Macroprudential policy at the Bank of England

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- A vital element of recent reforms to the UK architecture of financial regulation is the creation of a macroprudential authority at the Bank of England — the Financial Policy Committee (FPC).
- This article explains the role and powers of the FPC. It also describes some of the processes supporting the Committee.

Overview

The FPC's primary role is to identify, monitor, and take action to remove or reduce risks that threaten the resilience of the UK financial system as a whole. It comprises five Executives of the Bank of England, the Chief Executive of the Financial Conduct Authority, four external members and a non-voting HM Treasury member.

The FPC can issue Directions and Recommendations to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), and can make Recommendations to other bodies. For banks, the FPC has been given a power of Direction over sectoral capital requirements (SCRs) and will also be given a power to set the countercyclical capital buffer (CCB) under new EU legislation.

The FPC meets quarterly to a published schedule. Each quarterly round comprises a briefing on financial system developments; focused discussions of key threats to stability and potential macroprudential policy interventions; and a formal meeting to agree on policy decisions, for example to make Directions and/or Recommendations.

Accountability is a key element of the new arrangements. The FPC must explain the decisions it has taken, publish a Record of its formal meetings and, twice a year, publish a *Financial Stability Report* (*FSR*). FPC members also appear regularly at Treasury Committee hearings.

A typical FPC quarterly cycle

Briefing
- Analysis and research from Bank economists about risks to financial stability
- Market intelligence from the Bank's network of financial market contacts
- Supervisory intelligence and analysis from the PRA and FCA
- Assessment of the impact of existing FPC policies

FPC issues meetings
- FPC assesses and discusses the major risks to UK financial stability
- Discussion of potential macroprudential policy actions that might be required

FPC policy meeting
- FPC discusses and decides any macroprudential policy measures
- FPC reviews the setting of Direction instruments (CCB and SCR)
- FPC reviews the status of existing policies

Communication
- Policy set out in FPC statement/*FSR* and communicated to addressees of Recommendations and/or Directions
- Details of FPC deliberations set out in the FPC Record
- *FSR* sets out assessment of, and outlook for, the financial system
- Analysis promulgated including via the Bank's Agents and market contacts

(1) The authors would like to thank Victoria Kinahan and Michael Snapes for their help in producing this article. Aashish Pattani left the Bank in June 2013.

The crisis has underlined the importance of financial stability as a precondition for monetary stability and broader economic health and prosperity. Policymakers around the world recognised that focusing separately on price stability and on microprudential regulation of individual firms and markets was not enough. A broader approach — macroprudential policy — was needed to ensure the resilience and stability of the financial system.

In the United Kingdom, the Financial Policy Committee (FPC) was created to fill that gap. Its work is important globally, as well as domestically, given London's role as an international financial centre. That was recognised by the International Monetary Fund (IMF) in deciding to include the United Kingdom as one of five globally systemic economies covered in the IMF's 'spillover reports' on cross-country economic and financial linkages.(1)

Other countries are also introducing macroprudential regimes in the wake of the crisis. For example, in the United States the Financial Stability Oversight Council is responsible for identifying risks and responding to emerging threats to financial stability, with the Federal Reserve Board responsible for establishing enhanced prudential standards for systemically important firms. The European Systemic Risk Board (ESRB) contributes to the prevention or mitigation of systemic risks to financial stability in the European Union (EU). Within the EU, countries, including France and Germany, are also creating macroprudential authorities, partly in response to recommendations from the ESRB.(2)

An article in the 2013 Q1 *Quarterly Bulletin* summarised the main changes to the Bank of England as a result of recent reforms to the United Kingdom's system of financial regulation, including the creation of the new Prudential Regulation Authority (PRA) and the FPC. This article provides more detail on the specific role and powers of the FPC. It also describes some of the processes supporting the Committee.

Objectives of the FPC

Under the Bank of England Act 1998 ('the Act'), as amended by the Financial Services Act 2012, the Bank has a statutory objective to protect and enhance the stability of the financial system of the United Kingdom. The FPC is tasked with helping the Bank meet that objective and, subject to that, also supporting the Government's economic policy, including its objectives for growth and employment. Before determining or revising the Bank's financial stability strategy, the Bank's Court of Directors must consult the FPC.

HM Treasury is required to give the FPC written notice each year of the Government's economic policy and must make recommendations about the Committee's responsibility in relation to the financial stability objective. The Treasury may also make recommendations to the Committee, including regarding the Committee's responsibility in relation to support for the Government's economic policy and matters that the Committee should have regard to in exercising its functions. The Treasury sent the FPC a first remit and recommendations letter on 30 April 2013, to which the FPC responded in June 2013.(3)

The FPC has a statutory responsibility to identify, monitor, and take action to remove or reduce risks that threaten the resilience of the UK financial system as a whole. This is supported by the objectives of the microprudential regulators. The PRA is part of the Bank. It is responsible for the microprudential regulation of individual deposit-takers, insurers and major investment firms.(4) The Financial Conduct Authority (FCA) is a separate institution responsible for ensuring that relevant markets function well, for conduct regulation and for microprudential regulation of financial services firms not supervised by the PRA, such as asset managers, hedge funds, many smaller broker-dealers and independent financial advisers.(5)

Examples of systemic risks highlighted by the legislation include:

- risks relating to structural features of financial markets, such as connections between financial institutions;
- risks relating to the distribution of risk within the financial sector; and
- unsustainable levels of leverage, debt or credit growth.

Risks from linkages within the financial system

Linkages among financial institutions — including via common membership of payment, settlement and clearing systems — can, if infrastructure is strong, bolster system resilience, by allowing risks to be shared and managed. But if key firms or funds within the system are fragile, heightened interconnectedness can also make the system more vulnerable to shocks spreading from one institution to another.

Connections between markets and financial institutions increased and became more complex internationally ahead of the crisis, partly as a result of growth in cross-border investment in asset-backed securities and related products and greater sourcing by banks of funding from overseas.(6) When

(1) 'The size and interconnectedness of the UK financial sector make it a powerful originator, transmitter, and potential dampener of global shocks. The United Kingdom agglomerates core international financial functions making it a key node in 'funding' liquidity and balance sheet hedging, providing buoyancy to global markets and acting as a key channel transmitting shocks or stabilizing measures', see International Monetary Fund (2011).
(2) See European Systemic Risk Board (2011).
(3) See 'Remit and recommendations for the Financial Policy Committee — April 2013', available at www.bankofengland.co.uk/financialstability/Pages/fpc/remit.aspx.
(4) See Bailey, Breeden and Stevens (2012).
(5) See Murphy and Senior (2013).
(6) Parkinson and Speight (2003) describe the increased reliance of UK banks on overseas wholesale funding. Recent developments in cross-border credit are discussed by Hills and Hoggarth (2013).

the crisis broke inadequate disclosure meant there was widespread uncertainty about those institutions across the globe that were exposed — directly or indirectly — to sub-prime assets, such as loans extended to borrowers that are more likely to have difficulties meeting repayments. Given the poor capitalisation of many banks and shadow banks this, in turn, led to a breakdown in the functioning of interbank markets as financial institutions began to lose confidence in the resilience of their counterparties.

Risks relating to the distribution of risk

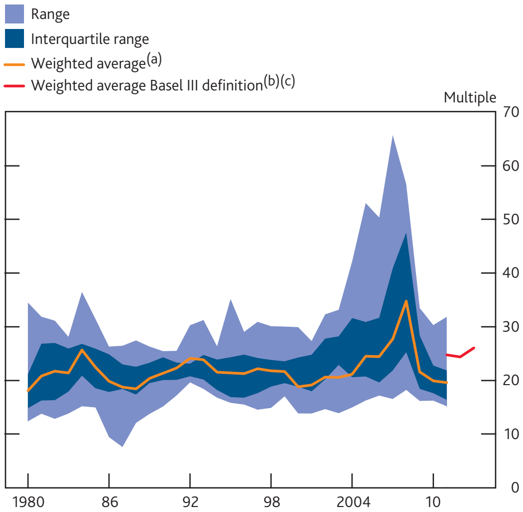
A second dimension of risk to systemic resilience is the distribution of risk within the financial system. Risk may be concentrated in specific parts of the system, for example in large financial institutions with a significant footprint in financial markets, or at critical infrastructure providers, such as central counterparties.(1) As a result, the resilience of the system as a whole depends on the strength of these entities.

Cyclical systemic risks

A third dimension to systemic risk relates to the cyclical build-up of debt or leverage. After an extended period of stability, financial firms, households and companies may take decisions to lend or borrow that make sense while economic conditions remain benign but, collectively, entail fragility across the system as a whole. A sudden economic slowdown can then lead to unexpected and widespread losses. The scale of losses across the system, and wider economic impact, may be amplified if lenders have insufficient capacity to absorb losses and as a result rein back on new activity.

The crystallisation of systemic risks following a large build-up of debt has been evident in previous financial booms and busts such as those in the United States, Scandinavia and Japan in the 1980s and 1990s. In the United Kingdom in the run-up to the recent crisis, balance sheets of financial institutions expanded rapidly relative to their capital base.(2) This can be seen in the increase in reported leverage of UK banks shown in **Chart 1**, defined as total assets — including, for example, the stock of outstanding loans — to capital, which can absorb losses on those loans.(3) Similar developments were seen in other financial systems. Rising asset prices and a progressive easing in access to finance went hand in hand. But as the crisis unfolded conditions reversed rapidly. For example, in the run-up to the crisis, as house prices rose, UK households were able to obtain mortgages at higher loan to value and loan to income ratios, but then terms tightened sharply as conditions deteriorated. In financial markets, the cost of accessing finance, as indicated by initial margin or haircut requirements — the collateral required to back borrowing — fell ahead of the crisis, but then rose sharply when the crisis hit. This had the effect of amplifying the falls in asset prices and activity in some markets and spreading problems across the financial system.

Chart 1 UK banks' reported leverage multiples



Sources: PRA supervisory data, published accounts and Bank calculations.

(a) The weighted average and ranges shown are based on a simple leverage multiple defined as total assets based on banks' published accounts to shareholders' claims (note a discontinuity due to introduction of IFRS accounting standards in 2005, which tends to increase leverage multiples thereafter). Data exclude Northern Rock/Virgin Money from 2008. The last data point in this series is at end-2011.
(b) The 'Basel III leverage multiple', from end-2011 onwards, is calculated as aggregate leverage ratio exposure, according to the proposed Basel III definition, over aggregate peer group Tier 1 capital. However, Tier 1 capital includes some 'grandfathered' instruments which will no longer be eligible after the full transition to Basel III in 2019. The Basel III sample includes Barclays, Co-operative Bank, HSBC, Lloyds Banking Group, Nationwide, Royal Bank of Scotland, and Santander UK. Last data point is June 2013.
(c) The Basel III leverage multiple series does not include adjustments to capital as discussed by the FPC and PRA earlier this year.

Banks also took on more liquidity risk by financing an ever higher share of their loans — which are typically extended over a long term — with short-term wholesale funding, including via shadow banks. Maturity transformation based on the provision of monetary services is a valuable service to the economy, allowing savers to have ready access to their deposits and borrowers to take out loans for extended periods. But excessive maturity transformation also makes banks and shadow banks prone to the risk of 'runs'. That can mean that they need to sell assets at depressed market prices in order to meet redemptions as they fall due, which can further undermine resilience. 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 more reliant on unstable sources of short-term funding, in particular from wholesale markets.

The combination of highly indebted borrowers, opaque capital markets and dangerously thin capital and liquidity positions across banks and shadow banks left the global financial system highly vulnerable to shocks. By the summer of 2007, an unusual pick up in defaults on mortgages to borrowers with poor credit records in the United States had led to the widespread closing of wholesale markets used by banks and others across the globe to finance residential and commercial

(1) See Nixon and Rehlon (2013).
(2) For a primer on bank capital as a buffer to absorb losses, see Farag, Harland and Nixon (2013) on pages 201–15 of this edition of the *Bulletin*.
(3) The weighted average 'simple leverage multiple' (shown in orange) differs from the 'Basel III multiple' (shown in red) due to the latter using a narrower definition of capital, a Basel III definition of exposures and a different sample of banks.

mortgage lending. As these sources of funding dried up, banks' liquidity came under pressure, with some forced to make 'fire sales' of assets to meet redemptions. Investors were uncertain whose difficulties were fundamental. As credit conditions tightened and economic activity slowed, asset prices fell and defaults rose. Eventually the spotlight turned to whether banks were adequately capitalised. As confidence withered, liquidity seized up. Lacking adequate resolution regimes, the authorities ended up matching liquidity support with taxpayer solvency support.

Powers of the FPC

One way that the FPC can mitigate threats to the resilience of the financial system is by raising awareness of systemic risks among financial market participants. The FPC is required to publish a *Financial Stability Report* twice a year which must identify key threats to the stability of the UK financial system. At times, simply warning about risks may be sufficient to catalyse action within the private sector to reduce vulnerabilities. But experience from before the crisis showed that warnings alone are not always enough.(1)

The new legislation gives the FPC two main types of power: *Recommendations* and *Directions*. EU law provides the overarching framework within which the FPC can use these powers. For banks, two key elements of EU legislation are the Capital Requirements Regulation and the Capital Requirements Directive IV, which are due to come into force in January 2014. While the EU regulation is directly applicable or 'maximum harmonised' — meaning that it restricts the scope for national variation in regulatory rules — some national flexibility is permitted. For example, in addition to the countercyclical buffer, a range of other tools are identified within a so-called 'macroprudential carve out' and can be set at a national level. For tools within that carve out, if the relevant national authority considers it needs to take action, it must notify various EU bodies of that fact and submit evidence and reasoning for taking the proposed measure. Once that process is complete, and provided the proposed action is not rejected by the European Council based on opinions of the other EU bodies, the measure can be introduced.

In seeking to meet its objectives, the FPC is not allowed to take actions that would in its view be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the economy in the medium or long term. It must also consider whether any adverse effects of its actions on financial institutions or activities are proportionate to the benefits. Generally, the FPC must also explain its reasons for taking action and provide, where practicable, an estimate of the costs and benefits that would arise from compliance. It must also, so far as is possible while complying with its objectives, seek to avoid prejudicing the PRA and FCA's respective objectives.

Powers of Recommendation

Under its power of *Recommendation* the FPC can ask the PRA and FCA to take measures to mitigate risks. Such Recommendations can cover any aspect of the activities of the regulators but cannot relate to a specified individual regulated entity. The FPC can also make Recommendations to the PRA and FCA on a 'comply or explain' basis — in which case, the regulators are required to act as soon as reasonably practical. If one of these regulators were to decide not to implement a Recommendation, it must explain the reasons for not doing so.

The FPC can also make Recommendations to other bodies, though not on a 'comply or explain' basis, so there is not a statutory obligation on the recipient to respond. For example, it could issue a Recommendation to the Bank of England in relation to the provision of liquidity to financial institutions (but not to a particular financial institution) or with regard to its oversight of payments systems, settlement systems and clearing houses. The FPC can also make Recommendations to other bodies, for example to the Financial Reporting Council or industry representative bodies, such as the British Bankers' Association.

The FPC can give Recommendations to HM Treasury, including over the scope of activities regulated under the Financial Markets and Services Act 2000. Developments in the structure of the financial system can leave regulatory rules out of date. For example, financial market participants can find ways to avoid regulatory rules, which may lead to risks shifting into new, hitherto unregulated areas. The job of microprudential bodies is to focus on risks to specific regulated institutions. The FPC can look more broadly at the emergence of risks across the system as it evolves and recommend changes to regulation that are needed to maintain stability. That could include a change to the regulatory perimeter — including the division between regulated and unregulated activities as well as the split of responsibilities between the FCA and PRA.

Powers of Direction

The FPC has a distinct set of powers to give *Directions* to the PRA and FCA to deploy specific macroprudential tools that are prescribed by HM Treasury, and approved by Parliament, for these purposes. To date, HM Treasury has given the FPC a power of Direction over sectoral capital requirements (SCRs). The FPC will also be given a power to set the countercyclical capital buffer (CCB) under new EU legislation.(2)

For each of its powers of Direction, the FPC must prepare, publish and maintain a written statement of the general policy that it proposes to follow in relation to the exercise of its

(1) The limits of warnings alone are discussed in a speech by Mervyn King, see King (2009).
(2) The countercyclical buffer is part of the Basel III reforms implemented in EU law via the Capital Requirements Directive IV and Regulation (CRD IV/CRR), which also include capital conservation and systemic risk buffers.

powers. The interim FPC published a draft policy statement relating to these two prospective Direction powers over capital requirements in January 2013.(1) This will be updated and reissued by the statutory FPC.

The Government has also stated its intention to provide the FPC with a Direction power over a time-varying leverage ratio tool, although this will come into effect no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. The FPC can at any time make a Recommendation to HM Treasury for its consideration if the Committee believes it needs an additional power of Direction.

Countercyclical capital buffers and sectoral capital requirements

The CCB and SCR tools both focus on banks' capital buffers. The more a bank uses capital — such as equity — to finance itself, the more it is able to absorb unexpected losses on its assets, without failing or needing to scale back on new lending.(2) As risks evolve over the cycle, varying the settings of these tools — and, therefore, banks' overall capital requirements — can reduce the chances of financial crises emerging by making banks better able to cope with unexpected losses.(3)

The CCB tool will allow the FPC to change capital requirements above normal microprudential standards in relation to all loans and exposures of banks to borrowers in the United Kingdom. Authorities abroad will also determine whether banks are required to have a CCB against foreign exposures.

The SCR tool is more targeted and allows the FPC to change capital requirements on exposures to specific sectors judged to pose a risk to the system as a whole. The FPC is able to adjust SCRs for banks' exposures to three broad sectors, namely residential property (including mortgages), commercial property and other parts of the financial sector. In addition, SCRs can be adjusted at a more granular level, for example on mortgages with high loan to value or loan to income ratios at origination. The CCB and SCR tools can be applied to all UK-incorporated banks, building societies and large investment firms (for example, broker-dealers).

The use of these tools can improve the ability of the financial system to withstand shocks. When the FPC judges that current and future threats to financial stability are low, the CCB applied to UK exposures and SCRs will be set to zero. In this case, banks will need to meet simply their normal, microprudential capital requirements. When threats to stability emerge, the FPC can raise the CCB or SCRs, requiring banks to have a larger capital buffer which can then be used to absorb unexpected losses when the 'cycle' turns.

The tools may also affect the resilience of the financial system indirectly through effects on the price and availability of credit. These effects are likely to vary over time and according to the state of the economy.(4) For example, in periods where there are concerns about the strength of financial institutions, both resilience and lending can be supported by recommending that banks raise capital. For those banks that are perceived by the market to be inadequately capitalised, official action to increase their equity capital will boost resilience and that is likely to reduce the cost of their funding, which will tend to improve credit availability.

In an environment where market participants perceive risks to the financial system to be small, banks may be able to borrow at a rate that is relatively insensitive to how much capital they have. In that case, if the FPC were to judge that the risks to overall financial stability were greater than believed by the market and hence instigated an increase in capital requirements, banks' cost of funding may rise. This might lead to a tightening in credit conditions facing households, companies and financial intermediaries, helping to arrest the build-up of vulnerabilities created by an overextension of credit and thereby boost banks' resilience.

When threats to resilience are judged to have receded and banks' capital buffers are judged to be more than sufficient to absorb future unexpected losses in the event of stressed economic or financial conditions, previously accumulated macroprudential capital buffers (the CCB or SCRs) might be reduced.

Other FPC responsibilities

In addition to using its powers of Recommendation and Direction, the FPC can influence financial system resilience by giving advice. It is consulted on a range of issues by other bodies. For example, the Bank's Court of Directors is required to consult the FPC on the Bank's overall financial stability strategy. The Bank also seeks the views of the FPC on developments in its Sterling Monetary Framework under a protocol agreed in May 2013.(5) In April 2013, the Chancellor announced a 'Help to Buy' scheme that will run for three years. Should the Government be considering an extension of the scheme at that time, the FPC would be asked for advice on the impact on systemic risks.

The Monetary Policy Committee (MPC) is also seeking the advice of the FPC as part of its new framework for forward guidance. The FPC is asked to alert the MPC if the stance of monetary policy poses a significant threat to financial stability

(1) See Bank of England (2013a).
(2) Note that in addition to unexpected losses, banks also expect some degree of losses to crystallise on loans (which will vary depending on the type of loan, credit rating of the borrower, and so on). Banks' lending practices should account for these expected losses, for example via the price of new lending and provisions. See, for example, Button, Pezzini and Rossiter (2010).
(3) This section draws on 'The Financial Policy Committee's powers to supplement capital requirements', see Bank of England (2013a).
(4) See Tucker (2013).
(5) See Bank of England (2013b).

that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the FCA and the PRA in a way consistent with their objectives. More broadly, in its remits to the MPC and FPC, HM Treasury asked the Committees to explain how they consider the policies of each other in discharging their responsibilities.[1]

Policy co-ordination is a central feature of the new arrangements, and one of the reasons for overlapping memberships of the FPC with other policy bodies (**Figure 1**). The FPC is also required to have regard to the United Kingdom's international obligations. To that end, it expects to co-operate closely with overseas macroprudential bodies, including the ESRB. Proposed new EU legislation sets out formal co-ordination arrangements on the CCB within the European Economic Area: overseas regulators will apply the CCB chosen by the FPC to their banks' UK exposures, while the relevant overseas regulators will normally set the CCB in relation to UK banks' overseas exposures. SCRs will be subject to different co-ordination arrangements under the EU legislation.

How do FPC rounds work?

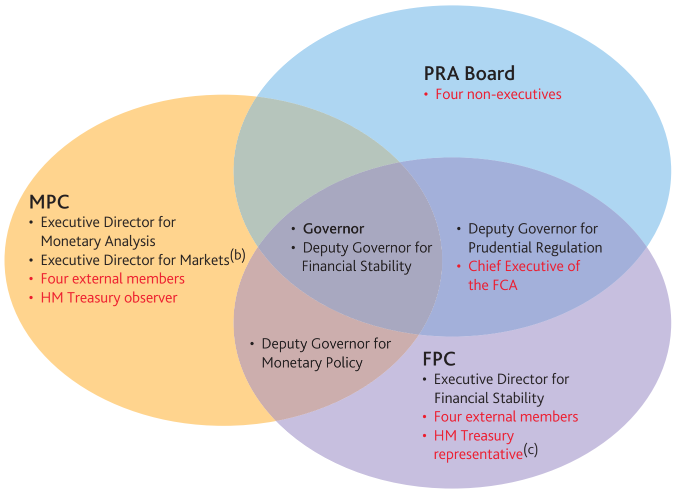
The composition of the FPC and its location in the central bank means it is able to draw on a diverse experience and a wide range of information in detecting and assessing threats to financial stability.

The FPC has ten voting members: the Governor (who chairs the FPC); the Deputy Governors for Financial Stability, Monetary Policy and Prudential Regulation; the Executive Director of the Bank of England for Financial Stability; the Chief Executive Officer of the FCA; and four external members (**Figure 1**). In addition, a representative of HM Treasury is a non-voting member of the FPC. The FPC therefore has direct insights from MPC members into developments in the macroeconomy and in its interaction with the financial system. Membership from the microprudential regulators — the PRA and FCA — ensures that supervisory intelligence relevant to financial stability is brought into the FPC's discussions. External members add to the diversity of experience and information available to the FPC. The Bank's Executive Director for Markets routinely attends FPC meetings so as to offer insights on financial markets.

The processes supporting the FPC, including the format of meetings in which members discuss risks to stability and possible policy responses, are likely to evolve over time. But experience over the past two years of the interim FPC can provide some insights on the broad shape of regular rounds.

The FPC has a pre-announced quarterly schedule, with the dates of formal policy meetings, published on the Bank's website.[2] A typical quarterly cycle contains four elements:

Figure 1 Membership of Bank of England policy committees[(a)]



(a) Members shown in red are not part of the Bank's Executive Team.
(b) The Executive Director for Markets will also routinely attend FPC meetings.
(c) Non-voting member of the FPC.

- briefing on financial system developments;
- focused discussions of key issues germane to UK financial stability and potential areas for macroprudential policy interventions;
- a policy meeting, culminating in decisions about macroprudential policy, for example to make Directions and/or Recommendations; and
- communication of the policy decision, including via the FPC Record and, twice a year, the *Financial Stability Report* (*FSR*).

The Committee is supported in these areas by a broad range of staff. A dedicated FPC Secretariat, housed within the Bank, is responsible for co-ordinating the wide-ranging inputs to the FPC, as well as supporting the Committee's outputs, including some of its public communications. **Figure 2** sets out the cycle for a typical quarterly FPC round. The various components of the process are described in more detail below.

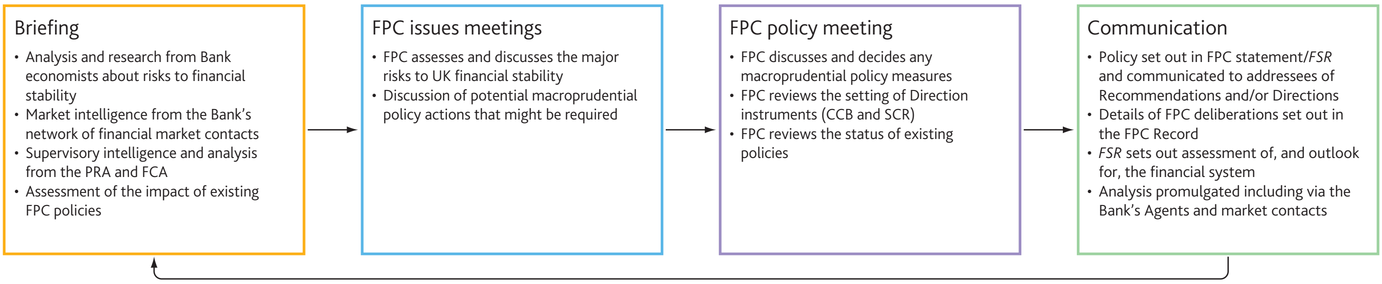
Briefing

Briefing papers produced by staff, including analytical work and market and supervisory intelligence, are circulated to the FPC throughout each quarter. Some papers are requested directly by the FPC, while others are provided on the initiative of staff. The information covers a very broad spectrum of issues and varies in detail depending on the topic.

At one extreme, the Committee receives short, factual updates on breaking news: for example, latest developments in vulnerable euro-area economies. At the other extreme the FPC

(1) See 'Remit for the Monetary Policy Committee', March 2013, available at www.gov.uk/government/uploads/system/uploads/attachment_data/file/221566/chx_letter_to_boe_monetary_policy_framework_200313.pdf and 'Remit and recommendations for the Financial Policy Committee – April 2013', available at www.gov.uk/government/uploads/system/uploads/attachment_data/file/207473/remit_fpc_290413.pdf.
(2) See www.bankofengland.co.uk/financialstability/Pages/fpc/meetings/default.aspx.

Figure 2 A typical FPC quarterly cycle



may receive in-depth reports, for example on loan forbearance by banks. The most common form of briefing tends to be short notes that examine recent economic or financial developments and use analytical techniques or intelligence to answer specific questions. For example, what are the key risks to UK financial stability arising from emerging market economies? Or to what extent is there evidence of exuberance and excessive 'search for yield' in financial markets?

A substantial proportion of the analytical support for the FPC's activities comes from staff in the Bank's Financial Stability Directorate. Market intelligence, supervisory insights and analysis from staff in other parts of the Bank and FCA, and on occasion HM Treasury, are also critical inputs into the FPC's activities. The Bank's market intelligence (MI) is drawn from an extensive, growing, and internationally diverse contact base including banks, dealers, brokers, asset managers, pension funds, insurance companies, hedge funds, private equity funds and infrastructure providers. It covers a wide range of markets, from 'vanilla' instruments such as gilts, equities, commodities, bonds and repo through to complex derivative products. It helps the FPC to understand better the qualitative behavioural patterns that underlie quantitative movements in financial variables and to spot new developments or risks that might introduce potential vulnerabilities into parts of the financial system.

Supervisory intelligence and other briefing are provided by staff from the PRA and the FCA. This allows the Committee to draw together granular supervisory insights to form a better understanding of developments across the system as a whole.

A focal point for the quarterly FPC briefings is a set of presentations by senior Bank (including PRA) and FCA staff on key developments. Agendas vary from briefing to briefing, but typically include:

- a summary of MI from the Bank's Markets Directorate (for example, risks arising from the search for yield);

- presentations by the Bank's Financial Stability Directorate on domestic and international macroeconomic and capital market risks (for example, risks of spillovers from stress in parts of the euro area, or signs of emerging threats to stability from beyond the regulatory boundary), resilience of the financial system (for example, risks from weak UK bank profitability) and non-cyclical issues affecting system resilience (such as banks' risk-weight methodologies or risk management practices at central counterparties); and

- a summary of supervisory intelligence from the PRA (for example, themes from banks' capital and liquidity planning); and

- a summary of key issues from the FCA (for example, on developments in relevant products, markets or among firms regulated by the FCA).

As part of this briefing, the FPC will consider a wide range of information, alongside economic and financial indicators. No single set of indicators can ever provide a perfect guide to systemic risks, or to appropriate policy responses, due to the complexity of financial interlinkages, the tendency for the financial system to evolve over time and time lags before risks become apparent. The FPC also monitors a specific set of indicators as a core input to the use of the CCB and SCR. These include measures relating to the size and composition of balance sheets within the financial system and among borrowers, and information on terms and conditions in financial markets. They are published in each *FSR* and on the Bank's website.(1)

The FPC sees attractions in synthesising information from a broad range of indicators via a stress-testing framework that can explore the resilience of the financial system in various adverse scenarios. To that end, it has asked the Bank, including the PRA, to develop a framework for regular stress testing of the UK banking system. Results from proposed future stress-test exercises will be discussed by the FPC.

There is some overlap between the briefing received by the FPC and the MPC. As noted above, FPC members who sit on the MPC are able to incorporate the insights that have been

(1) See, for example, the June 2013 *Financial Stability Report*, available at www.bankofengland.co.uk/publications/Documents/fsr/2013/fsrfull1306.pdf.

provided to them as monetary policy makers into macroprudential policy discussions. In addition, analysis on issues such as credit conditions, the banking system and financial market developments is produced jointly by staff across the Bank, and circulated to both Committees. Furthermore, FPC members have the opportunity to observe the monthly briefing session held for the MPC, and *vice versa*. PRA Board independent members can also attend these two briefing meetings.

Issues discussions

'Issues' discussions are an opportunity for the Committee to assess the major risks to UK financial stability and discuss in more detail key areas of concern. Staff prepare briefing and analysis to support FPC discussion of potential macroprudential policy responses. The Committee also considers a range of issues relevant to its statutory responsibilities, including the effect of potential policy interventions on resilience and the economy. These deliberations guide staff in preparing any further material to support the Committee's subsequent policy decisions.

The FPC is updated by staff, or members of the Committee, on progress in implementing previously issued policy decisions.

Policy meeting

New macroprudential policy measures that may be required to mitigate risks to financial stability are discussed and, where appropriate, agreed by the FPC at the policy meeting. Aside from FPC members, only a few Bank staff are present, including a Secretariat with responsibility for producing the Record of the discussion.

The legislation sets out that the Chair of the FPC — the Governor or, if the Governor is not present, the Bank's Deputy Governor for Financial Stability — should seek to ensure that macroprudential policy decisions of the FPC on new Recommendations or Directions are reached by consensus wherever possible. Where that is not possible a vote is taken by the Committee.

At the policy meeting, the FPC also reviews formally the status of previous policy Recommendations or Directions. The Committee assesses actions taken in response, and decides whether to withdraw the policy measure — if it has been successfully implemented or is no longer required to mitigate risks to UK financial stability — or to retain it as being in progress.

Where it judges that disclosure is against the public interest, the FPC is able under section 9V of the Act, to delay disclosure and make private Recommendations. But the Committee is required to review any private Recommendations that it may have made previously, and to consider whether publication is still against the public interest.

Accountability

The FPC policy decision, including any new Directions and/or Recommendations that have been agreed, are communicated to those to whom the action falls — for example, the PRA or FCA. The policy decision is communicated to the public in either a short statement typically released a week after the policy meeting — in the first and third quarters of the year — or in the *FSR* in Q2 and Q4.

Under the Act, the *FSR* must include: the FPC's view of the stability of the UK financial system at the time of the *Report's* preparation; an assessment of the developments that have influenced the current position of the UK financial system; the strengths and weaknesses of the UK financial system; risks to the stability of the UK financial system; and the Committee's view of the outlook for the stability of the UK financial system. It also reports the Committee's view of progress against previous Recommendations and Directions, as well as reporting any new policy actions taken to reduce and mitigate risks to stability. The *FSR* is prepared by the FPC, with a draft produced by Bank staff. The FPC provides comments and formally agrees the text at a special meeting prior to publication.

The key messages and policy actions in the *FSR* are conveyed to a wide audience. A press conference is held when the *FSR* is published. Participants in financial markets — including the Bank's network of market intelligence contacts — are also informed of policy decisions when the *FSR* is published. FPC members and other Bank staff hold regular meetings with financial market participants where FPC decisions are discussed. The Bank's network of Agents across the United Kingdom is able to promulgate and discuss messages with business contacts, often supported by FPC members or other Bank staff.

A formal Record of the policy meeting is published at present around a fortnight after the corresponding meeting. It must specify any decisions taken at the meeting and must set out, in relation to each decision, a summary of the Committee's deliberations.(1)

FPC members also appear regularly before Members of Parliament at Treasury Committee hearings, where they are required to explain their assessment of risks and policy actions. The Treasury Committee has also held appointment hearings for members.

The procedures followed by the FPC are kept under review by a committee of the Court of Directors of the Bank, the Oversight Committee established under the Act. It may appoint persons

(1) Although, as previously discussed, the Act gives the FPC the right to delay disclosure of private Recommendations where it judges immediate publication to be against the public interest.

to conduct specific performance reviews, which would be published unless the Bank's Court judges that publication at a particular time is against the public interest.

Conclusion

In the period leading up to the crisis insufficient attention was paid to tackling risks and vulnerabilities across the financial system as a whole. The FPC fills that gap by identifying, monitoring and, crucially, taking action to remove or reduce systemic risks to the resilience of the financial system. This article has described the objectives and powers of the FPC. It has also provided an overview of some of the processes currently supporting the Committee.

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