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Financial Policy Committee statement from its policy meeting, 20 September 2011

The Financial Policy Committee held its second formal meeting on 20 September. Since its previous meeting there had been severe strains in financial markets, which stemmed in large part from continuing concerns about the sustainability of external and internal debt positions of some countries, especially in the euro area. Anxiety about the consequences of these issues for banks had increased materially and, in turn, the perceived vulnerabilities of banks were adding to strains in financial markets.

The Committee recognised that dealing with the problems facing the international financial system as a whole would require long-term reforms to tackle unsustainable debt positions and the cumulative and persistent loss of competitiveness in a number of euro-area countries. But given the scale of current risks, the Committee also discussed the need for shorter-term measures to reduce the risk of a significant disruption to financial stability, and so to the supply of credit to UK 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, which had placed them in a somewhat stronger position to withstand adverse developments whilst maintaining the supply of credit to the economy. The Committee had advised UK banks in June that, if their earnings were strong, they should seek to build capital levels further, given the risks to the economic and financial environment. But events had lowered the likelihood that banks would be able to strengthen their balance sheets in this way over the short term.

The Committee therefore 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. This could include raising long-term funding whenever possible and ensuring that discretionary distributions reflected any reduction in profits.

The Committee also 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. For example, at the present time, some actions taken to raise capital or liquidity ratios could potentially worsen the feedback loop between the financial sector and the wider economy and so should be avoided.

Moreover, the Committee recognised that, in the event that severe risks crystallised, it would be natural for banks' capital and liquidity ratios to be run down to ensure that lending to the non-financial economy was not impaired.

In addition to identifying, and advising on measures to mitigate, risks to the financial system, the Committee's terms of reference – set out in the Government's February 2011 consultation document – required it to carry out preparatory work and analysis in advance of the legislation to put the Committee on a statutory basis coming into effect. This included assessing and advising on potential macroprudential instruments. The Committee devoted part of its meeting in September to an initial discussion of this issue.

The role of the Committee was to identify and take action to mitigate risks that built up within the financial system as a whole. In order to fulfil that role, 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.

The Committee considered a variety of potential tools within each category. Under the first, it considered instruments targeted at capital and liquidity, such as maximum leverage ratios, countercyclical capital and liquidity buffers, variable risk weights and provisioning practices. Under the second category, examples included limits on loan to value ratios and margining requirements. Under the third category, it discussed, among others, disclosure requirements, obligations to conduct financial trading via organised platforms and/or cleared via central counterparties, and adjusting risk weights to reflect the degree of interconnectedness of institutions within the financial system. But there would need to be further debate about which precise tools the Committee would advise HM Treasury to include in the initial set of instruments over which it had directive powers. There was time for such further debate before that advice was due in the first half of 2012.

The Committee recognised that its understanding of how such instruments were likely to work would improve with experience. As such it was minded to recommend a relatively narrow initial set, which could then evolve. Furthermore, 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 expeditious.

Finally, **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**.

Further details of the Committee's discussions will be published in the Record of the Committee's meeting on 3 October, 2011.