# Financial Policy Committee statement from its policy meeting, 16 March 2012

At its meeting on 16 March, the Financial Policy Committee (FPC) discussed 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 (Section A of this statement). These are distinct from its powers of Recommendation that could be used in addition to powers of Direction. Both powers would be important and potentially powerful. The choice between their use would depend on the precise circumstances and the nature of the risk the Committee was seeking to mitigate.

The Committee also considered the outlook for financial stability, including progress in implementing its previous recommendations (Section B of this statement).

## A. Macroprudential policy tools: powers of Direction

Building on its previous discussions about macroprudential tools in September 2011 and in the run-up to its policy meeting, the interim FPC agreed to advise HM Treasury that, in order to meet its proposed objective, the statutory FPC should initially have powers of Direction over the following tools:

- the countercyclical capital buffer;
- sectoral capital requirements; and
- a leverage ratio.

In addition to banks, the range of institutions to which these tools would apply could include building societies, investment firms, insurers and a variety of funds and investment vehicles. The Committee also agreed that it was minded to advise HM Treasury that the statutory FPC should have powers of Direction over a time-varying liquidity tool, but it could not sensibly specify the form that this tool should take until the international microprudential standards in this area had been agreed.

The Committee agreed that it might be useful for the statutory FPC to have powers of Direction in respect of the terms of collateralised transactions by financial institutions. But it concluded that this tool should be reconsidered once international discussions had progressed further.

In addition, the Committee agreed that powers of Direction over disclosure requirements would be desirable but that it could be difficult to meet the test set by HM Treasury in its February 2011 Consultation Document that powers of Direction should be specific.

Finally, the Committee noted that while powers of Direction over loan to value (LTV) and loan to income (LTI) restrictions could be beneficial for financial stability, use of these tools would require a high level of public acceptability. Other tools, such as the ability to vary sectoral capital requirements, might be able to achieve at least some of the same financial stability benefits. The Committee agreed that it should not advise that the FPC be given powers of Direction over such tools at this time, but it encouraged further debate of that possibility and these tools may be appropriate after further analysis and reflection.

For other instruments, Recommendation powers were deemed sufficient at present.

Under the Financial Services Bill, the FPC will be charged with taking actions to remove or reduce risks which could threaten the resilience of the UK financial system. Its ability to meet its objective will hinge on the powers granted to it by Parliament.

Two categories of powers are envisaged for the statutory FPC to enable it to meet its objective. First, the FPC will have the power of Direction to ensure implementation of macroprudential measures by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Second, the FPC will have a power to issue Recommendations. In principle, these could be made to a wide range of parties. In the case where Recommendations were made to the PRA or FCA, the FPC would have the option to require them to comply or publicly explain their non-compliance. 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. Powers of Direction and Recommendation would both be important and potentially powerful. In making a choice between their use, 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 flexibility in implementation.

In its February 2011 Consultation Document and June 2011 White Paper, HM Treasury said that the interim FPC should provide advice on which macroprudential tools the statutory FPC would need powers of Direction over in order to meet its proposed objective. HM Treasury had requested that the Committee give this advice in the first half of 2012.

The Committee had held an initial discussion about this topic at its meeting in September 2011. A Bank and Financial Services Authority (FSA) staff Discussion Paper, *Instruments of macroprudential policy*, had subsequently been published in December 2011. A number of responses had been received, which were taken into consideration by the Committee. The Committee then devoted a significant part of its discussions in March, in particular at its policy meeting, to finalising its advice.

## Overarching considerations

The Committee's discussions focused exclusively on powers of Direction. Before considering individual tools, the Committee agreed a number of overarching considerations that would affect its advice.

The Committee identified several characteristics of powers of Direction and Recommendation that had a bearing on its advice. First, HM Treasury had stated that tools over which the statutory FPC would have 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 could be defined with reference to existing microprudential standards. Second, having been granted any powers of Direction over specific tools, the statutory FPC would have to publish a statement on how it would expect to use them and would then be held regularly accountable for their use. 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.

These characteristics implied that powers of Direction were more likely to be suited to targeting systemic risks that varied over time. The Committee noted the importance of being able to tackle other risks, notably those stemming from structural features of financial markets or the distribution of risk within the financial sector. The Committee thought that these types of risks would be a major focus of its work, but judged that they could, in the first instance, be mitigated most effectively and proportionately through its powers of Recommendation.

The Committee agreed that these considerations also pointed towards the statutory FPC initially having powers of Direction over a narrow set of tools. But given that systemic risks, and the FPC's understanding of them, would evolve over time, it was 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.

The Committee noted that implementation of the FPC's macroprudential powers — both via Direction and Recommendation — might be constrained by EU law. The Committee decided that in giving its advice to HM Treasury it would set aside any potential future constraints not least because of significant uncertainties around current negotiations. The Committee welcomed HM Treasury's continuing efforts to ensure that developments in EU legislation did not create an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom.

## Suggested powers of Direction

### Countercyclical capital buffer

The Committee agreed that it should advise HM Treasury that the statutory FPC should take decisions about the appropriate setting of the countercyclical capital buffer in the United Kingdom.

Consistent with the new Basel III standard, national regulators may adjust banks' required capital ratios through a time-varying capital buffer in certain circumstances. Requiring this 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 the previous increase, could help to mitigate an excessive contraction in lending supply during a downturn of the credit cycle.

The Committee noted that the countercyclical capital buffer provided a simple, aggregate tool which would be readily applicable in an international context. Any decision made by the FPC to change the buffer in the United Kingdom was likely to be reciprocated for foreign banks active in the United Kingdom by their home regulator, at least up to the levels agreed in the Basel III standards. That would enhance the ability of the FPC to stem over-exuberance in UK credit growth in some circumstances and support credit growth in others.

The Committee also noted that there might be circumstances when it would be necessary for the 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 assets.

### Sectoral capital requirements

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

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 are required to hold against certain types of exposure relative to the microprudential requirement. For example, the Committee 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. The targeted nature of this approach might also be easier to communicate and explain to the public in such circumstances.

The Committee agreed that it 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. The Committee agreed that it would 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.

### Leverage ratio

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.

A leverage ratio limit would constrain financial institutions' ability to increase the overall size of their exposures relative to their capacity to absorb losses. Key strengths of the leverage ratio were its simplicity, transparency and the fact that it does not depend on an assessment of the relative riskiness of assets. Importantly, by restricting overall balance sheet size, a leverage ratio might mitigate funding risks indirectly.

## Institutions to which these tools could apply

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 could be applied to any entity regulated by the PRA and FCA, as long as the regulator had the necessary powers to implement them. 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, insurers and a variety of funds and investment vehicles. The tools would most easily be applied to those classes of firms for which an existing basis within the microprudential framework was already in place. The Committee recognised that the precise scope of the FPC's instruments would need to be specified in secondary legislation in due course, and that the perimeter of regulation would need to be kept under constant review.

## Potential powers of Direction

### Liquidity

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. By making them vulnerable to runs and other stresses in funding markets, this had been a key source of financial instability in the past. Committee members agreed that it was likely to be desirable in due course to have powers of Direction over an instrument that would tackle the build-up of such vulnerabilities. But the Committee noted that international microprudential standards in this area were still being designed. As a result, it was hard for the Committee to judge what form any such instrument should take. The Committee agreed to discuss the specification of such an instrument once the international microprudential standards had evolved.

### Margining requirements

The ability to vary the terms of collateralised transactions entered into by financial institutions was 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. While this was an area in which international standards were under development, the timescale for this was currently unclear. And the Committee noted that such an instrument, as indeed with some other instruments, was likely to require a high degree of international co-ordination to be effective, because unilateral restrictions by the UK authorities could be circumvented. The Committee agreed to return to the tool once international discussions had progressed further.

### Disclosure requirements

The Committee discussed whether to recommend that the statutory FPC should have powers of Direction over disclosure requirements. 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. Disclosure issues had accounted for a significant part of the Committee's deliberations over the past year and the Committee was engaged through several channels in promoting transparency to enhance financial stability. But the Committee recognised that a general power to set disclosure requirements may not meet the test set by HM Treasury that powers of Direction should be specific. The Committee agreed that, at some point in the future, it might need to be able to compel specific disclosure to mitigate systemic risk. So a key question was whether HM Treasury might 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 restrictions

The Committee noted that some other countries' experiences of tightening mortgage terms and conditions, for example via loan to value (LTV) or loan to income (LTI) restrictions (or both together), 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.

While recognising the potential power of these instruments, the Committee also noted that the use of these tools would require a high level of public acceptability. Unlike the other instruments proposed, these instruments would directly affect how much individuals and businesses may or may not be able to borrow.

The Committee did not perceive the public debate necessary to achieve acceptability for such instruments to be sufficiently advanced at present and would welcome further debate. It also noted that other tools, such as the ability to vary sectoral capital requirements, and particularly those relating to residential mortgages by LTV or LTI, might be able to deliver at least some of the same financial stability benefits. In the light of these considerations, the Committee agreed that it would not advise that the FPC be given powers of Direction over such tools at this time but these tools may be appropriate after further analysis, reflection and public debate.

### Other instruments over which powers of Direction were considered

The Committee 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 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.

### Potential gaps in the scope of instruments subject to powers of Direction

The Committee also discussed possible gaps in the scope of instruments over which it had advised that the statutory FPC should have powers of Direction. Systemic risks could develop outside of regulated entities. Within the United Kingdom, the FPC had a responsibility to monitor the perimeter of regulation and make recommendations to HM Treasury on changes that may be necessary to safeguard systemic stability. Where risks might be growing beyond the potential 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.

### Conclusion

Systemic risk could arise from a number of sources. In particular, it could stem from excessive balance sheet leverage, and fragile funding positions; excessively loose terms and conditions of lending; and fragilities in market structures. At its September meeting, the Committee had identified that it would need to have powers that would enable it to target each of these different sources of risk. After further discussion in March, the Committee agreed to advise HM Treasury to include in the statutory FPC's initial toolkit: control over the setting of the countercyclical capital buffer in the United Kingdom; sectoral capital requirements; and a leverage ratio. These tools would provide control most directly over the balance sheets of a range of financial institutions. But some of these tools, in particular sectoral capital requirements, had the flexibility to be targeted at a wider range of systemic risks. And where systemic risks arose that could not be tackled directly by these powers of Direction, the Committee had powers of Recommendation at its disposal.

## B. Conjuncture and previous recommendations

At its March meeting, the Committee also discussed economic and financial developments since its November 2011 meeting and progress made in implementing its previous recommendations. Immediate financial market tensions had subsided somewhat but the overall outlook for financial stability remained fragile. Banks had made some progress against the Committee's three recommendations from November 2011. But the Committee remained concerned that capital was not yet at levels that would ensure resilience in the face of prospective risks and noted that the ability to make further progress via greater restraint of cash distributions was limited. It therefore advised banks to raise external capital as early as feasible. The Committee would reconsider progress against all its recommendations at its meeting in June 2012.

### Conjunctural developments

The Committee discussed developments in the macroeconomic and financial environment since its November 2011 meeting. Committee members agreed that the outlook for financial stability had improved in the near term. The European Central Bank's (ECB's) long-term refinancing operations (LTRO) had improved confidence in European banks' funding positions. 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.

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. 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.

## Previous recommendations

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

### Building capital levels

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 best they might build capital in the short term. Some progress had been made by the banks in meeting the Committee's recommendation. In 2011, variable remuneration paid in the form of cash had fallen in four of the five largest UK banks that had reported and by 17% in total at those banks. 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.

Nevertheless, the Committee remained concerned that capital was not yet at levels that would ensure resilience in the face of the prospective risks. It therefore agreed on the need for banks to continue to restrain cash distributions, including via share buybacks. But the scope to build capital through this route was limited. It therefore advised banks to raise external capital as early as feasible.

### Improving balance sheet resilience

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, and 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 and would revisit this recommendation at its meeting in June.

### Disclosing leverage ratios

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 had indicated that progress on the recommendation was on track.

### Other previous recommendations

The Committee noted that work was continuing in response to its ongoing recommendations from June and September. The Committee would formally review progress against these recommendations again at its meeting in June.

Further details of the Committee's discussion will be published in the Record of the Committee's meeting on 28 March 2012.