

The Bank's macroprudential tools

Written evidence to Treasury Committee inquiry

Introduction

1. The Association for Financial Markets in Europe (AFME) welcomes the opportunity to give evidence to the Treasury Committee (the Committee) in connection with their inquiry into the Bank of England (the Bank) macroprudential tools.
2. AFME represents a broad array of European and global participants in the wholesale financial markets. Our 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive and sustainable European financial markets that support economic growth and benefit society. Given that the importance of the UK macroprudential framework - both to help to identify future risks to the EU and to help guide other Member States in the development of similar approaches – and the importance of the UK framework dovetailing with Europe, we believe it is important that AFME continue to engage in the ongoing debate.

Executive Summary

3. Before focussing on the Financial Policy Committee's (FPC's) macroprudential tools, it is important to consider the wider domestic and international frameworks in which they will be developed and used; in particular:
 - The effectiveness of the FPC's powers of direction and recommendation and the underlying macroprudential tools can be limited by inadequate coverage. The interim FPC appreciates that significant systemic risks can be posed by non-banks and that the perimeter of regulation therefore needs to be kept under constant review to ensure that tools can be applied to the relevant risk posing entities. However, AFME believes that it is also important to consider and take into account that, notwithstanding changes to the regulatory perimeter, some types of macroprudential tool may not be effective with or applicable to some types of firm. For example, regulatory capital or liquidity requirements do not apply to some sizeable types of consumer lending operation and so varying capital or liquidity buffer requirements would have no impact.

- Whilst there is a clear case for individual countries to have a macroprudential authority with the capacity and flexibility to vary capital, liquidity and perhaps margining requirements to underpin the resilience of the financial system, nevertheless, given the close integration of global capital markets, the high risks of spillovers and regulatory arbitrage, it is important to consider the international and global aspects of macroprudential policymaking. There are also clear risks to economic growth of the unilateral application of capital or other requirements to UK firms only. Effective coordination mechanisms and/or instrument design features will therefore be needed in those instances in which specific macroprudential tools are used in response to sources of vulnerabilities that impact across national jurisdictions and to mitigate the risk of level playing field issues arising.
 - Although the interim FPC acknowledges the importance of international coordination it is not clear how the FPC might interact with the European Systemic Risk Board (ESRB) or the European Supervisory Authorities (ESA's), or wider international fora including the Financial Stability Board (FSB). Particularly given the FPC's limited scope in relation to branches of incoming EEA firms and cross-border business, we believe that the Financial Services Bill should set out the FPC's responsibilities to and gateways with the ESRB.
 - We also continue to believe that the FPC's objectives should be aligned, in so far as is appropriate, with the ESRB, and we welcome the Chancellor's recent announcement of the change to the Financial Services Bill to ensure the FPC has an objective to consider the wider economic context.
 - Resolvability and linkages to the evolving crisis management framework should also be a key area of focus, as ensuring failure can occur without contagion should contribute significantly to ensuring financial stability.
4. AFME is conscious that practical experience with the formulation and use of macroprudential policy and tools is relatively limited, and we are broadly supportive in principle of the macroprudential tools the interim FPC has requested the FPC be granted powers of direction over, although with important caveats and concerns in some areas. We have also noted additional tools which might over time be provided to the FPC, including LTV and LTI tools and the ability for regulators to define stress tests and test parameters in relation to firms' Internal Capital Adequacy Assessment and Individual Liquidity Adequacy Assessment frameworks. It will be important, more widely, to ensure that the macroprudential tools selected provide sufficient flexibility either on an individual basis or in combination to enable supervisors to target and mitigate sources of systemic risk without causing significant unintended consequences to other businesses and the wider economy.
5. AFME considers also that supplementary buffers, capital requirements or other resources built-up or retained during an upswing should be released sufficiently in advance of a downturn to

reduce impediments to the flow of credit to the economy and to ameliorate pressures on the real economy and economic growth. We do, however, note that to date all of the tools proposed relate to the ability to vary regulatory capital requirements and we would caution against an undue focus on capital only, and we set out concerns as to the extent to which the release of prudential resources might be possible in practice. In particular, it is possible that markets may view firms that did release their buffers in a less positive light.

Whether the interim FPC has requested the most appropriate tools over which the FPC should be given the power of direction?

6. AFME is supportive of the interim FPC's overarching considerations in relation to the selection of its tools and view the tools requested as having the potential to provide ways of seeking to address macroprudential risks, albeit with some important caveats surrounding their use. Given the relative inexperience with the use of macroprudential policy and tools, AFME agrees with the FPC's approach in the near term to confine the range of tools to a fairly narrow range and we consider that over time a wider range of tools might be developed as experience and understanding in the use and effects of tools increases.
7. AFME agrees with HM Treasury also that the tools over which the FPC would have powers of Direction should be specific, rather than broad or open ended. However, innovation and change in the financial system together with lessons learned on the design and implementation of macroprudential tools point to the fact that it will be important to ensure that there is sufficient flexibility to allow this set of tools to be augmented or adapted quickly when the need arises.
8. AFME considers that the countercyclical capital buffer could indeed provide a simple, aggregate tool and that the Basel III framework envisages reciprocity agreements to deal with concerns of cross-border leakage. However, we note that the additional costs the buffer imposes may encourage banks to seek higher profits to compensate for the higher costs of capital and therefore increase exposure to higher risk areas at the expense, potentially, of sectors of more direct relevance to the real economy and economic growth.
9. AFME notes the possible use of sectoral capital requirements in conjunction with or as an alternative to the use of countercyclical buffers. AFME agrees that the use of sectoral capital requirements could enable macroprudential supervisors to better target sources of systemic risk by allowing them to target a particular class or type of asset. It is, however, not clear how the concept of sectoral requirements or variable risk weights could be applied consistently to firms using different approaches and models for the calculation of their Pillar 1 capital requirements. In addition, there is a risk also that attempting to channel credit through adjusting risk weights could be perceived as applying a form of 'industrial policy' without adequate Parliamentary oversight. . Moreover, it is not clear how effective attempts to vary the flow of credit to different sectors of the economy are likely to be, especially in extreme economic periods and if banks from other jurisdictions were not working to the same constraints.

10. AFME agrees that leverage ratio can be used as a backstop to risk weighted requirements, particularly where excessively optimistic risk measures tend to reduce risk weighted assets and associated capital requirements. However, we are also of the view that the leverage ratio should remain a Pillar 2 measure and should not be transitioned to Pillar 1. This is because the leverage ratio presents a greater constraint to some types of firm, e.g. a universal bank is more heavily impacted than a broker dealer, it has a disproportionate impact on some types of business, e.g. trade finance, and it may give rise to counter-intuitive risk management incentives as in general the effects of hedging transactions are not recognised, and indeed count towards the leverage limit.
11. More widely, we note that all of the proposed powers of direction relate to the ability to vary regulatory capital requirements and we would caution against an undue focus on capital only.

Whether additional tools should be given to the FPC (these may include tools rejected by the FPC, not considered by the FPC or that use the balance sheet of the Bank of England).

12. In terms of LTV and LTI restrictions, the interim FPC stated some of the attractive features of these tools, including the advantage that they send a clear and strong public signal of emerging risks to lenders and borrowers. AFME would add also that these measures have the advantages also of being targeted and straight-forward to implement and adjust in line with developments in the market and that they are likely to limit lending more directly or quickly than changes in capital or liquidity requirements which work through the price of lending. On a less positive note these instruments might unduly restrict lending to some credit-worthy borrowers and could be avoided by borrowers increasing borrowing for the purchase of property through personal loans and/or other types of borrowing.
13. We note that, given the socio-economic effects, the interim FPC considered that the use of these tools would require a high level of public acceptability; the interim FPC, therefore, agreed that it should not advise HM Treasury that it be given powers of direction over such tools at this time but that these tools might be appropriate after further analysis, reflection and public debate. AFME and its members disagree, however, and consider that the FPC must be able to send strong signals to the economy as a whole about bubble concerns directly rather than only through instigating changes to firms' balance sheets. We agree also with the IMF which has stated that 'additional powers should include the ability to limit LTV and LTI ratios, as higher capital requirements alone may be insufficient to restrain property bubbles. This will be especially true if most banks are comfortably above minimum capital requirements during the boom, such that higher risk weights on property loans may have little effect on banks' lending behaviour. In addition, we would note that LTV and LTI restrictions can be removed or relaxed by regulatory authorities without influencing the markets' perception of individual firms.

14. A further and important tool which does not appear to have been considered by the Committee is the use of stress testing to inform variable capital and liquidity requirements. In particular, regulators could instruct firms in relation to the stress tests and test parameters that need to be modeled in firms' Internal Capital Adequacy Assessment Process ('ICAAP') and Individual Liquidity Adequacy Assessments ('ILAAs'), and these tests would in turn impact the scale and composition of the liquid assets buffer and capital requirements (denominator and numerator) as part of the Pillar 2 framework rather than through trying to apply more 'rigid' or 'one size fits all' approaches under Pillar 1 calculations.
15. AFME agrees that it would be desirable for the FPC in due course to consider powers of direction over time varying liquidity tools. However, it will be important first for regulators to ensure that there are sufficiently clear and effective international arrangements in place for the microprudential supervision of liquidity before this can take place.
16. AFME, in addition, considers that margining requirements can target the provision of liquidity from the shadow banking sector but that these are difficult to implement and are sometimes easy to circumvent. Any tools in this area would need to take into account international developments to ensure consistency and that approaches to dealing with potential inconsistencies and difficulties are reflected. There may also be concerns that regulatory authorities may seek to directly alter the commercial terms of individual transactions.
17. Tools that use the balance sheet of the Bank of England, such as for example reserve requirements, have the advantages that they are straight forward to implement and can be varied to reduce overall levels of lending. They tend, however, to be unsophisticated and do not target particular categories of lending and so could be damaging to certain economic sectors. They may in addition cause banks to seek higher returns to compensate for increased costs of funding and therefore expand higher risk businesses. The FPC might also seek to consider tools that influence market structures which are primarily geared towards dealing with cross-sectoral risks.
18. It is, moreover, equally important to consider that in addition to the use of macroprudential tools, the ability to allow firms to fail without leading to contagion to other financial institutions is a very significant mitigant to systemic risk, and there may be a role for the FPC in identifying instruments which contribute to bank resolvability or enable international resolvability measures to function more effectively.

The extent to which the FPC's powers of recommendation are appropriate, and how they will work with the powers of direction.

19. The FPC's powers of recommendations are widely drawn; in particular, the FPC may give recommendations to "persons other than" the Bank, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Whilst we recognise the rationale for this widely drawn power, we are unsure of the power that an FPC recommendation would have if given to a

body such as the Financial Reporting Council and believe that there should be some check to seek to ensure that recommendations focus on the FPC's areas of competence. We also believe that any recommendations to classes of authorised persons should be made through the appropriate microprudential regulator and not directly.

20. In practice, we believe that the FPC is likely to use its powers of recommendation more frequently than its powers of direction - which we see as an *in extremis* measure. We believe that such an approach would recognise both the 'sovereignty' and the competence of the microprudential regulators, with powers of direction being used in emergency situations or where the PRA and the FCA have not resolved material concerns that were the subject of previous FPC recommendations.

What structures should be created to provide the necessary transparency and accountability structures for the use of the tools;

21. The ongoing debate with respect to the governance arrangements for the enlarged Bank - which we will not enter into in this response - is critical to ensuring the new tools are subject to proper transparency and accountability. In particular, though, we concur with the Committee that, to avoid the risk of 'groupthink' within the FPC, and to ensure there is an appropriate range of expertise available, there should be a majority of external members.

22. In our view, transparency and the clear communication of policy decisions are central elements of accountability. We therefore welcome the requirement that the FPC publish ex ante statements of the general policy it proposes to follow in relation to the exercise of its power of direction in so far as it relates to a particular tool (although, as discussed later, there may also be a case for the FPC to publish guidelines on the use of its power of recommendation) and records of FPC meetings and meetings between the Governor and the Chancellor.

23. We believe, however, that, in addition:

- there should be a rigorous public consultation process built into the development and use of FPC tools. Consultations should be required on, for example, on the design of the tools in secondary legislation (e.g. an HM Treasury consultation based on Bank of England proposals) and the FPC's general policies in relation to the use of tools, and where possible on exit strategies from the use of particular tools, both when they are deemed to have served the purpose intended or when they might be considered obsolete owing to changes in the market or the development of more appropriate regulatory tools and frameworks.
- HM Treasury should be required (except in extremis) to lay a copy of all directions before Parliament (rather than laying a direction "if they think fit") to enable proper Parliamentary scrutiny (particularly by the Committee).
- FPC recommendations in relation to the use of specific macro-prudential tools should be subject to the same scrutiny process as directions.

- The FPC should be required give Treasury – and Treasury should be required to lay before Parliament - an ex post assessment of the impact/effects of each direction given by the FPC (or recommendation in relation to the use of a specific macroprudential tool). That said, given the timings differences between the implementation of macroprudential policy and the accrual of difficult to measure and intangible benefits, it is important that the FPC should be sufficiently insulated from pressures linked to the political cycle.

24. More specifically, AFME agrees with the points raised in the Committee's report to the House of Lords on the Bill in relation to the need for the development of indicators of financial stability which should be published and against which the FPC should report.

Whether the FPC should provide guidance on the use of the tools, and if so, what from that guidance should take.

25. AFME supports the requirement that the FPC prepare and maintain a written statement of the general policy that it proposes to follow in relation to the exercise of its power of direction so far as it relates to a particular tool. There may also be a case for the FPC to prepare and publish guidelines on the circumstances under which it is likely to use its power of recommendation in relation to specific macroprudential tools.

26. To the extent necessary, guidance on the use of particular tools in specific circumstances could prove useful in enabling the regulatory authorities to identify and target particular types of categories of risk. The form of guidance would depend on the nature and extent of the systemic risks that needed to be addressed and on the complexity and inter-relationships of the products, firms and markets on a case by case basis. Such guidance could form part of the FPC's policy statement and/or, given that the PRA and FCA may be given discretion as to how to comply with an FPC direction, be published separately by the PRA and FCA.

Whether the tools requested, taken as a whole, should be symmetrical, that is, the extent to which they should ameliorate downturns as well as upswings in credit cycles.

27. Supplementary buffers, capital requirements or other resources built up or retained during an upswing should be released sufficiently in advance of a downturn, to reduce impediments to the flow of credit to the economy and to ameliorate the downward pressures on the real economy and economic growth. If regulatory requirements were responsive to changes in economic factors, it would ensure that the right balance is struck between ensuring a stable financial system and enabling banks to support economic growth. Nevertheless, practical concerns remain as to the extent to which firms would actually be able to reduce buffers or other requirements during a downturn. By way of illustration, markets are by their very nature procyclical, and even if the FPC and regulatory authorities relaxed macroprudential requirements

in a down-turn, it is possible that markets may view firms that did reduce their buffers in a less positive light.

What further analysis should be provided by the Bank of England before the macroprudential tools are granted to the FPC, and what analysis should be periodically produced by the Bank of England once any tools have been introduced.

28. There are significant and often complex inter-linkages between several areas of the prudential framework, for example regulations on capital, leverage, liquidity and large exposures, and it will be important for the FPC/Bank to understand and to be able to model the interplay and effects of changes in these areas to avoid unintended consequences and market distortions.
29. Once the tools have been introduced, we believe the Bank should provide detailed on-going and ex post analyses of the actual effects of tools, both to update their internal models and to improve the FPC's and Parliament's understanding of any socio-economic impacts. It is also important that the FPC maintains an ongoing dialogue with the ESRB and other international and domestic bodies with a macroprudential remit to share data and emerging best practices.
30. In particular, given the importance of international coordination, including the potential economic impact of the unilateral use of tools in the UK only, we believe that that the FPC should be required to report on the extent of international reciprocity and the extent to which any other mechanisms to ensure global consistency have been effective.

The Association for Financial Markets in Europe

28th June 2012