Two Cheers for Financial Stability

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Two Cheers for Financial Stability

Howard Davies

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Introduction

This lecture series is dedicated to the memory of William Taylor (1933–1992). William Taylor's career in Washington DC included 15 years at the Board of Governors of the Federal Reserve, where he rose to the position of Staff Director of Banking Supervision and Regulation, and culminated in his appointment as Chairman of the Federal Deposit Insurance Corporation in 1991. The lecture series is intended to honor his long career of distinguished public service and to recognize his dedication to ensuring the strength and stability of the financial system.

The lectures have traditionally been offered either at the biennial meeting of the International Conference of Banking Supervisors or, in intervening years, at the time of the annual meetings of the International Monetary Fund and World Bank in Washington, DC.
Two Cheers for Financial Stability

Howard Davies

I was greatly honored when Paul Volcker asked me to deliver tonight’s lecture, which I believe is the 9th in what has so far been a very distinguished series. I know the series is distinguished because, in preparation for this evening, I read the previous 8 lectures. They are mostly available from the Group of Thirty at the modest price per unit of $10, though the last 2, by Stanley Fischer and William McDonough, can be had for $10 for the pair. The unusual example of dramatic price deflation which I am sure Paul Volcker, in his professional life at the Federal Reserve, would have tried hard to avoid.

Sadly, I did not have the opportunity to know Bill Taylor personally, since I came into the world of banking supervision only in 1995. But I know of his work by reputation, and I am sure that Bill McDonough, in 2002, was right to describe him as a man who “embodied the ideals of a central banker and bank supervisor: measured, professional and impartial.” We would all be proud to have such adjectives associated with us at the end of our careers. Bill Taylor also, of course, served as Chairman of the Federal Deposit Insurance Corporation (FDIC). In the United Kingdom, for historical reasons, we have no obviously equivalent body, but we are well aware of the hugely important role which the FDIC plays in the American banking system, as the penultimate line of defense in the event of a banking crisis.
I hope that my subject matter this evening, Financial Stability, would have been of interest to Bill Taylor in both his key roles, at the Federal Reserve and the FDIC. He may have been puzzled by my title: “Two Cheers for Financial Stability,” with its implication that my enthusiasm for the concept is somewhat qualified.

My aim is to reflect on what we mean by Financial Stability, and what we do, or should do, in its service. The thoughts I offer will be from a severely practical perspective, though I have labored through some of the theory; because while I am no longer an active regulator, I am not quite an academic. When you pay your $10, or perhaps $5 for the printed version, you will find footnotes, and the other accoutrements of an academic production, but I am not writing for a refereed journal. So the only authentic academic feature will be a concluding plea for more research—which I have learnt is the obligatory coda at the end of any self-respecting piece of work from a university.

The Financial Stability Industry
The Financial Stability industry has been growing so rapidly in recent years that it is surprising to note that the term itself is of relatively recent coinage. A paper published just a few months ago by William Allen, formerly of the Bank of England, and Geoffrey Wood of City University in London2 records that “the Bank of England used the term in 1994 to denote those of its objectives which were not to do with price stability or with the efficient functioning of the financial system. We are not aware of any earlier usage of the phrase.” Certainly if you look at Alan Greenspan’s 1996 William Taylor lecture, which dealt with of banking crises, you will not find the term used.3 Yet, nowadays, it would be hard to find a speech on the financial system, by a central banker or a regulator that is not peppered with the phrase.

I think it is right that the first regular publication with Financial Stability in the title was the Bank of England’s Financial Stability Review,4 first launched in 1996. I must confess that I was the prime mover in establishing that publication, which we produced in collaboration with the then securities regulator in London, the Securities and Investments Board. The early working title ‘Prudence’ had three advantages: it accurately captured the drift of many of the articles, it became, Gordon Brown’s favorite word, and it happens to be my wife’s name. However, Eddie George was not amused, so it became the Financial Stability Review.
The confession is that the real reason we established the Review at that time was to stake out the Bank of England's territory in financial supervision ahead of the 1997 election, which we thought might bring change to the regulatory system in the United Kingdom. While no established reform plans were then on the table, we knew that, after the Bank of Credit and Commerce International and Barings Bank incidents, as a banking supervisor the Bank of England was on the back foot. Even though, I would assert, the Bank did essentially the right thing in each case and was, overall, a rather good banking supervisor. Indeed much of the risk-based approach taken by the Financial Services Authority (FSA) has its origins in the Bank of England.

Furthermore, the then elaborate British system of statutory and self-regulatory organizations in the securities market was ripe for reform. It seems that whoever won the election, reorganization was inevitable. So the Bank agreed that I, as the Deputy Governor, should become a member of the Securities and Investments Board and that we should work together around a new publication, which would demonstrate that the Bank had an important contribution to make to the theory and practice of financial regulation. We were deploying our tanks in a forward position, ready for the turf war we expected to break out.

In retrospect, while it succeeded in raising the tone of the debate, it was an entirely unsuccessful attempt to protect the Bank's role in institutional supervision. After the election, the Bank's armored columns were rolled back overnight: out of the securities markets, and out of banking as well, leaving just a small brigade in the ultimate central banking stronghold—the payments system. But in spite of the base motivation, and the lack of success in our prime aim, the Financial Stability Review has remained a part of the landscape, and indeed it has spawned imitators elsewhere. I would not dare to suggest that any of the motivations elsewhere are similar to those of the Bank of England in 1996.

Indeed, it may be provocative to use the term imitators. We should perhaps say, more neutrally, that others have reached a similar conclusion: that from time to time it is useful to review the state of the financial system to assess potential vulnerabilities and sources of instability and crisis, and to publish the results. So we now have, among others, the Regular Global Financial Stability Report from the International Monetary Fund (IMF). In addition, Domestic Financial Stability reports, based on the Bank of England model and sometimes
with the same title, are published in France, Sweden, Norway, Spain, Japan and Austria, and soon elsewhere. The People’s Bank of China plans to publish a Mandarin version shortly. There is now an academic “Journal of Financial Stability” which hit the bookstands, or perhaps the book stacks, in 2004. Of course, there is also a Financial Stability Forum (FSF), now chaired by Roger Ferguson and a Financial Stability Institute (FSI) in Basel under Josef Tosovsky. For all I know, there may be a financial stability cocktail and an ice cream flavor too. Certainly, there is a financial stability Internet chat room, and if you have 22mbs to spare in your mailbox you can download its contents. The contents are not quite as racy as those of some fan club chat-rooms, but at least you may safely show them to your spouses and children. There are around 11 million references to the term on Google, though none on Ebay. Financial stability, sadly, is something money can’t buy.

Given this blossoming of output and activity, the world over, it is a pity that the Bank of England did not take out an international patent on its invention. Had it done so, the Bank’s modest coffers would now be overflowing. But had we tried to register a patent, we would have run into a small problem: What precisely was our definition of financial stability? Could we define it in a way which would satisfy the requirements of the patent, or indeed the copyright authorities?

Definitional Problems
In 1996, the answer to that question was clearly no. What is more surprising is that, in spite of all the forests felled since, we are no closer to an agreed definition of the term. In his Per Jacobsson lecture last year, Charles Goodhart reviewed the literature on financial stability, and looked hard at what the Bank of England has been doing under that heading. His verdict was that “there is currently no good way to define, nor certainly to give a quantitative measurement of, financial stability.” On the Financial Stability Review he commented that there is “no overall coherent model lying behind it all, as there is with the Bank’s Inflation Report”. Furthermore “there is no clear cut instrument, nor a clear cut objective, except the negative one of avoiding financial instability.” There are, he argued, “lots of valuable bits and pieces that come under the wing of a financial stability function but it is, perhaps, arguable whether they amount to a coherent whole.”

The Bank has responded by setting out what is described as ‘A Framework for Financial Stability,’ in a paper presented earlier this
year by one of the Deputy Governors, Sir Andrew Large. But, even there, Large acknowledges that there is ‘neither a clear over-arching analytical framework nor a commonly agreed set of indicators of incipient financial instabilities.’

Lest it seem that Charles Goodhart is pursuing a vendetta against his former employer, he argues that this lack of definitional clarity is one which characterizes worldwide discussion of the subject. Furthermore, Professor Phil Davis, who orchestrates the chat room I referred to, asked his contributors to define financial stability, but, several megabytes later, he found that the most persuasive responses came from those who argued that it was best defined as just the absence of financial instability.

A more systematic review was undertaken by Sander Oosterloo and Jakob de Haan, the results of which were published in the second edition of the Journal of Financial Stability. They reviewed the activities of a wide range of central banks in this area and their conclusion is that there is “no unambiguous definition of financial stability or systemic risk, and that generally the responsibility is not explicitly formulated in laws. There is considerable heterogeneity in the way central banks pursue their financial stability objective,” they said, and added, that “the democratic accountability of the financial stability function of central banks is often poorly arranged.”

Some central bankers themselves recognize this problem. Lars Heikensten, the Governor of the Swedish Riksbank noted last year that “the concept of financial stability is slightly vague and difficult to define.”

It would be fair to acknowledge, however, that a number of efforts have been made to produce a definition. Rick Mishkin has defined financial stability as “the prevalence of a financial system, which is able to ensure in a lasting way, and without major disruptions, an efficient allocation of savings to investment opportunities.”

There is an attractive clarity and simplicity about this definition, but Allen and Wood identify two difficulties. First, they point out, “no-one would no say that savings were allocated efficiently to investment opportunities in the Soviet Union, but the Soviet Union did not suffer from financial instability, except right at the end of its existence.” Furthermore, they argue that this definition is not one which helps us in a practical way. It is not possible to know until after the event, if indeed then, whether or not savings have been efficiently allocated to investments. How is a regulator, or a central banker pondering
liquidity support, helped by this definition? It fails the important 'observability' test.

Another, rather more detailed definition was proposed in 2003 by Michael Foot, formerly of the Financial Services Authority (FSA). He suggested that we might consider the financial system to be stable if the following four conditions were met:

1. That there is stability in the value of money (low inflation in other words),

2. That the employment rate is close to its natural rate,

3. That there is confidence in the operation of key financial institutions and markets and

4. That there are no relative movements in asset prices that would in time undermine the first three conditions.

Foot's definition has the benefit of being, at least in good part, observable, though there is an obvious element of judgment in the assessment of confidence, and in determining how large and rapid asset price movements need to be to pose a threat to overall price stability. The main difficulty I see is that the creation of conditions which promote full employment, in particular, owes much to a range of other policies, notably in relation to the labor market, which take us a long way from the concerns and responsibilities of central banks and financial regulators. If we define financial stability very broadly, then we may find it difficult to disentangle the contribution made to it by the financial authorities.

Andrew Crockett, as General Manager of the Bank for International Settlements (BIS), while he did not offer a single definition of financial stability, argued that it was important to distinguish between the stability of individual institutions, and the stability of markets. He believed we should focus more on market stability, recognizing that particular institutions may come and go. This is an important point, to which I shall return.

There are many others who have taken the view that it is easier to approach a definition of financial stability by looking at the other side of the coin. In other words, by defining what we mean by financial instability, or by financial crisis. A paper by Andrew Haldane and others in the Bank of England's Financial Stability Review last year, maintains that “financial instability could be defined as any deviation
from the optimal saving-investment plan of the economy that is due to imperfections in the financial sector.” This, again, is conceptually attractive but suffers from the same difficulties as Mishkin’s definition of financial stability which, indeed, it closely resembles. The problem of determining when we have departed from the “optimal saving-investment plan” is very difficult. Perhaps such deviation is observable in extreme circumstances, such as the Asian financial crisis of the late 1990’s, but in other less extreme circumstances it may not be a reliable and operational guide.

Perhaps, therefore, we might be safest with Walter Bagehot, as we often are in this fraught territory. Bagehot’s definition of a crisis was a situation “when the Bank of England is the only institution in which people have confidence.” ¹⁷ I suppose I can agree that, if there has been a general crisis such that there is no longer market confidence even in the United States Federal Reserve, we are probably in of trouble, but we might hope for a definition which gives us a little advance warning before that unhappy point is reached.

In reviewing these attempts to find, as it were, the North West Passage of the financial world, I reflected on how useful these various definitions might be in helping a financial regulator to make the many awkward decisions he or she is required to address in the course of business. I frankly cannot recall a decision we reached at the FSA which was decisively influenced by our view on the optimal saving-investment plan.

Against that operational test I am attracted by the approach taken by William Allen and Geoffrey Wood,¹⁸ who define episodes of financial instability as “episodes in which a large number of parties, whether they are households, companies, or (individual) Governments, experience financial crises which are not warranted by their previous behavior.” They suggest that “a distinguishing feature of episodes of financial instability is that innocent bystanders get hurt.”

As with all attempted definitions in this area, it begs a number of questions, and depends in practice on the exercise of judgment. But I can certainly recall circumstances at the FSA in which the innocent bystander test was a useful one, in practice, and one which we implicitly, if not explicitly, used. Would the consequences of the failure or closure of an individual institution be such that we might expect confidence in the sector as a whole to be materially damaged, with adverse consequences for depositors, investors or policyholders, well beyond those with a
direct relationship to the institution in difficulty? In other words, what happens when the safety net arrangements for investors, policyholders or depositors in an individual institution turn out to be inadequate?

If we adopt this type of definition of financial stability as our working hypothesis, so to speak, what are the implications? Would it, in practice, have any consequences on the way we oversee and supervise markets, or is this definitional work merely a tidying up academic exercise?

In fact, I believe there could be some significant consequences. To understand what these might be it is helpful to parse the issue into three elements:

- Tolerance level of market movements, disruptions and indeed, institutional failure.
- The institutional arrangements to oversee financial stability which are most appropriate, both domestically and internationally.
- The implications for the role of supervisors themselves, in particular—though not exclusively—banking supervisors.

**Tolerance**

One concern I have about the way in which financial stability is discussed in some central banking circles is that the two stabilities, monetary and financial, are talked of in the same breath, and seen as parallel objectives which, by implication, should be thought about in very similar ways. Yet, they are surely very different objectives.

On the monetary side, the argument in favor of a low and stable inflation rate was won many years ago. We may debate the extent to which monetary authorities should accommodate the inflationary implications of exogenous price shocks, but even those in the more accommodating camp would ascribe strict limits to the degree of that accommodation, and to its duration. So central banks tend to aim at a very tight definition of monetary stability. Over the 8 years of its independent existence as a monetary authority, the Bank of England has kept the inflation rate within the permitted 1% band around the target rate at all times. Neither Eddie George nor, so far, Mervyn King has been obliged to write a letter to a Chancellor explaining divergence outside this band. Yet further proof, if any were needed, that in this email age the art of letter writing is dead.

But surely financial stability is quite a different concept altogether? We cannot possibly aim to keep the volatility of the equity market within
a 1% band. More significantly, in a dynamic and competitive financial
market place we are bound to see episodes of overshooting and, to coin a
phase, irrational exuberance, episodes which we should not always seek
to restrain. We know that financial markets are prone to overshooting
and to bubbles and crashes. There is extensive literature, which I have
discussed elsewhere, on the psychology of over optimism, which is
powerful in explaining some observed events in financial markets
through the last three centuries. Given the explanations we now have of
these extravagant fluctuations it is not clear that we could restrain them
effectively with the modest tools available to the financial authorities,
even if we wanted to; nor is it clear that we should want to do so.

Booms and busts have their own positive value. There is a process
of Schumpeterian creative destruction at work in financial markets,
both at the level of financial instruments, and of financial institutions
themselves. It is not clear that we should seek to constrain that process
very tightly. It may not be appropriate or tactful for financial regulators,
or central bankers, to positively welcome institutional collapses, but in
the privacy of our gilded halls, or functional open plan office suites, we
may quietly regard them as mildly beneficial, from time to time—as long
as our innocent bystander test is not extravagantly violated.

So the language we should adopt in discussing financial stability is not
the same as the one we need when we praise successful monetary policy.
Volatility can be, and frequently is, present even when the financial
machinery, in an operational sense, is working perfectly. The price
stability lexicon is not the best sourcebook for our speeches. Instead, we
need to emphasize that not all extravagant market movements should
be constrained; not all institutional failures should be seen as a failure of
the regulatory regime; and, that we have safety nets in place to protect
the innocent, but those safety nets should not be so high, nor the mesh
so fine that they catch every falling star.

In my view, this points to the need for regulators to clearly explain
that they are not aiming to achieve a zero failure objective. Furthermore,
it is a justification, furthermore, for an element of co-insurance in
deposit protection schemes—something which has been implemented
to a much greater extent in the United Kingdom, than in the United
States. It is an argument for deposit protection schemes which are not
hugely generous. The limit in the United Kingdom is 90% of £33,000,
considerably lower than it is in the United States. In addition, it is an
argument, too, for institutional arrangements which set the bar for
official sector support for failing institutions as high as possible. I shall come on to talk about the institutional arrangements in the United Kingdom in a moment or two.

This approach is not easy to implement, or to make credible. Curiously, it may be more difficult to make investors and depositors understand that they may not be rescued, than that they will be. There is evidence that people believe that the authorities will intervene in individual cases, even when they say they will not. Regulators typically try to describe this limited assurance in the language of risk-based regulation, language which politicians find rather difficult. As one recent research report by Julia Black of the London School of Economics Law department, observes “the risk based frameworks may provide regulators with rational and systematic ways of making [difficult] choices, but whether they will enable them to weather the next political storm remains to be seen.”

I do not interpret that, however, as an argument for saying that one should not try.

I would argue that another consequence of this rather restricted definition of the financial stability objective is that one of the prime tasks of regulators should be to help the market to impose its own disciplines. One has a better chance of not reacting inappropriately if reasonable warnings have been issued to market participants in advance. I would see this as the essential justification for the financial stability reports issued by the IMF, by some central banks and by the FSA. Interestingly, Allen and Wood are doubtful even about the value of these reports. They acknowledge that “such publications serve a useful purpose if they draw the attention of innocent bystanders to financial risks that they might otherwise have overlooked. However, if they go further, and analyze the risks facing large financial institutions, “such publications carry a moral hazard...the effect of free publication may be to increase rather than reduce the risk of financial instability.”

Here I part company with them. That is partly because the FSA, certainly, has always couched its financial stability reviews in terms of identifying risks to the regulator’s objectives, rather than to those of financial institutions themselves. The regulator’s objectives are essentially those of protecting innocent bystanders, and the integrity of the system as a whole, not of protecting a particular institutional structure. I agree that, if the authorities step over the line, and seek to put themselves in the shoes of those running major banks, the exercise can be dangerous. That risk is equally present in line supervision departments where there
is sometimes a temptation to substitute the regulator's judgment for that of the bank. So, as long as the purpose of those reviews is clear, I see them as having considerable value though it may not be the value I initially had in mind when I launched the Bank of England’s Review.

**Domestic and International Institutional Arrangements**

The second area affected by our working definition is the appropriate institutional arrangements for financial stability, both domestically and internationally. Here I suspect that I am, to some extent, a prisoner of my own experience, and I see strong attractions in the new model in the United Kingdom. I well recognize that on this side of the Atlantic, I am entering heavily contested territory, so I will try to tread carefully.

My first observation is that sources of financial instability are not now limited to problems in the banking system. If we look back at events in the past where financial crises have been costly to resolve, it is true to say that most of them have occurred in the banking system, or at least the shocks have been transmitted through the banking system. But more recently we have seen the serious threat of a financial crisis arising in a large hedge fund, and I would say during my time at the FSA the nearest we got to a serious threat to domestic stability arose from problems in the life insurance sector. So a comprehensive arrangement for monitoring financial stability today will include those with supervisory responsibilities for insurance and securities markets as well as the banking sector. Andrew Large’s paper presents a useful taxonomy of potential crises.22

But cannot the same effect be achieved if the central bank has the responsibility for financial stability as well as monetary stability, leaving regulators, whether within or without the central bank, to handle the grubby business of day to day relationships with individual institutions?

This question proved the liveliest issue in the run up to the establishment of the FSA in London. It was argued, on the one hand, that responsibility for financial stability should rest uniquely with the Bank of England, leaving the FSA as the day-to-day supervisor. In defense of that proposition one could argue that there is a positive benefit in distancing the responsibility for systemic stability from the monitoring of individual institutions, on the grounds that a supervisor who has systemic responsibility might be inclined to argue that any institutional failure ought to be prevented, in order to cover up past weaknesses in supervision. That case had been made in the past in relation to the Bank
of England, on the rescue of Johnson Matthey. So this argument may run in favor of ensuring that the supervisor does not have a systemic responsibility, but of course it also implies that supervision should indeed be removed from the central bank.

A cousin of this argument may be found in the literature which discusses the link between monetary and financial stability—the so-called ‘nexus’ debate. In one such paper Roger Ferguson argues that inventors may ‘undervalue’ the risks they take on if they expect that the central bank will act to offset future financial stability concerns.²³

You can see that, as far as the central bank is concerned, these arguments are two edged swords which must be wielded with considerable care. A safer argument for the central bank is that a supervisor outside the central bank would not have the kinds of economic and analytical expertise necessary for the financial stability task. Furthermore, since lender of last resort support would be provided by the central bank, it was important that it should have its own ability to assess market conditions, so as to know whether or not liquidity assistance could be justified. It would not be reasonable to expect the central bank to provide support on the recommendation of a regulator, without its own independent means of checking the justification.

This latter argument was accepted by the Government as a powerful case in favor of the Bank of England retaining responsibility for the stability of the financial system as a whole, which it has done. But the Government also took the view that the supervisor should itself have a statutory objective to maintain confidence in the UK’s financial markets. That objective runs in parallel with the Bank of England’s responsibility for systemic stability. Why was this thought to be appropriate? Largely, it is because to separate the responsibilities for supervision and systemic stability with an institutional bright line would create a potential source of friction between the two authorities. A regulator with only a consumer protection responsibility might be led to take actions which posed risks for the financial system as a whole. The Bank would then be obliged to stop it, by playing its ‘systemic’ ace on the trick.

That is not a purely theoretical point. There were two instances during my time at the FSA where it became a real issue. The first concerned mis-selling of investments and mortgages, whereby an aggressive approach by the regulator, which could perhaps be justified in consumer protection terms, if only the interests of the consumers directly affected were considered, could well have generated a systemic crisis. The
amount of compensation potentially payable would have threatened the viability of many insurance companies. Secondly, when the stock market fell precipitously in 2001, maintenance of rigorous solvency rules for insurance companies could have forced them into further sales of equities with the risk of a dangerous forced selling spiral destabilizing the market. In both cases the justification for regulatory forbearance, to use a term we do not typically employ in the United Kingdom, was, essentially, one related to financial stability using the safe harbor of the regulator’s responsibility for market confidence. Had the FSA not been endowed with such a responsibility by Parliament, it would have had to ask the Bank of England to instruct it, or advise it, to act differently. That would have been an uncomfortable episode for both sides. It was far better that the FSA’s and the Bank’s systemic stability objectives could be debated, with the Treasury, in the context of the Tripartite Standing Committee on Financial Stability, and appropriate judgments reached.

That is essentially the reason why the Memorandum of Understanding (MOU) between the Bank of England, the FSA and the Treasury articulates the responsibilities for financial stability in the way it does.24

There is a further argument for this set of institutional arrangements, which is rooted in what I said earlier about the innocent bystander definition, and the case for a non-zero failure regime. It is clear from the terms of the memorandum of understanding that both the Bank and the FSA need to reach a judgment about the likelihood that an institution or institutions will fail, and about whether such failure would create a systemic crisis. The FSA’s market confidence objective means that the authority itself must reach that judgment, separately from the Bank of England. It is clear that after the event both institutions could, and certainly would be held accountable by Parliament for the view they took. The MOU also provides that the Treasury may, if solvency assistance is required, or is a likely consequence of liquidity support, prevent that support being given. Interestingly, the Treasury may not request the Bank of England to support an institution. Here, I note, in passing, that this is a rigorous restriction on politicians. In many other countries the relationship would be precisely the other way round, with the Ministry of Finance able to instruct the central bank to provide support, but not necessarily able to prevent it doing so.

In my view, the value of this arrangement is two-fold. First, there is the banal point that two or three heads are often better than one in reaching the very difficult decisions involved in justifying or rejecting support to
the market. Second, and just as importantly, this arrangement, which is well publicized, introduces an element of ambiguity and uncertainty about the provision of support. I regard that as positive because it emphasizes to market participants that they should not assume that support will be forthcoming. They cannot take a nod and a wink from either the supervisor or the central bank as an indication that they will be bailed out. The provision of financial support is like a slot machine where 3 cherries need to come up in a line before it will pay out. Of course I know that Las Vegas is full of people who believe that will happen the very next time they pull the lever. But we may hope that Chief Executives and Finance Directors of banks and insurers make a more rational assessment of risks and probabilities. So, I am a strong supporter of the distribution of responsibilities for financial stability which we now have in the United Kingdom.

One thing which we learned in the Tripartite Standing Committee, to which I referred, was that many, if not most of the threats to the stability of the London financial markets arose from developments elsewhere. London is such an international market place that the reverberations of developments in Asia, the Middle East, Turkey, Argentina, or on Wall Street are strongly felt in Threadneedle Street or on Canary Wharf. So much of the time of our financial stability watchers is spent on international surveillance. We therefore saw the need for a global approach to financial stability, to provide the framework for our national assessments. That was certainly one reason why Gordon Brown was a prime mover in the establishment of the Financial Stability Forum in 1999.

I do not have time to speak at length about the FSF. So I will limit myself to three very brief observations.

First, I am a strong supporter of the existence of the Forum. It has perhaps, struggled to find the optimal role for itself within the international financial architecture, but I am convinced it fills an important gap. Perhaps some of the early ambitions were unrealistic: such as the expectation that the FSF might act as a kind of global financial fire brigade. But there is nowhere else where insurance and securities supervisors come together with central banks, Finance Ministries and the International financial institutions. I think it not retrospectively vainglorious to claim that the Chairman of the FSA in London is a significant member of the global defense force against financial instability. Yet until the establishment of the FSF there was no forum in which I met central bankers or the IMF or the World Bank. In retrospect, that seems very odd—and it seemed odd to me at the time.
Secondly, I think the FSF can, at times, afford to take initiatives of its own. Perhaps, at the outset, it bit off more than it could chew in establishing a range of working parties— one of which on highly leveraged institutions I chaired. I am sure it is right to look for other bodies to take up issues which it identifies. But it would be wrong to exclude the possibility that there are issues which the Forum is uniquely placed to address, particularly where they involve bringing together the interests of all the central banks, supervisors and International Financial Institutions which make up its membership.

Thirdly, and this is a matter for domestic authorities rather than for the FSF itself: there could be a much tighter linkage between the FSF vulnerabilities exercise, the IMF's Global Financial Stability report, and the analyses produced by individual countries. In London we began to try to analyze these analyses, and to see whether in our domestic work we were picking up the broad themes identified by the staff of the FSF in Basel. I am not sure I have seen much evidence of that kind of articulation taking place elsewhere. It seems to me, there ought to be a kind of hierarchy of analysis, with concerns and assessments moving up and down the chain, to ensure that all the major threats to the integrity of our financial markets are being identified.

**Supervision**

The third and last area in which the “innocent bystander” definition may have implications is in the practice of financial supervision itself.

The classic strong form definition of the role of financial supervision may be found on the website of the Financial Stability Institute in Basel. There, the Institute argues that financial stability is crucial for sustained economic growth which cannot be achieved without a strong financial system. It goes on to say that, to create a strong financial system, “effective supervision is the key.” The argument is that information deficiencies create incentives to take undue risks and that, and here I quote directly, “only effective financial supervision can successfully counteract this behaviour.”

The Financial Stability Institute carries out a lot of useful work. It is playing a key role in up-skilling supervisors around the world, and sensitizing them to the systemic implications of what they are doing. But I am afraid I find this definition of the role of supervision to be overstated and, indeed, the supervisors who proclaim such a mission are doomed to fail to fulfill it, and to create both disappointed expectations and moral hazard.
Allen and Wood advance this counter argument in a rather rigorous way. They argue that we are currently in a transition from a highly controlled financial system, to a much freer environment. In this transitional phase supervisors have made an important contribution to improving standards of risk management in commercial and financial institutions. But now, they argue, in most developed countries at least, the market environment is far more competitive, so the maintenance and further development of risk management standards will not require anything like the same degree of regulatory activity and involvement. Indeed, they say "we think that excess regulation can unintentionally inhibit the development of risk management techniques, and thereby retard further improvements in risk management standards." They believe that Basel II, in particular, in imposing a more detailed risk measurement framework on commercial banks, has the capacity to do more harm than good.

I do not follow Allen and Wood that far. I believe there is a happy medium between their hands-off skepticism and the over inflated claims for supervisors on the BIS website. That happy medium will be different in different countries, at different times. But supervisors should always be aware of the dangers of making decisions which are properly those of financial institutions themselves, and of imposing a rigid framework of risk management which may, through promoting a homogeneous approach to risk across the market, or by introducing dangerous procyclicalities, have the effect of increasing, rather than reducing systemic risk. They should also be careful always to consider the potential impact of their activities on competition. The Act of Parliament establishing the FSA imposes a requirement on the authority to produce an analysis of the impact of any new regulation or supervisory practice on competition. That would be a useful discipline in other countries, and indeed in Basel. Can all features of Basel II be justified against the innocent bystander test? Perhaps we should give the latest version of the new Accord to a sample of passers by on 19th Street to gauge their response.
Conclusions
My two cheers for financial stability have now, I hope, been explained, as well as the absence of the third.

It is important for financial supervisors to have regard to the interests of the financial system as a whole, or they may be led, inadvertently, into taking decisions on consumer protection which can damage the system. But they should be careful not to think, or imply, that supervisors can maintain a smooth path for asset prices, or to guarantee the existence of a particular set of financial institutions indefinitely. They should be aware of the long-term benefits of creative destruction. They should not think that monetary and financial stability are identical twins.

They should also be cautious in describing the limits of their ambitions, both in terms of the security they can offer to those who transact with financial institutions and in terms of the role that supervision may play. They should try hard to use their statutory responsibilities and influence to promote market efficiency through information disclosure and risk analysis. And they should use some version of the innocent bystander test when considering any intervention which could be costly to the public purse.

But I said I would end, as all academic papers do, with a plea for more research. In this case it is a plea I borrow from my colleague Charles Goodhart. He argued in his Per Jacobsson lecture last year that too little work had been done on modeling systemic stability, and the threats to it. In relation to Basel II, for example, there have now been four quantitative impact studies—not necessarily producing quite the answers expected—focusing on the implications of Basel II for individual banks. It is far more difficult to model the impacts on the system as a whole, but just as important. Charles himself has advanced some more detailed thoughts on how this modeling can be done, which I will not repeat at this late stage.

Instead, I will end where I began, with thanks to Paul Volcker and the Group of Thirty for their invitation to reflect on my experiences as a central banker, a supervisor and briefly both.
Endnotes

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