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RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

20 SEPTEMBER 2011

This is the record of the Interim Financial Policy Committee meeting held on 20 September 2011.

It is also available on the Internet

http://www.bankofengland.co.uk/publications/minutes/fpc/pdf/2011/fpc1110.pdf

In June 2010, the Chancellor of the Exchequer set out a plan for fundamental changes to the system of UK financial regulation. In July 2010 and February 2011, the Government published consultation documents on the proposed changes, and in June 2011 issued a White Paper. The proposed reforms include the establishment of a Financial Policy Committee (FPC) charged with identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

The Government intends the FPC to be a Committee of the Bank of England's Court of Directors, and in February 2011 the Court created an interim FPC to undertake, as far as possible, the future statutory FPC's macroprudential role. Although lacking the proposed statutory powers of Direction and Recommendation of the statutory FPC, the interim FPC contributes to maintaining financial stability by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. It also carries out preparatory work and analysis in advance of the creation of the permanent FPC.

The Committee meets at least four times a year and a record of each meeting is published within six weeks.

The next meeting of the FPC will be on 23 November, and the record of that meeting will be published on 6 December.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 20 SEPTEMBER 2011

At its meeting on 20 September 2011, the FPC agreed the following policy recommendations:

1. **The Committee recommended that banks should take any opportunity they had to strengthen their levels of capital and liquidity so as to increase their capacity to absorb flexibly any future shocks, without constraining lending to the wider economy.**

2. **The Committee advised the FSA to encourage banks, via its supervisory dialogue, to manage their balance sheets in such a way that would not exacerbate market or economic fragility.**

3. **The Committee urged HM Treasury to continue its efforts to ensure that developments in European legislation did not provide an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom, as envisaged in the consultation documents proposing the establishment of the Financial Policy Committee.**

4. **The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.**[1]

[1] The text in this paragraph was omitted from the version of the Record that was initially published on 3 October 2011. The Committee agreed at its June 2014 meeting to release this text, for the reasons set out in the Record of that meeting.

1 The interim Financial Policy Committee had two main tasks. First, it would undertake, as far as possible, the future statutory FPC's macroprudential role by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. Second, it would carry out preparatory analysis in advance of the legislation to put the Committee on a statutory basis coming into effect. In particular, in its June 2011 White Paper the Government had asked the Committee to provide HM Treasury with an update on its work on macroprudential tools towards the end of the year and report to the Treasury again with its recommendations for the permanent FPC's toolkit in the first half of 2012.

2 The Committee devoted part of its meeting to each of these topics, initially discussing current threats to stability emanating from the macroeconomic and financial environment and possible measures to safeguard the resilience of the UK financial system, before turning to discuss macroprudential tools.

The macroeconomic and financial environment

3 Since its previous meeting there had been severe strains in financial markets, which stemmed in large part from continuing concerns about the sustainability of the external and internal debt positions of some countries, especially in the euro area. Over the period, these concerns had spread beyond Greece, Ireland and Portugal. Credit default swap (CDS) premia had risen to record highs for a number of countries, while the spreads of many euro-area sovereign bonds over German bunds had increased sharply. Concerns had persisted despite the announcement by heads of state of the euro area and European Union institutions on 21 July of an additional support package for Greece, measures to enhance the European Financial Stability Facility and the European Stability Mechanism, and the subsequent extension of the ECB's Securities Market Programme.

4 Financial market pressures had been aggravated by indications of a synchronised slowing in global economic growth and an increase in uncertainty about the prospects for the world economy. Equity markets around the world had been volatile and over the period as a whole had fallen sharply. There had been a notable flight to quality, with assets perceived to be relatively safe attracting increased demand, including UK and US government debt, not withstanding a rating downgrade by one agency in the latter case.

5 Anxiety about the consequences of these issues for banks had increased materially and, in turn, the perceived vulnerabilities of banking systems were adding to strains in financial markets.

CDS premia on banks' unsecured bonds had risen sharply, particularly in some parts of the euro area. Bank equity prices had also suffered significant falls and had underperformed equity markets in general. Since the June meeting, euro-area banks' equity prices had fallen by over a third.

6 UK banks' CDS premia had also risen, although by less overall than those of some euro-area banks. That was consistent with UK banks' direct exposures to vulnerable sovereigns being relatively limited. UK banks had also made significant new disclosures, in part as a result of their participation in the EBA stress testing exercise and also following FSA action in response to one of the FPC's recommendations on such new disclosures in June. This had provided more information about the extent of their exposures to these various risks, which should help to mitigate contagion from problems elsewhere in the financial system. Nevertheless, UK banks still had exposures to the private sectors of some of the most vulnerable economies, as well as to other countries in the euro area. There was a risk that a sharp deterioration in vulnerable European economies might have adverse implications for credit conditions in other economies, whose banks were more heavily exposed. Counterparty credit risks for UK banks could arise from links between banking systems.

7 One consequence of the strains in financial markets had been the virtual closure to banks of public term unsecured funding markets. There had been very little senior unsecured term debt issued by banks in public markets in Europe since May. Issuance was typically low during August in primary capital markets, and while there had been some secured issuance around the start of September, this had since slowed. There had also been growing signs of impairment of shorter-term interbank funding markets in Europe, especially in US dollars, which had prompted the announcement of additional US dollar liquidity-provision operations by central banks. Although UK and other EU banks had already met a significant proportion of their anticipated funding needs for the year, they might begin to dispose of assets or reduce the availability of lending if they expected their access to funding markets to remain impaired for a significant period or if the maturity of money market placements continued to shorten. Market intelligence suggested that some tightening in lending standards had already begun, or was about to begin, across a number of banks in Europe. A further tightening of credit conditions could lead to an adverse feedback loop between weaker activity and a deterioration in credit quality, both in the United Kingdom and the euro area.

Resilience and lending

8 The Committee recognised that dealing with the problems facing the international financial system as a whole would require long-term reforms to tackle, among other things, unsustainable debt positions and a cumulative and persistent loss of competitiveness in a number of euro-area countries.

9 The Committee also discussed whether there were shorter-term measures to mitigate the immediate risk that a further deterioration in conditions in the euro area, in particular, could lead to significant disruption to UK financial stability and hence to the supply of credit to households and firms, which could feed back through the economy to increase the pressure on the financial system. UK banks had made progress over the past two years in building up their capital and liquidity, and reducing leverage. That had placed them in a somewhat stronger position than they had been in previously and, relative to many other banks, they were better able to withstand adverse developments without the supply of credit to the economy becoming impaired. A key question for the Committee was whether further steps could be taken to strengthen their resilience.

10 The Committee was concerned that conditions in Europe could deteriorate rapidly, with widespread dislocation spreading across interconnected global financial markets. The Treasury member of the Committee noted that HM Treasury already had contingency plans in place to provide capital and funding backstops to UK banks should conditions deteriorate further. The Committee thought that the Treasury should prepare for a full range of eventualities. In some especially severe scenarios, more far-reaching solutions might be required, which some members of the Committee felt should extend to the potential write down of some private-sector holdings of bank debt. **The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened**. It judged that publishing on 3 October 2011 this recommendation in the record of its meeting would be contrary to the public interest given the risk of further undermining already fragile market sentiment. But in line with the terms set out in the draft Financial Services Bill (section 9R(1)) it would keep that judgement under review and would

publish this recommendation as soon as it judged publication no longer to be against the public interest.[2]

11 The Committee had advised UK banks in June that they should take the opportunity of periods of strong earnings to build capital, given the scale of risks to the economic and financial environment. While events had lowered the likelihood that banks would be able to strengthen their balance sheets in this way over the short term, the Committee judged that this advice was still appropriate. Banks could also bolster their resilience in other ways. These included raising long-term funding whenever possible, and ensuring that discretionary distributions were adjusted downwards to reflect any reduction in profits. **The Committee recommended that banks should take any opportunity they had to strengthen their levels of capital and liquidity so as to increase their capacity to absorb flexibly any future shocks, without constraining lending to the wider economy.**

12 The Committee also considered whether regulatory interventions aimed at protecting and potentially stimulating credit supply might be helpful in maintaining overall financial stability. The Committee discussed whether it could signal that, while it would not welcome a reduction in levels of bank capital or liquidity, it would be content for ratios to fall if that were driven by an increase in lending to the non-financial sector. Leaning against the pro-cyclical tendency of individual banks to restrict lending as risks rose might have positive feedback effects, reducing overall credit risks on banks' balance sheets and enhancing the resilience of the system. It could be argued that banks were holding 'buffers on buffers' which suggested that banks did not perceive them as potentially useable. While most members agreed that at some point, as banks progressed towards their new Basel 3 requirements, it would be possible for buffers to be released counter-cyclically while maintaining confidence in banks' resilience to stress, they doubted that this point had yet been reached. The Committee felt that, in such circumstances, it would be important for the Committee to explain clearly why falling ratios would support, rather than impair, the overall stability of the system as a whole and the lending it provides.

13 A number of members questioned the strength of this positive feedback loop in current circumstances, notwithstanding evidence of constrained credit availability to some businesses. They argued that in current conditions it was likely that market, rather than regulatory,

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requirements were the binding constraint on banks' behaviour, so signals from regulators were unlikely to stimulate credit availability. By reducing ratios at a time of elevated risks, market participants might well come to see banks as being more fragile, and they might interpret regulatory advice to cut buffers as a signal that banks were more fragile than previously had been thought. This could lead to a rise in funding costs, which might have the unintended effect of impairing credit availability further.

14 In addition, some members indicated that further consideration was required of the extent to which it was possible under the Financial Services and Markets Act 2000 for the FSA to take into account the potential collective benefits of increased credit availability in its judgments relating to appropriate regulatory ratios.

15 A number of members also placed particular weight on the argument that it would be premature for banks to run down their ratios now, and deplete resilience, in light of shocks that had occurred in the recent past, given the risk that larger shocks could lie ahead. But in the event that conditions did deteriorate sharply, the Committee agreed that it was important that capital and liquidity buffers were useable: it would make no sense for banks to constrain lending, thereby aggravating the adverse consequences for financial stability, because they believed that they would not be allowed to run down their buffers even temporarily to cushion the shock.

16 For some members, there was a distinction to be made in current conditions between the levels of capital and liquidity buffers. For those members it would be natural in current stressed funding market conditions for banks' liquidity buffers to fall, and this could occur without dangers to market confidence provided that capital ratios were maintained at high levels. For others, market perceptions of capital and liquidity buffers were unlikely to be separated, and reductions in liquidity buffers could therefore undermine the ability of banks to maintain funding and, thereby continue to support credit supply.

17 Taking all the arguments into account, the balance of opinion on the Committee was that it would be inappropriate in current circumstances for banks to reduce capital or liquidity ratios.

18 The Committee also discussed whether shifts in the composition of banks' balance sheets might improve their ability to weather future stress, or help to prevent amplification of stresses through the system as a whole. A significant element of the increase in banks' balance sheets in the years prior to the crisis had been an expansion in intra-financial sector claims, including trading portfolios. While banks had scaled back such exposures over the past two years, some

members argued that there might be scope for some banks to lower such exposures further. That might reduce the risk of spillovers from stress among counterparties or the impact of severe market dislocation, and help to preserve or even increase capacity to support lending to the non-financial economy. It was important, though, that banks avoided actions which could worsen the feedback loop between the financial sector and the economy. Even if these did not involve immediate reductions in lending itself, actions such as large sales of assets into illiquid markets or an abrupt withdrawal of interbank lending might impair other institutions' capacity to supply financial services to the wider economy. As such, **the Committee advised the FSA to encourage banks, via its supervisory dialogue, to manage their balance sheets in such a way that would not exacerbate market or economic fragility.**

Macroprudential instruments

19 The Committee turned to an initial discussion of the macroprudential instruments that it might seek once the legislation to put it on a statutory footing came into effect. As set out in the Government's February 2011 consultation document, the proposed powers of the Committee included the ability to make recommendations on matters that it believed were relevant to meeting its objectives to the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) on a "comply or explain basis", and to issue recommendations to other bodies. In addition, it was proposed in the consultation document that the Committee should have powers of direction through which it could require specific actions by the PRA and FCA.

20 The Committee considered the circumstances under which it was likely to want to use its powers of direction and when it would be more appropriate to rely on its ability to make recommendations. Directive powers would be valuable, for example, in circumstances in which action was required urgently or where the systemic priorities of the macroprudential authority needed to take precedence over the rules applicable at the level of individual firms in the interest of the system as a whole. Recommendations might be sufficient in situations where these circumstances did not apply.

21 The Committee judged that to fulfil its responsibility to identify and take action to mitigate risks that built up within the financial system as a whole, it would require directive powers over a set of specific macroprudential tools that could help it tackle key sources of systemic risk.

22 In discussing the sources of systemic risk, the Committee noted how a rapid expansion of balance sheets and high levels of leverage could increase the vulnerability of the financial system

to losses or an evaporation of confidence. There was ample evidence from past crises – such as those in the United States, in Scandinavia and in Japan in the 1980s and 1990s as well as from more recent global events – that an excessive expansion of credit and a boom in asset prices could unwind rapidly, leading to falling collateral values, rising defaults, and associated liquidity pressures on banks. In some of these cases, the build-up of imbalances had been widespread, while in others it had been more focused, at least initially, on specific sectors, such as residential and commercial real estate. Separately, as noted above, intra-financial system exposures had expanded rapidly prior to the recent crisis, heightening risks from counterparty default and liquidity hoarding. As imbalances had unwound, banks' equity buffers had proved insufficient to absorb losses, and a credit crunch had emerged, adversely affecting the real economy and amplifying banking-sector losses further. So it was likely that the Committee would need to have directive powers over instruments that mitigated risks to the resilience of the system as a whole stemming from leverage and risk taking in aggregate and sectorally.

23 The Committee noted that systemic risks could also arise from an excessive mismatch between the typically longer maturity of banks' assets relative to their liabilities. While such maturity transformation was a core function of the banking system, it exposed banks to the risk of runs and the possibility that they might need to sell assets at depressed market prices in order to meet redemptions, which could further undermine resilience. These risks were likely to be heightened when banks held relatively illiquid assets financed by flighty short-term funding. In the run-up to the crisis, UK banks, in common with their international counterparts, had reduced their holdings of liquid assets and, at the same time, had become increasingly reliant on unstable sources of funding. When the crisis hit, many flighty sources of funding for these banks had disappeared and fire sales of assets to meet redemptions had amplified market strains, putting further pressure on the solvency and liquidity positions of leveraged financial institutions. The Committee therefore judged that it would be likely to need directive powers over instruments that enabled it to tackle imbalances in liquidity and funding positions.

24 A pro-cyclical, progressive relaxation of terms and conditions on new lending, and on financing transactions in financial markets, had been common risk-amplifying features in past crises. For example, the availability of mortgages at high loan to value (LTV) and loan to income (LTI) ratios had increased prior to the crisis facilitating greater lending, before reversing sharply during the crisis. In financial markets, margining requirements on secured financing and derivatives transactions, including against risky or illiquid collateral, had fallen as conditions

became buoyant, but then had increased significantly in the crisis, amplifying the falls in activity in some financial markets and transmitting shocks across the system. So it was likely that there would be circumstances in which the Committee would want to restrain pro-cyclical shifts in the terms and conditions associated both with loans and other financial transactions.

25 Market structure could also be a source of systemic risk. While links between individual financial institutions helped them to manage risk, it could also make the system as a whole more vulnerable to contagion from shocks to individual entities. The distribution of risk within the financial system also mattered. When risk was concentrated in a small number of institutions, markets or infrastructures, and there were questions over their resilience, the system was more vulnerable than if risk were more evenly distributed. Distress or failure of an individual entity or system could have widespread consequences and ultimately large economic costs. In addition, experience of sub-prime debt exposures, and more recently of sovereign debt, had highlighted how the opacity of interconnections and exposures in the system could amplify spillovers in times of stress by increasing uncertainty about who was at risk. So there would be advantages to having tools in these areas too.

26 In light of this discussion, the Committee judged that, alongside its broader scope to make recommendations, it would need to have directive powers over three broad categories of policy tool affecting:

(i) the balance sheets of financial institutions (including non-banks);

(ii) the terms and conditions of transactions in particular financial markets; and

(iii) market structures.

27 The Committee reviewed a number of potential tools within each category. Under the first, it considered that instruments targeted at capital and liquidity requirements, such as maximum leverage ratios, countercyclical capital and liquidity buffers, and time-varying provisioning practices could help limit vulnerabilities arising from excessive balance sheet expansions and contractions. Variable risk weights could have a role in targeting emerging risks in particular sectors. The Committee also discussed how, at certain points in the cycle, it might want to influence not just regulatory ratios, but also the numerator or the denominator of those ratios. For example, its June recommendation to banks on capital buffers had explicitly asked banks to build capital by restricting distributions – increasing the level of capital in the numerator

of capital ratios – rather than by reducing risk-weighted assets in the denominator. There was also interest in evaluating measures that might influence the flow of new lending relative to its stock, for example differential risk weights for new and old loans.

28 Under the second category of tools, it was noted that an ability to restrict the quantity of lending at high LTVs, or high LTIs, might limit such lending more directly or quickly than changes to capital or liquidity requirements which worked through the price of lending, although restrictions of this sort might also unduly restrict lending to some credit-worthy borrowers. As such, some members thought that such tools might best be used after other steps had been tried. Members also felt it would be important to have tools that influenced financing conditions in a wider set of markets, for example margining requirements.

29 Under the third category, targeted disclosure requirements might help to limit the risk that uncertainty about specific exposures or interconnections might amplify disturbances. Variations in risk weights on intra-financial system activities might lean against excessive exposures of institutions within the financial system. Finally, the Committee noted that the resilience of markets that were central to the smooth functioning of the system as a whole could be strengthened by obligations to conduct financial trading on organised trading platforms and/or to clear trades through central counterparties.

30 The Committee recognised that this was only an initial discussion and it would not be sensible to rule out other tools at this stage. There was time for further debate about the precise tools that the Committee would advise HM Treasury to include in the initial set of instruments over which the Committee would have directive powers before that advice was due after its 2012 Q1 meeting. That debate could include consideration of how broadly or narrowly tools should be defined to balance flexibility against unacceptably wide discretion. In future work to review the merits of alternative instruments, the Committee would attach particular importance to tools for which it could be relatively more confident of their effectiveness in mitigating systemic risk. This would be critical for determining how the Committee would deploy a specific tool, explain its actions and intentions, and account for its decisions, through Parliament, to the wider public. The Committee would need to assess the robustness of tools to regulatory arbitrage, the scope for international leakage, the speed and durability of impact on systemic risk, the potential for unintended consequences for market functioning and the impact on growth of the UK economy in the medium or long term.

31 The Committee recognised that its understanding of how instruments were likely to work would improve with practical experience. Using tools that were well understood would help the Committee to explain and account for the use of its instruments to external stakeholders. It was also conscious that it would have powers of recommendation that could be used, as well as specific directive powers. As such, it was minded to recommend initially a relatively narrow set of instruments for directive powers, which could evolve over time. Furthermore, it was clear that innovation and change within the financial system would give rise in due course to new risks to which the Committee would need to respond. For these reasons, it was highly likely that the list of instruments over which the Committee had power of direction would need to be refreshed from time to time. So the procedure laid out by HM Treasury and Parliament by which this would happen would need to be both clear and expeditious.

32 In addition, the Committee was concerned that its ability to achieve its proposed statutory objective by varying regulatory requirements at a national level could be constrained by current proposals by the European Commission to implement Basel 3 and other regulatory rules in Europe through so-called maximum-harmonising regulations. **The Committee urged HM Treasury to continue its efforts to ensure that developments in European legislation did not provide an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom, as envisaged in the consultation documents proposing the establishment of the Financial Policy Committee.**

33 Finally, the Committee welcomed the publication of the Independent Commission on Banking's report. It would consider the Commission's recommendations in coming meetings.

The following members of the Committee were present:

Mervyn King, Governor
Paul Tucker, Deputy Governor responsible for financial stability
Charles Bean, Deputy Governor responsible for monetary policy
Hector Sants, Chief Executive of the Financial Services Authority, Deputy Governor designate for prudential regulation and CEO-designate of the Prudential Regulation Authority
Adair Turner, Chairman of the Financial Services Authority
Alastair Clark
Michael Cohrs
Paul Fisher
Andrew Haldane
Robert Jenkins

Tom Scholar attended as the Treasury member

Martin Wheatley, Managing Director of the Financial Service Authority's Consumer and Markets Business Unit and CEO-designate of the Financial Conduct Authority attended as an observer

Donald Kohn was unable to be present, but contributed to the Committee's discussions.