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Remarks at the virtual event "Early COVID-19 lessons for macroprudential policy," held by the Peterson Institute for International Economics, October 15, 2020

1. I want to talk today about what we have learned – and what we are likely to learn - from the COVID crisis about financial stability and macro-prudential policy.

2. First, what do I mean by ‘financial stability’? (I have to say as the Deputy Governor for Stability that I am often asked to define ‘financial stability’; I envy my colleague on the Monetary Policy side in this respect).

3. For me, financial stability first and foremost is about ensuring the financial system does not amplify economic shocks and, if possible, serves to dampen them. In other words, that the financial system as a whole doesn’t make things worse. And if possible, makes them better.

4. A very important part of that is ensuring that the financial system does not cause the shock in the first place as it did 10 years ago. But, as we are seeing now, the shock can originate outside the financial sector and in those cases it is just as important to ensure the system does not amplify it.

5. When economic prospects change sharply and there is a radical increase in uncertainty about the future, the danger, as we saw 10 years ago is that the financial system can overshoot into ‘fear’ ‘mode.

6. The resulting breakdown in the supply of credit and financial services to the real economy makes the recession worse, which in turn worsens the shock to the financial sector, which then further increases the dynamics of fear.

7. The reforms of the last 10 years have been designed not just to ensure that the system does not create another great financial crisis, but also to give the system the resilience to enable it to avoid an overshoot of risk aversion.

8. So how well have we done? And what are we likely to learn as this crisis evolves?

9. On the first question, the short answer is that the banking system – in the UK and in other advanced economies - has so far come through the crisis pretty well. It has had the capital strength to absorb the initial surge in demand for credit as corporates called down their credit facilities, to provide forbearance to households through payment holidays and to weather the sharp increase in risk and prospective impairments without contracting the supply of credit.

10. Other post crisis reforms have ensured that bank liquidity and counterparty credit risks have not destabilised the system – in contrast to the great financial crisis.

11. On the non-bank financial system, the picture is less encouraging. The economic shock of COVID led initially to a flight to safety which rapidly became a frantic and hugely destabilising dash for cash in which even safe assets were in danger of spiraling into fire sale dynamics.

12. It took massive central bank intervention to halt these dynamics and restore order and, going back to my definition of financial stability, to prevent this part of the system making the crisis worse.

13. The FSB along with national authorities is now conducting a holistic review for the G20 to ascertain the lessons we can learn from this real stress event and to answer the question of whether we need more liquidity resilience in non-bank finance and if so how that should be achieved.

14. That, however, is not my subject today. Rather I want to look forward at two of the key questions for macroprudential policy the next stages of this crisis are likely to pose in relation to banks.

15. First, whether the buffers of capital that were such a central part of the post-GFC banking reform will prove useable and if so, for what purpose?

16. And second, how stress testing of the banking system, a key financial stability tool developed following the last crisis should operate in an actual stress.

17. On the first question, there has always, to be frank, been a residual ambiguity about the primary motivation for the Basel 3 capital buffers.

18. Were they intended to provide a safety margin on solvency so that banks could absorb losses without jeopardising their regulatory capital minima? One might caricature this as the 'micro-prudential' approach.

19. Or, rather, were they intended to provide space for banks to support the economy in stress and to avoid the overshoot of a credit crunch – which would deepen the recession and worsen the impact on banks. This could be caricatured as the 'macro-prudential' approach.

20. I have deliberately posed this question in exaggerated terms. The two motivations overlap to a large extent. And for most of the time, it is not really necessary to distinguish between them.

21. But in the current crisis, with impairments in prospect, withdrawal of government loan guarantee schemes and great uncertainty about the future path of the economy, the potential tension between these approaches comes into sharper focus.

22. To be clear, this is not, and should never be, about asking banks to weaken underwriting standards. It is about the extent to which banks should lean against an increase in their risk aversion as opposed to the increase in their risk.

23. Or to put it another way, when banks have the capital space within capital buffers, to ensure that they view credit decisions primarily through the lens of the borrower's balance sheet rather than primarily through the lens of their own balance sheet.

24. Nor should this be seen as an issue of altruism. While increasing risk aversion and preserving capital to the maximum extent might appear the right approach for each bank in isolation, the collective impact of such an approach on the economy will increase losses for all banks. [see, for example the analysis in our May interim Financial Stability Report]

25. These are not easy judgements to make – either for banks or for supervisors. And at the moment banks in the UK are well

above their capital buffers. But I suspect we will need to think through this question more as the recovery, albeit bumpy, gathers pace, as impairments mount and as it becomes clearer how permanent the damage will be in different sectors of the economy.

26. We should however also ask ourselves whether we have created disincentives in the regulatory framework to using buffers to support the economy. I have in mind here the first mover penalty for a bank to go into its capital buffers and the way distribution restrictions kick in. There are signs that these features of the system will make banks reluctant to use their buffers The Bank has been working with other members of the Basel Committee on these issues. The Committee has encouraged firms to make use of buffers and has committed to pursuing additional measures if needed.

27. And of course, it is not just the views of banks and supervisors that matters; the market will also take its own view on solvency.

28. We can perhaps learn from our experience with the counter-cyclical capital buffer which has been lowered, system wide in a number of jurisdictions freeing up capital headroom without first mover disadvantages or adverse market reaction.

29. Long before this crisis the FPC of the BoE reached the conclusion that we needed to have a positive countercyclical buffer even when risks in the financial sector were not elevated (the so-called 'resting rate') – in part because, exactly as has happened with COVID, a risk could crystallise very quickly. Last year, before the crisis struck, we decided to increase the 'resting rate' to 2%.

Looking to the future, we may want to revisit the balance between the various capital buffers with a view to having more in countercyclical buffers that are releasable by regulators and less in the fixed buffers.

30. Finally, a few words on the lessons we are learning about stress testing of the banking system in a period of stress.

31. The Bank of England like other jurisdictions uses stress tests to ensure that the banking sector is resilient to tail risks – to very severe but plausible stresses in the tail of the historical distribution.

32. We have also for some years now adopted a countercyclical approach to stress testing. The aim is to increase the severity of the stress as risks build up in the financial system to ensure banks have the capital to meet higher risks and, commensurately, to reduce the severity when risks taking is subdued, as in the period following a major stress.

33. The current stress is however highlighting the questions that arise in the use of stress testing during the period of the stress. We are now clearly in the tail of the distribution of economic events – in the UK the Q2 drop in GDP was the severest for 300 years. But of course, we do not know if we will go further into the tail and if so, how much further.

34. Given my earlier points about using the resilience we have built up before the crisis to support the economy during the current stress, it would be counterproductive to impose a tail event on a tail event and make banks capitalize to that level of risk. To do so would mean forcing banks into defensive actions just when such actions are counterproductive.

35. But on the other hand, we do need to test and to communicate the banking sectors resilience to the more adverse COVID impacts and other plausible shocks on the horizon.

36. The problem is compounded of course by the nature of this crisis in which economic outcomes will be driven by health outcomes that will affect different sectors of the economy in very different ways. In such a stress, historical distributions of bank losses in previous recessions give us little guide to the probability of further shocks.

37. One way to address this problem is to construct ‘severe’ and ‘extremely severe’ scenarios such as those around a major second wave and further national lockdowns of the sort we saw earlier this year.

38. Many jurisdictions have adopted this approach. The problem, in my view, is that a great amount rests on the construction of these ‘adverse’ scenarios, which are essentially

informed guesses that probably now fall somewhere between the central case and true tail events.

39. The Bank of England has therefore adopted a ‘reverse stress test’ approach. We have looked to establish how much worse economic outcomes would need to be to deplete capital buffers by as much as our pre COVID stress test.

40. The high level answer was that we would need to see cumulative GDP losses of around £610 billion (nearly 30% of 2019 annual GDP) - twice as high as those in the MPC’s central economic case - and unemployment rising to 15 %, leading to £120 billion in credit losses to deplete capital by as much as in the pre COVID stress test. And even then, banks would use up only 60% of the buffers they hold over their minimum requirement.

41. Based on this result, the FPC was able to conclude that: the UK banking system was resilient to a very wide range of economic outcomes; that, to go to my first point, it had the capacity to use buffers to support the economy; and that it was in its own interests to do so.