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RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

16 MARCH 2012

This is the record of the Interim Financial Policy Committee meeting held on 16 March 2012.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1203.pdf

In June 2010, the Chancellor of the Exchequer set out a plan for fundamental changes to the system of UK financial regulation. Following on from two consultations, the Government published a Financial Services Bill in January 2012. 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 is also carrying 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 22 June and the record of that meeting will be published on 6 July.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 16 MARCH 2012

At its meeting on 16 March, the FPC agreed unanimously a statement outlining its advice to HM Treasury regarding the macroprudential tools over which the statutory FPC should have powers to Direct action by the Prudential Regulation Authority and the Financial Conduct Authority. This statement was published by the Bank of England on 23 March 2012.

1 At its meeting on 16 March, the Committee considered two topics: first, its advice to HM Treasury regarding the macroprudential tools over which the statutory FPC should have powers to Direct action by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA); and second, its view of the outlook for financial stability, including the progress made in implementing its previous recommendations and whether to make any new recommendations.

Macroprudential policy tools: powers of Direction

2 In its February 2011 Consultation Document and June 2011 White Paper, HM Treasury had asked the interim FPC to provide advice on the macroprudential tools over which the statutory FPC would need powers of Direction in order to meet its proposed objective. HM Treasury had requested that the Committee give this advice in the first half of 2012, in order to help it frame the necessary secondary legislation under the Financial Services Bill currently going through Parliament. The Committee devoted a significant part of its discussions in March to finalising its advice, in the light of its deliberations at its September 2011 meeting and the responses to the Bank and Financial Services Authority (FSA) staff Discussion Paper, *Instruments of macroprudential policy* published in December 2011.

Overarching considerations

3 Before turning to the potential instruments that could be included in the FPC's advice on powers of Direction, the Committee discussed a number of overarching considerations. In particular, Committee members felt it was important to keep in mind that the statutory FPC would have two categories of formal powers. First, the FPC will have the power of Direction to ensure the implementation of a macroprudential measure by the PRA and the FCA. Second, the FPC will have a power to make Recommendations to a wide range of parties. Where Recommendations were made to the PRA or FCA, the FPC could make them on a 'comply or explain' basis, in which case the PRA and FCA would be obliged either to comply with the Recommendation or to explain non-compliance publicly. Recommendations could also be made on the means and timing of implementation of a Direction given that the FPC's powers of Direction would not extend to such issues.

4 The Committee agreed that powers of Direction and of Recommendation would both be important and potentially powerful. Committee members discussed whether or not there should

be a presumption that Recommendations would be used first wherever possible since they allowed for greater flexibility in implementation. Under this approach, Directions might be used only when the Committee felt that prompt action was essential. Most Committee members, however, felt there should be no such presumptive sequencing. More generally, in making a choice between the use of Recommendations and Directions, the Committee would need to consider the nature of the risk it was seeking to mitigate, the urgency of taking action and the benefits that could accrue from the microprudential authorities having greater flexibility over implementation.

5 The Committee identified several considerations that had a bearing on its advice. First, HM Treasury had stated, in its February 2011 consultation document, that the FPC's powers of Direction should be specific, rather than broad or open-ended. The Committee noted that it would be easier to ensure such specificity where tools can be defined with reference to existing microprudential standards. Second, having been granted any powers of Direction over specific tools, the Financial Services Bill required the FPC to prepare and maintain a published statement on how it would expect to use them. It would be held regularly accountable for their use. In this regard, the Committee noted that it should aim to identify indicators that would likely influence its decisions with respect to each of its instruments; and also that decisions to leave an instrument unchanged would need to be justified. Third, having a specified set of powers of Direction would not preclude the FPC from issuing a wider range of Recommendations to achieve its objective.

6 The Committee agreed that systemic risk could arise from a number of sources. In particular, it could stem from excessive balance sheet leverage and fragile funding positions amongst financial institutions; excessively loose terms and conditions of lending and other financial transactions; and fragilities in market structures. At its September 2011 meeting, the Committee had identified that it would need to have powers that would enable it to mitigate each of these different sources of risk. Committee members felt that, on the whole, powers of Direction were more likely to be suited to targeting systemic risks that varied over time. While systemic risks arising from fragilities in market structures would be a major focus of its work, the interventions that the Committee was likely to need to make in this area were better tackled with one-off actions. Therefore, the Committee judged that the risks relating to market structures could, in the first instance, be mitigated most effectively and proportionately through its powers of Recommendation. Furthermore, such Recommendations could be underpinned by either Directions or Recommendations relating to capital requirements as applied to particular types of activity.

7 The Committee agreed that these considerations pointed towards the statutory FPC initially having powers of Direction over a narrow set of tools. Given that systemic risks, and the FPC's understanding of them, would evolve over time, Committee members considered it would be important that there was flexibility to adapt this set of tools quickly in some circumstances. As such, the Committee welcomed the Government's inclusion of a clause in the Financial Services Bill setting out a clear and expeditious parliamentary process for altering this set of tools, as and when the need arose.

8 Committee members noted that implementation of the FPC's macroprudential powers—both via Direction and Recommendation—might be constrained by EU law or regulatory or technical standards. In particular, the latest draft legislation which would implement the Basel III standards in Europe indicated that the FPC might be constrained in both the scope and the timing of implementation of its macroprudential instruments. The Committee decided that in giving its advice to HM Treasury it should set aside such potential future constraints not least because of the significant uncertainties around current negotiations. The Committee welcomed HM Treasury's continuing efforts to ensure that developments in European legislation did not create an impediment to the ability of the Committee to use macroprudential instruments in the interests of financial stability in the United Kingdom.

Balance sheet instruments

9 Committee members agreed that the statutory FPC should have powers of Direction over the countercyclical capital buffer, sectoral capital requirements and a leverage ratio. While a range of views were expressed on the relative merits of these instruments, it was agreed unanimously that the Committee should recommend them to HM Treasury. It was recognised that these instruments would have somewhat overlapping effects and so would need careful explanation. Committee members also agreed that the use of each instrument should be determined with regard to the nature of the systemic risk of concern and that there should be no hierarchy relating to their application.

Countercyclical capital buffer

10 Committee members agreed that the countercyclical capital buffer set out in the new Basel III standards provided a simple, aggregate tool which would be readily applicable in a time-

varying manner. The buffer would increase the capacity of the system to absorb losses and could act to mitigate systemic risks, for example arising from unsustainable balance sheet growth or poor risk management. At other times, reducing the required buffer, back towards the minimum level, and so unwinding previous increases, could help to mitigate an excessive contraction in lending supply during a downturn of the credit cycle. Committee members recognised that in a downturn there could be greater uncertainty about the responses by banks to a reduction in the countercyclical capital buffer.

11 Another advantage of the countercyclical buffer was that, under the proposed international agreements, any decision made by the FPC to change the buffer in the United Kingdom was likely to be reciprocated by the home regulator of foreign banks active in the United Kingdom, at least up to the levels agreed in the Basel III standard. That would enhance the ability of the FPC to stem over-exuberance in UK credit growth in some circumstances and underpin credit supply in others.

12 The Committee noted that there might be circumstances where it would be necessary for a Direction to adjust the countercyclical capital buffer to be accompanied by a Recommendation as to the appropriate balance between the change in the level of nominal capital and the level of assets. The Committee's recommendation at its 23 November meeting had already provided an example of such a case—the Committee had recommended that banks build capital levels by limiting distributions or raising external capital.

Sectoral capital requirements

13 The Committee agreed that it would advise HM Treasury that the statutory FPC should have powers of Direction to vary over time financial institutions' capital requirements against exposures to specific sectors.

14 Sectoral capital requirements could enable the FPC to target risks building in specific areas more precisely than the aggregate countercyclical capital buffer. They could be applied by scaling up the amount of capital that firms were required to have against certain types of exposure relative to the microprudential requirement. In assessing the case for use of this tool, some members noted that the over-exuberance that had preceded previous financial crises had tended to emerge

first in specific sectors, such as commercial and residential property or lending to other leveraged parts of the financial sector.

15 Some members noted, however, that it may prove difficult for the FPC to identify over-exuberant lending to narrowly-defined categories of exposure at an early stage in the credit cycle. Over-exuberant sectors might also appear very profitable. As a result, the FPC might need to adjust sectoral capital requirements by large amounts to curb lending to these sectors. It was also highlighted that the impact on a banks' overall capital position of applying an additional sectoral capital requirement would be small if lending to that sector made up a small proportion of the bank's overall lending. This consideration might further increase the scale of the required adjustment. Set against that, in certain circumstances, it could be better to use a targeted instrument. Increasing the headline capital requirement might sometimes leave relatively untouched an apparently profitable sectoral boom while causing a lower supply of credit to other parts of the economy.

16 Committee members recognised that changes in sectoral capital requirements would have more direct and transparent distributional consequences than changes in aggregate capital requirements. As a result, it would be particularly important to justify clearly any decisions over sectoral capital weights with respect to the FPC's objective of underpinning the resilience of the financial system. The Committee agreed that sectoral capital requirements should not be used to try to steer the supply of credit to achieve objectives other than financial resilience.

17 Members agreed that the FPC would need to avoid an excessively activist, fine-tuning approach in setting any sectoral capital requirements. That suggested an approach that allowed requirements to be specified for a small set of broad sectors such as residential mortgages, commercial property, other corporate lending and intra-financial sector activity, either in the United Kingdom or overseas. It might also be desirable to be able to vary capital requirements for mortgage or other property-related lending to households and businesses differentiated, for example, by their loan-to-value or their loan-to-income ratio at origination. Such an approach might be effective in containing risk from new lending into a sector that was booming or had otherwise been more risky than was reflected in the microprudential regime's normal calibrations.

A leverage ratio

18 The Committee agreed that it would advise HM Treasury that the statutory FPC should have powers of Direction to set a maximum ratio of total liabilities to capital and to vary it over time. It was noted that, for banks and building societies, it would be natural to use the internationally agreed definition of leverage that had been set out in the Basel III standards.

19 A leverage ratio limit would constrain financial institutions' ability to increase the overall size of their exposures relative to their capacity to absorb losses. Two key strengths of the leverage ratio were its simplicity and transparency. Committee members felt that there was widespread understanding of the risks posed by excessive balance sheet expansion relative to loss absorbing capital and, consequently, that FPC decisions to set a leverage ratio limit would be easy to communicate and justify. Committee members also emphasised the fact that a leverage ratio did not depend on an assessment of the relative riskiness of assets. They expressed concern about evidence of a lack of consistency across banks' internal assessments of the riskiness of various categories of exposures. Control over a leverage ratio could be an effective way of counteracting problems with mis-calibrated risk weights. A few Committee members were concerned, however, that the leverage ratio would represent a crude backstop for the inadequacies in risk weights. In particular, if a leverage limit were used in isolation, some financial institutions might shift the composition of their balance sheets towards riskier assets while maintaining the level of total assets unchanged. A combination of instruments was needed, as was built into the Basel III regime.

20 A few Committee members suggested that it might be sufficient for there to be a simple constant leverage backstop, akin to that envisaged in the new Basel III standard. A number of Committee members emphasised that, by restricting overall balance sheet size, a leverage ratio limit might also have the benefit of mitigating funding risks indirectly. In this respect, the leverage ratio could play a distinct role to risk-weighted capital ratio measures.

Institutions to which these tools could apply

21 The Committee discussed the range of financial institutions that could be affected by a Direction issued by the statutory FPC. The Financial Services Bill stated that the statutory FPC's powers of Direction over tools would mean that the impact could be felt by any entity regulated

by the PRA and FCA, as long as the regulator had the necessary implementation powers. The Committee agreed on the need to ensure that the effectiveness of the tools would not be limited by inadequate coverage. In the recent financial crisis, instability had on some occasions been created by non-banks as well as banks, including through regulatory arbitrage. In addition to banks, the range could include building societies, investment firms (for example, investment banks or securities firms), insurers and a variety of funds and investment vehicles. The tools would most easily be applied to those classes of firms for which a basis within the microprudential framework was already in place. The Committee recognised that the scope of the FPC's instruments would need to be specified in secondary legislation in due course and that the perimeter of regulation should be kept under constant review. Given the need to justify that FPC actions were proportional to, and well targeted on, financial stability risks, it was agreed that in each case that FPC Directions were given to the PRA and FCA they should be specific about the types of institution to which they were to be applied.

Potential powers of Direction

A liquidity instrument

22 A key risk faced by many financial institutions, and banks in particular, derives from the fact that they typically borrow funds on a short-term basis and lend over a longer term. Committee members agreed that it was likely to be desirable, in due course, for the statutory FPC to have powers of Direction over a liquidity instrument that would tackle the build up of such vulnerabilities.

23 All Committee members recognised that an important consideration in this area was that there was currently no commonly accepted regulatory liquidity standard; international microprudential liquidity standards were still being designed. As a result, it was hard for the Committee to judge what form any such instrument should take. Overall, the Committee was minded to advise HM Treasury that the statutory FPC should, in due course, have powers of Direction over a time-varying liquidity tool; it agreed, therefore, to return to discuss the specification of such a liquidity instrument once the international microprudential standards had evolved.

Margin requirements

24 The ability to vary the terms of collateralised transactions entered into by financial institutions was also identified as a potentially important macroprudential policy tool. In some cases, this would entail the setting of minimum margin requirements which would determine the required excess of collateral value over funding provided or exposure incurred. In particular, this type of tool could be aimed at wider market vulnerabilities and therefore might be useful in targeting risks building outside of regulated institutions. Some members thought this was potentially a very important type of instrument. It would, for example, help constrain the evolution of leverage in shadow banks and in what could be obscure chains of financial transactions.

25 The Committee noted that for this instrument in particular there would need to be a high degree of international co-ordination for it to be effective because unilateral restrictions by the UK authorities could be circumvented. Since this was also an area in which international standards were still under development, the Committee agreed to return to this tool once these negotiations had progressed further.

Disclosure requirements

26 The Committee discussed whether to recommend that the statutory FPC should have powers of Direction over disclosure requirements. Committee members agreed that, in principle, powers to require financial institutions to publish consistent information in a timely manner about their activities could be a powerful tool in fostering awareness of risks in the financial system and allowing market participants to take appropriate mitigating actions, thus enhancing market discipline. It was noted that disclosure issues had accounted for a significant part of the Committee's deliberations over the past year and that the Committee was engaged through several channels in promoting transparency to enhance financial stability. Some Committee members considered that the number of occasions where requiring firms to disclose some aspect of their balance sheet immediately would increase financial system resilience was likely to be relatively small. These members thought it might be sufficient for the statutory FPC simply to make Recommendations about disclosure requirements; increased disclosure resulting from such Recommendations would most likely be applied on a permanent basis. Other Committee members, however, thought that there could be some circumstances where relying on

Recommendations would not be sufficient, and that a Direction would be needed to ensure timely actions. Such an approach was consistent with aiming to enhance market discipline.

27 An important consideration for all Committee members was that a general power to set disclosure requirements may not meet the test set by HM Treasury that powers of Direction should be specific. Overall, the Committee agreed that, at some point in the future, it might need to be able to compel specific disclosure to mitigate systemic risk. Committee members agreed, therefore, to ask HM Treasury to consider whether it would be prepared in this particular area to ask Parliament to grant the FPC a broad power of Direction over disclosure, within any appropriate constraints, without knowing what specific future disclosure the FPC would judge necessary to tackle systemic risks.

Loan-to-value and loan-to income ratios

28 A number of Committee members were attracted to the possibility of the FPC having a power of Direction over loan-to-value and loan-to-income ratios on real estate lending to households and businesses. Some other countries already used such tools and they appeared to have been effective in limiting financial instability. Such tools had the advantage that they could be applied to all regulated UK mortgages, irrespective of whether they were provided by an institution that was prudentially regulated in the United Kingdom, using the FCA's conduct of business powers. These tools would naturally apply to new lending flows, perhaps making them particularly useful at certain points in the cycle. They also had the advantage of sending a clear and strong public signal of emerging risks to lenders and borrowers.

29 While recognising the possible effect of such instruments, other Committee members noted that they could directly affect how much specific individuals and businesses were able to borrow, regardless of all their circumstances judged relevant by the lender. Recognising this sensitivity, Committee members agreed that more public discussion and understanding would be required for the FPC to have such a power. Some members felt that it might be particularly difficult in this area for the statutory FPC to determine confidently sustainable levels of property prices and, therefore, to calibrate the circumstances under which loan-to-value and loan-to-income ratios should be varied. Committee members noted that other tools, such as the ability to vary sectoral capital requirements, and particularly those relating to residential mortgages by loan-to-value or

loan-to-income ratios, should be able to deliver some of the same financial stability benefits, without such hard quantitative constraints on borrowers' access to credit.

30 A few Committee members felt that the FPC's objective of ensuring the resilience of the UK financial system would be advanced if an appropriately calibrated fixed ceiling were to be recommended for loan-to-value and/or loan-to-income ratios. In this scenario, the statutory FPC would not vary these ratios through the credit cycle.

31 Overall, the Committee decided that it would not advise that the statutory FPC be given powers of Direction over such tools at this time; Committee members felt, however, that these tools may be appropriate after further analysis, reflection and public debate.

Other instruments

32 The Committee also considered the other instruments discussed at its September meeting—time-varying provisioning practices, restrictions on distributions, the mandated use of central counterparties and the design and use of trading venues—as well as those identified in feedback on the December 2011 Bank and FSA staff Discussion Paper. A number of these tools would be important measures for the FPC to consider but deployment via powers of Recommendation was thought likely to be more appropriate.

33 The Committee also discussed possible gaps in the scope of instruments over which it had advised that the statutory FPC should be given powers of Direction. Systemic risks could develop outside of regulated entities. Within the UK, the FPC had a responsibility to monitor the perimeter of regulation and make recommendations to HM Treasury on changes that might be necessary to safeguard systemic stability. Where risks might be growing outside the scope of domestic regulation, including via UK branches of European banks and direct cross-border lending to UK households and businesses, the Committee noted that these might be taken to the European Systemic Risk Board and via it, if necessary, to the European Supervisory Authorities. Other risks might be more appropriately raised with global regulatory bodies such as the Financial Stability Board. The Committee also recognised the importance of taking into account the potential effects of its policy decisions on other countries. This was another area where international co-ordination would be helpful.

Conjuncture and previous FPC recommendations

34 The Committee then turned to discuss the economic and financial developments since its November 2011 meeting and the progress made in implementing its previous recommendations.

35 Committee members agreed that the near-term outlook for financial stability had improved. The European Central Bank's (ECB) longer-term refinancing operations (LTRO) had contributed to better funding conditions for European banks. That had had positive spillovers for UK banks: CDS premia for the five largest UK banks had fallen from around 240 basis points to 190 basis points on average and their equity prices had risen by around 35% on average since the first LTRO in late December. UK banks' term debt issuance had also been strong since the start of the year, including issuance in unsecured markets that had previously been closed to some banks.

36 The Committee agreed, however, that conditions remained fragile. While the ECB's operations had alleviated some of the immediate tensions, questions remained about the indebtedness and competitiveness of some European countries. Committee members agreed that banks with large exposures to those countries where risks of persistent low economic growth and potential credit defaults remained high should be particularly alert to the need to build capital.

37 Against that backdrop, the Committee discussed progress made in response to the recommendations it had agreed at its November 2011 meeting.

Building capital levels

38 The Committee had recommended in November that, given the exceptionally threatening environment, if earnings were insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months. Following this recommendation, the FSA had discussed with the largest UK banks how they might build capital in the short term.

39 Overall, some progress had been made by the banks in meeting the Committee's recommendation. Specifically, the Committee welcomed the decision by a number of banks to limit the cash element of variable compensation in favour of newly issued, loss-absorbing equity. In 2011, variable remuneration paid in the form of cash had fallen in four of the five major banks

that had reported and by 17% in total. Aggregate nominal capital at the three largest UK banks that did not have a significant element of public ownership had increased by over £1.5 billion in the second half of 2011. But there were significant variations across banks. Aggregate nominal capital levels had fallen for the UK banks that had a major element of public ownership, although that had been affected by restructuring actions which had been agreed with the authorities.

40 While some progress had been made, the Committee remained concerned that capital was not yet at levels that would ensure resilience in the face of the prospective risks. Consequently, Committee members agreed unanimously to maintain the November capital building recommendation. Committee members emphasised the need for banks to continue to restrain cash distributions, including via share buy-backs, but also recognised that the scope to build capital through greater restraint of distributions was limited. Some Committee members emphasised that greater restraint in distributions could, at some point, have counter-productive consequences by affecting banks' ability to issue fresh equity capital. Overall, the Committee advised banks to raise external capital as early as feasible. This would improve financial system resilience but without potentially harmful deleveraging.

Improving balance sheet resilience

41 The Committee had recommended in November that the FSA should encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy. A number of UK banks were taking steps to reduce balance sheet exposures to bolster their resilience while supporting lending, for instance through reducing exposures to specific categories of non-loan assets. The FSA was monitoring banks' lending plans closely to ensure that such actions did not undermine their provision of lending to the wider economy. The Committee welcomed the progress made to date but judged that it was appropriate for these banks to continue to take steps to bolster resilience while maintaining lending. The Committee agreed unanimously to maintain the November recommendation on improving balance sheet resilience, and decided to review progress in this area again at its June meeting.

Disclosing leverage ratios

42 The Committee had recommended in November that the FSA should encourage banks to disclose their leverage ratios, as defined in the Basel III standards, as part of their regular

reporting not later than the beginning of 2013. Discussions between banks and the FSA in this area were ongoing. In particular, some technical issues had been raised about the appropriate definition of capital to be used in the leverage ratio calculation in light of the phase-in arrangements for Basel III. Committee members agreed that banks should at least disclose their leverage ratios calculated using the definition of capital that would take effect once Basel III was implemented fully but that banks would be free to disclose additional measures as well.

Other considerations

43 The Committee noted that work was continuing in response to its ongoing recommendations from its meetings in June and September 2011. It was agreed that progress against these recommendations would be formally reviewed at the Committee's next meeting in June.

44 Committee members also noted that work was continuing to analyse other risks that had been highlighted in the December *FSR*. Concerns were expressed about the possible financial stability risks from rising asset encumbrance levels on banks' balance sheets. One problem in this area was a lack of timely information available to the authorities and market participants about the extent of individual banks' encumbrance levels. Committee members noted that the FSA was conducting a survey in this area to gather additional information, the results of which should be available in time for the next meeting. Reflecting this, the Committee decided to return to this issue at its June 2012 meeting, alongside a range of other issues.

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, CEO of the Financial Services Authority
Adair Turner, Chairman of the Financial Services Authority
Alastair Clark
Michael Cohrs
Paul Fisher
Andrew Haldane
Robert Jenkins
Donald Kohn
Jonathan Taylor 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 also attended in a non-voting capacity.