FPC: One year young

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The Financial Policy Committee of the Bank of England (FPC) is now one year old. Its purpose is to identify and where possible mitigate threats to the UK financial system. Financial stability is the goal.

During the past twelve months, systemic fragility and troubles in the euro zone have been the key threats. Restoring confidence in the UK banking system has been the priority. That banks should build balance sheet strength - has been the primary recommendation. Today, the country's banking system is among the better capitalized and funded.

Financial stability requires a healthy economy and a healthy economy requires financial stability. Thus since its first meetings, Committee members have questioned whether there might be a trade-off between the strengthening of bank balance sheets on the one hand, and ensuring sufficient credit availability on the other. In other words, was there a choice to be made between safer banks and a stronger economy? The discussion continues. To date, the following facts have informed the Committee's recommendations:

1. Confidence must be maintained in our banks without which the banking system will cease to function. Loss of confidence in the banking system is the single biggest threat to lending. The strengthening of bank capital and liquidity has been critical to restoring confidence.

2. The balance sheets of the UK's major banks total some STG 6 trillion. The aggregate of UK lending to small and medium sized enterprises is below STG 200 billion. The Committee is concerned about that portion of SME lending which seeks and merits credit. It is also concerned about the loss absorbing buffers needed to support the other 5.8 trillion.

3. There is a difference between capital levels and capital ratios. Higher capital levels absorb loss, inspire confidence and support lending. By contrast capital ratios can be "improved" by reducing lending without increasing capital.

4. Capital is not something locked away in the vault. An incremental pound of capital can fund an incremental pound of loans. And given current bank leverage, each pound of additional capital can support some 20 pounds of additional small business lending - provided of course that the liquidity funding is available. Alternatively, some portion of incremental equity could support new lending with the remainder used to build buffers and reduce leverage.

5. Allowing capital ratios to fall *might* lead to new real economy lending - but it might not. It might merely fuel intra-financial risk-taking with little positive impact on small business requests.

6. And even if lower ratios did lead to new business lending, to which businesses would the loans go: to a manufacturer in Manchester or a shoe factory in Shenzen?

These facts and concerns help explain why the FPC has consistently emphasized loss absorbing “levels of capital” as opposed to capital *ratios*. And it explains why the Committee has said that if bank assets are to be shrunk, the shrinking should start first and foremost with intra-financial risk-taking. In short, balance sheet strength is compatible with the supply of credit to the UK economy - whilst lack of resilience real or perceived, would curtail it.

A final fact which the FPC faces is the concentrated nature of the country’s banking system. Six major banks represent 80% of UK real economy lending. Two banks represent over 40% of UK SME lending. To the extent that restoring general confidence and systemic resilience was the challenge, the recommendations have necessarily applied to all major institutions across the board.

However, the progress made to date now permits a more differentiated approach to resiliency recommendations. Thus although certain sector risks remain challenging and the threats from the euro zone undiminished, some UK institutions are less exposed than others. Those most vulnerable should continue to build capital. Those less exposed and who are well positioned by their franchise to lend to the domestic economy should feel free to utilize any excess liquidity buffers to do so. And they can now do so confidently - given the available support from the new Bank of England facilities.

Recently the Chancellor announced that the FPC will add an economic growth objective to that of stability. As you can see, the Committee is already there. The tension between the two will be in the timing not the goal.

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He writes in a private capacity.