’ may be compromised; bankers [and bank shareholders] whose remuneration and profits are likely to be impacted; and the public and other users of credit because “live now, pay later” has an enduring appeal.

For these reasons:

- (i) **The objectives and mandate should be set by the political process.**
- (ii) The conduct of policy within the framework should be **independent of political process but accountable to it.**
- (iii) **The arrangements should incorporate features which have proved themselves in other policy areas, notably monetary policy.** This includes regularity of assessment, even if perhaps less frequent than for monetary policy.
- (iv) **Particular qualities/experience and skills will be needed.** Irrespective of the precise institutional arrangements an SPC would need individuals with experience and skills at the highest level covering:
 - central banking
 - supervision of financial markets and financial innovation
 - practical experience of systemic events
 - academic understanding of the issues
 - handling relationships with Ministries of Finance/Treasuries
- (v) To command respect there needs to be adequate **accountability of policymakers** to legislatures and public: the arrangements should have “legitimacy” in the eyes of directly interested parties and the population at large
- (vi) To support this, **the process by which policy decisions are made should be transparent.** Where appropriate the supporting analysis and assessment of early warnings should be disclosed, recognising that in some cases immediate disclosure may be undesirable and risk generating a destabilising erosion of confidence. This might apply to eg situations involving individual financial firms. A process for deciding what falls into that category would be needed and for judging cases

involving potential breaches of commercial confidentiality. Financial Stability Reviews go some way in this direction but they typically stop short of reviewing the background to policy decisions as such. The transparency process proposed in this chapter could be seen as an extension of the thinking behind FSR's, beyond being a channel for early warnings into a more formalised and effective framework for policy accountability. It is in any event important to enhance public understanding of financial stability issues, which should in turn facilitate acceptance of 'unpopular' decisions if these are seen to be directed at avoiding the high social costs of financial crises.

- (vii) There needs to be confidence that effective means and **authority** exist to implement policy decisions, whether the instruments are under the direct control of the SPC or lie with other bodies.
- (viii) **Dedicated resources** will be needed to assist the SPC carry out proper assessment and provide support.

5. The 'Vehicle' for systemic policy delivery: Institutional arrangements

A Committee

The choice of institutional arrangements will be a function of the legal, cultural and political environment in each jurisdiction. The options include a new self-standing institution, a department of an existing institution, or a semi-autonomous committee either within or anchored to an existing institution. Different approaches are already emerging [European Systemic Risk Committee at the ECB, separate committee as per the US Senate Bill].

For the sake of illustration as mentioned above we have assumed the creation of a Systemic Policy Committee (SPC).

Should the SPC be freestanding or anchored to an existing institution?

The proposition in this chapter is that a model with the SPC anchored or close to the central bank, has merit. There are valuable precedents in terms of monetary policy in many jurisdictions.

This would build on and put onto a more formalised footing central banks' 'traditional' role in the area of financial stability. Specifically:

- Despite recent setbacks central banks command respect because of their expertise on systemic issues, their independence (in many cases) from political manipulation, their unique role as creators of central bank money and implementers of monetary policy, and their position at the ‘nerve-centre’ of both national and international financial systems. Furthermore, they typically have wide experience of macroeconomic policy-making through their historic relationships with finance ministries.
- Against this background, many people assume or expect central banks to be responsible for handling systemic issues. In that sense systemic policy is not ‘new’. But in former times central banks tended to act ‘presumptively’ without a formal or statutory mandate to do so.
- A difficulty arose when formalised mandates for monetary policy were given to central banks, complete with accountability provisions. This made it less comfortable – and indeed potentially dangerous - to act presumptively in relation to systemic policy. And governments/legislators shied away from trying to create such formalised processes for systemic stability because of the difficulties in defining objectives and scope. The UK in 1997 is a case in point when responsibility for monetary policy was awarded to the Bank of England, but its role in relation to systemic stability was left unclear. This effectively encouraged an emphasis on monetary policy which tended to ‘crowd out’ systemic issues. It is that deficit which we are now trying to address.

Issues arising in relation to location

Power

If the central bank, an unelected body, is given responsibility for systemic policy, in addition to monetary policy and its normal central banking functions, would this mean that it became too powerful? Might it suffer from political challenge and reputational risk causing its effectiveness to be compromised?

The question as to the degree of power that different jurisdictions feel comfortable placing in the hands of the central bank is an important one to which there are no easy or general answers. The matter is further complicated by the move in some jurisdictions to place responsibility for micro-prudential supervision with the central bank as well. If housing both systemic policy and micro-supervision, as well as monetary policy within the central bank were indeed thought to mean too great a concentration of power, there seems a strong case for assigning systemic policy to the central bank and micro-supervision to a third party - either a unitary supervisory authority like the FSA [Japan, UK] or a standalone prudential supervisor like APRA [Australia]. But it is beyond the scope of this article to examine this issue further.

Interface with the political process

This interface clearly needs to be handled effectively. The mechanism suggested is that, following models in a number of jurisdictions, the mandate and objectives of systemic policy should be set by the political process, and that the execution of the mandate should be handled independently from but accountable to it.

How will the interface with fiscal and competition policy be handled?

Again paralleling monetary policy, from the point of view of the SPC these would be taken as ‘givens’. There would be debate however as to the extent to which it should be expected to make recommendations, and with what degree of authority, in relation to these other established policy areas [see section 1 mandate above].

Handling crises

The framework in this chapter is designed to handle mitigation of systemic risks in ‘peacetime’. More debate is needed on how the arrangements would need to evolve in the event of an incipient or actual crisis, in particular how the key role of the Ministry of Finance/Treasury in such conditions would be accommodated; on the ‘trigger’ mechanism for moving from ‘peacetime’ to ‘crisis’ mode; and on the role of the SPC itself at a time of crisis. Appropriate resolution machinery is separately widely under discussion.

Appendix: A framework for the UK: *an illustration*

This chapter concludes with an illustration of how such a process might be constructed in the UK taking account of the considerations mentioned in the chapter.

A new systemic policy framework could usefully borrow from the Monetary Policy Committee (MPC) experience. This might suggest the following:

- (i) A Committee, the ‘Systemic Policy Committee, [SPC]’, should be established whose broad remit, following the issues outlined in section 1. above, would be determined in legislation and whose specific objectives would be specified from time to time by the government. The SPC would be anchored at the Bank of England and would have independence in making its policy decisions. Its association with the central bank should help to reinforce its independence.
- (ii) Membership would include
 - Governors of the Bank;
 - Senior officials of the supervisory authority;
 - Those with practitioner experience of the financial sector [possibly non-conflicted and/or recently retired members of the financial services industry, including infrastructure providers]. This could include members of the Banks Board [Court];
 - Academics with a particular expertise in financial markets and institutions;
 - An observer from HM Treasury.
- (iii) Size of committee might be 8-10.
- (iv) Members could be appointed through the political process as per the MPC, and be fully accountable individually for decisions made, both before parliament and more generally.
- (v) Consideration would be needed as to how to ensure the availability of reliable and timely data from a variety of sources. Any barriers to automatic exchange of data would need to be overcome and perhaps facilitated by including representatives of the suppliers on the Committee.
- (vi) Consideration would be needed as to how to establish a method for achieving consensus with a possible ‘voting’ framework, as well as the ability to explain directly to the political authorities how the SPC would behave if it feared that its policy objectives might not be met [the ‘letter writing to the Chancellor’ process].
- (vii) The SPC might normally meet, say quarterly, rather than monthly, given the frequency with which major items of data become available and the relative infrequency of periods of serious stress. As for the MPC, there could be provision for exceptional meetings to be held if felt necessary.
- (viii) Minutes of SPC meetings would be published. Today’s Financial Stability Review assesses the systemic conjuncture, but the minutes would explain in addition the reason for the policy response.
- (ix) Accountability for the effective functioning and resourcing for the Committee could lie with the Bank’s Board [Court].

