BANK OF ENGLAND

How the Old Lady will make banks safer

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The Bank of England's Financial Policy Committee (FPC) is not yet very familiar to the general public, certainly in comparison with the Monetary Policy Committee which sets interest rates. But it is truly groundbreaking, and has the potential to dramatically change the regulation of the British financial sector, making it safer and better able to support the economy, through bad times as well as good. Everyone in the country has a stake in the future success of the FPC, even if they don't realise it yet.

It fills a huge gap in the regulation of the financial sector that was exposed by the recent crisis. Its job is to protect and enhance the resilience of the financial system as a whole in order to ensure stability in the provision of financial services to the real economy. No group of regulators has previously been given both the ability and the responsibility to meet this objective.

Of course, we will never be able to prevent shocks to the financial system altogether, but we can try to build up the defences so as to make crises less likely and reduce their impact.

The FPC has 11 voting members and is chaired by the Governor of the Bank of England. It includes executives from the Bank and the Financial Services Authority, as well as four external members who are all experts in financial markets and public policy. This ensures a wide range of views are incorporated into our often lively debates. We meet formally four times a year, and publish records of those meetings, including any policy decisions, and our analysis of the risks facing the financial system.

The FPC will have legal powers to direct the successors to the FSA – the new Prudential Regulation Authority (the bank supervisors) and the new Financial Conduct Authority (charged with responsibility for consumer protection and market conduct) – to take specific actions. It can also make recommendations to these bodies which they must implement, or explain publicly why not. And it can issue recommendations more broadly to help meet the FPC's objective.

At our March meeting we discussed which instruments should be included in the toolkit of specific legal, directive powers. We have asked for a short list, although there may be a case for adding more as we learn about how the tools can be used in practice.

What has the FPC asked for? The first is the directive power to require banks to hold extra capital – essentially shareholders' money – over and above the internationally agreed minimum standards, if risks are building up in the system. That extra capital would act as a cushion if risks crystallised and the banks faced losses. And the FPC will be able to allow those extra buffers to be run down if conditions are stressed, so as not to jeopardise lending to the economy.

In addition, the FPC would like to be able to require firms to hold more capital against particularly risky types of lending. In the past, there have often been bouts of excessive lending to the commercial property sector

for example. Being able to adjust sector-specific capital requirements to reflect such risks may help promote more stable lending.

Finally, the FPC has asked for directive control of a simple leverage ratio – the ratio of total capital to total lending as defined by international standards – that provides a clear, comparable and simple way to limit the most excessive build up of risks on the balance sheets of our banks.

To apply even this limited set of tools will require a great deal of public support and that requires the FPC to be as transparent and accountable as possible. That is in everyone's interests.

Spotting and taking actions to mitigate risk in the financial system will be a tough ask. But no one who has lived through this crisis would argue it is not worth the effort.