How resilient is the UK's financial system?

The term 'resilience' has become firmly established in the lexicon of financial policy makers since the financial crisis of 2008. But what do we really mean by resilience? How do we measure our progress towards a more resilient financial system? And have post-crisis reforms been sufficient to achieve this goal? The New Economics Foundation (NEF) set out to answer these questions by identifying the key factors that determine the resilience of financial systems and using this to construct a Financial System Resilience Index to compare the UK's position with other countries' financial systems over time.

Key findings

The Index reveals that the United Kingdom has the least resilient financial system among leading industrial (G7) nations. It is unusually large and homogenous, highly interconnected (both domestically and internationally), highly complex and highly reliant on funding from the wholesale financial markets when compared to other G7 countries. In addition, levels of household debt are high and the proportion of real economy lending[1] is strikingly low.

This suggests that the UK's domestic economy remains highly exposed to vulnerabilities in the financial system while, conversely, the financial system is not performing well in terms of its basic social and economic functions.

Considering the resilience indicators in this study under a number of future scenarios suggests that, under current financial policy frameworks (such as higher capital adequacy requirements) or market developments (such as 'challenger banks'), this position is unlikely to improve significantly.

Key recommendations

NEF recommends that regulators should:

- Publish their definition of financial system resilience, making clear how it is distinct from individual bank resilience and from financial stability.
- Collect and publish data on the resilience factors in this study, and use this to evaluate policy.
- Assess system resilience as a distinct exercise from 'stress tests' of individual banks, and make these system-wide dynamics a priority for further research.

Specific policy implications of the analysis include:

- Competition policy must promote diversity, not simply more 'lookalike' challenger banks.
- Policy makers cannot rely on complex new capital requirements to ensure system resilience: structural reforms could be more effective.
- Peer-to-peer lending could significantly improve system resilience, but this depends on how the industry evolves.

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Policy and practice context

It is now almost seven years since the collapse of Lehman Brothers triggered a global financial crisis. The impact of that crisis is still being felt in countries across the world, from the loss of economic output and employment to the resulting sovereign debt crises and austerity programmes. The question of whether we can expect another financial meltdown, and how the system will cope if one does occur, is of huge public policy importance. The term 'resilience' is gaining currency with financial policy makers and regulators, but there is no clear common understanding of what this means or how we can measure it.

About the study

This research was carried out by NEF. It set out to develop a framework for assessing and measuring financial system resilience over time and between countries. The research was carried out between September 2014 and April 2015 and included: a review of the key literature on financial system resilience and of existing datasets and indicators on aspects of financial system resilience; two expert roundtables held in November 2014 and February 2015; a series of individual interviews with regulators and academic experts.

Based on this, the researchers identified seven key domains affecting financial system resilience, with indicators for each domain. These indicators were calculated for G7 countries over several years and then combined into a composite index. The utility of the framework for assessing future policy and market developments within the UK was explored by considering the potential impact of different scenarios on financial system resilience.

Defining financial system resilience

Too often, policy makers implicitly equate 'financial system resilience' with the ability of individual banks to withstand short-term, externally generated shocks without going bust. This approach, which fails to appreciate more recent advances in complexity economics, is far too narrow to be useful. Attendees at the expert roundtable agreed: as one put it, 'It doesn't help to think of resilience in the traditional way of just "how much capital are banks holding?"'

Instead, we need to understand resilience as:

- *adaptive:* not just about the ability to return to 'business as usual' following a shock, but to adapt and evolve;
- *systemic:* complex systems cannot be understood simply as the sum of their parts – and financial system resilience cannot be understood simply as the sum of the resilience of individual banks;
- *self-reinforcing:* addressing the system's tendency to *generate* internal shocks (like the 2008 sub-prime mortgage crisis), not just its ability to bounce back from external shocks.

For the purposes of this study, 'financial system resilience' is defined as *'the capacity of the financial system to adapt in response to both short-term shocks and long-term changes in economic, social and ecological conditions while continuing to fulfil its functions in serving the real economy.'*

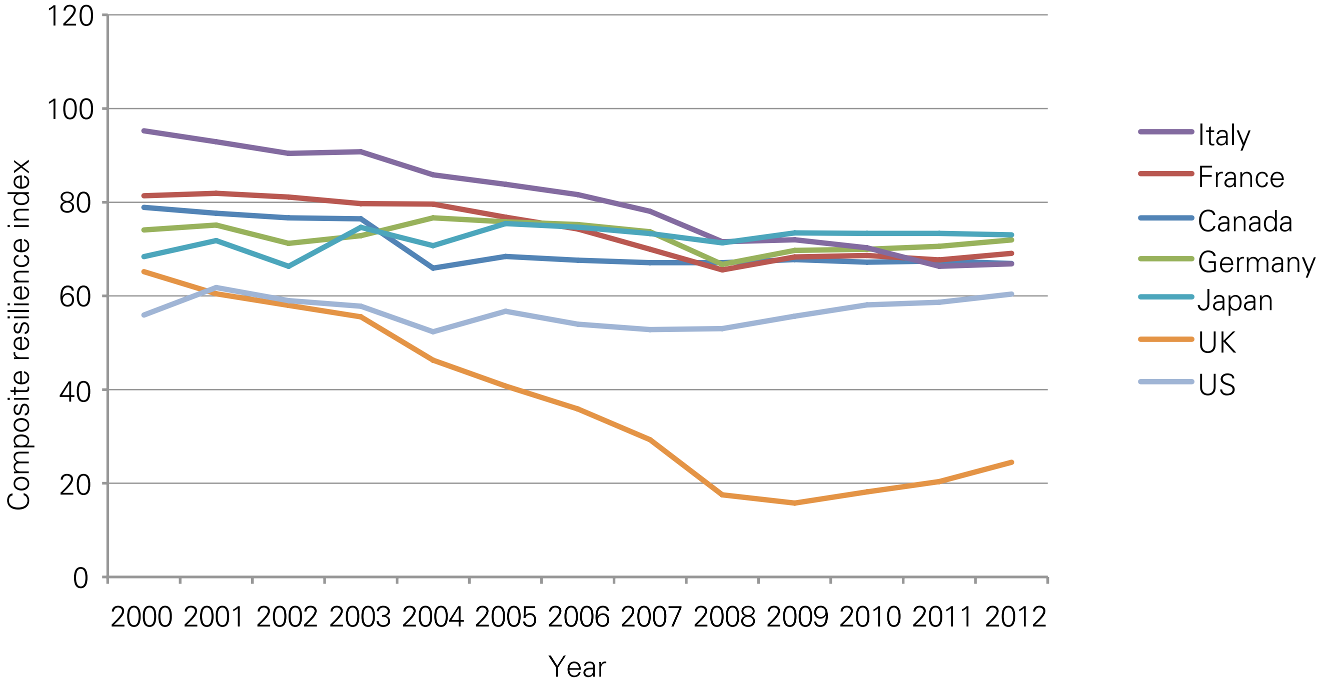
The researchers' focus is specifically on the banking system because of the unique risks that banking activities pose to financial system resilience.

Factors affecting financial system resilience

Drawing on academic and policy literature and a series of expert interviews and roundtables, the researchers identified six key measurable resilience factors that are often overlooked in policy debates:

1. **Diversity:** Healthy systems have a diversity of actors that occupy a variety of different niches in the system and employ different strategies to thrive. Competition between *types* of bank is more important for resilience than competition between individual banks.

The International Financial System Resilience Index.



2. **Interconnectedness and network structure:** The way the financial network is wired up affects the way a crisis spreads. For example, systems that are highly interconnected (both internally and externally) can allow local difficulties to spread rapidly to different countries and markets.
3. **Financial system size:** Financial systems that are large relative to their domestic economy pose a greater threat to economic stability.
4. **Asset composition:** Where banks are lending and investing matters – financial assets that are particularly prone to boom and bust pose a greater threat to resilience than other types of lending.
5. **Liability composition:** The way in which banks are funded also matters, with short-term funding from the wholesale financial markets being potentially more fickle and volatile than longer-term sources of funding, including deposits.
6. **Complexity and transparency:** The increasingly complicated chains of financial transactions that lie behind the products and services offered to customers can spread risks around the financial network and make those risks harder to assess, especially during a crisis.

Comparing national financial systems' resilience

NEF compiled numerical indicators for each of these factors, to enable comparisons to be made between different countries' financial systems and to discover whether they had become more or less resilient over time. The indicators were then averaged to produce a composite index, which also includes a seventh factor – leverage – in order to capture the primary focus of regulatory efforts to improve bank resilience since the financial crisis. These indicators were calculated for all G7 countries over the period 2000–12 (see figure).

Conclusions

The composite index of G7 countries does not make for happy viewing for the UK. According to the index, the UK financial system's resilience deteriorated significantly, and more sharply than other G7 countries, prior to the financial crisis. This trend weakens one of the standard arguments in defence of the UK financial system – that its size and periodic fragility are a result of London's long-standing historical status as a global financial centre.[2] In fact, the UK's very rapid deterioration in the mid 2000s shows that the vulnerability of our financial system is the result of recent developments such as huge mergers and acquisitions and the expansion of speculative and complex bank activities.

Although the UK's financial system resilience has improved slightly since the financial crisis, it remains the worst in terms of diversity, interconnectedness, financial system size, asset composition and complexity and transparency.

Recommendations

NEF makes five overarching recommendations for policy makers and regulators with a mandate to promote financial system resilience:

- Explicitly define financial system resilience (as distinct from financial stability).
- Measure and publish resilience indicators in the seven domains identified in this study.
- Apply multi-criteria analysis to policy making, including these resilience indicators as criteria.
- Assess the resilience of the system as a separate and distinct exercise from assessing the resilience of individual financial institutions (i.e. bank stress tests).
- Conduct further research on the impact of different network structures on financial system resilience.

NEF also used the framework to consider the impact of five different scenarios on future UK financial system resilience: a significant increase in the peer-to-peer (P2P) lending market; the emergence of a challenger bank; implementation of the Vickers reforms; implementation of new capital adequacy requirements;[3] and NEF's proposal to restructure RBS into a network of locally governed public service banks. This identified some specific implications for policy:

- Whatever their other merits, 'challenger banks' are unlikely to significantly improve the resilience of the UK's financial system unless their business models are clearly distinct from existing banks. Policy makers should consider more creative approaches to enabling genuine competition and diversity – such as a reformed RBS.
- Policy makers should be extremely wary of relying on detailed, complex risk-weighted capital requirements to ensure financial system resilience. Structural reforms, such as separation of retail banking from investment banking, could have a more positive impact, depending on their design – but these are currently under threat at European Union level.
- Policy makers looking to support the P2P lending sector should distinguish between simple P2P (which could be extremely positive for system resilience) and securitised P2P (whose impacts on resilience are much more doubtful).[4]

Notes

1 Lending to non-financial corporations and to households for consumption; mortgage lending and lending to other financial corporations have been excluded.
2 Such an argument was partially made in a recent Bank of England article (Bank of England, 2014, 'Why is the UK financial system so big and is that a problem?').
3 Rules about the amount of high-quality capital that banks must hold in reserve to protect them from losses – adjusted based on the perceived riskiness of their assets.
4 More information on simple P2P and securitised P2P is available in the full report (see 'further information').

Further information

This summary is published by the Friends Provident Foundation, an independent grant-making charity. The views expressed in this summary are those of the NEF, and not necessarily those of the Foundation. The full report, *Rethinking Resilience: The Financial System Resilience Index* by Josh Ryan-Collins, Christine Berry and Tony Greenham, is published by NEF and is available from www.neweconomics.org.

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