THE FINANCIAL SERVICES PRACTITIONER PANEL

RESPONSE TO BANK OF ENGLAND DISCUSSION PAPER
‘INSTRUMENTS OF MACROPRUDENTIAL POLICY’ DECEMBER 2012

10 February 2012

Introduction

The Financial Services Practitioner Panel is the statutory Panel set up under FSMA to represent the interests of practitioners to the FSA. As such, we have a close understanding of policy development at the FSA, and have taken a keen interest in the Government's plans for regulatory reform. The details of the Panel's remit, and its current membership are outlined in Appendix 1.

1. Summary of response

The Bank of England Discussion paper on Instruments of Macroprudential Policy ("the paper") is a welcome step forward in the development of these macroprudential tools which will be a vital component of the new regulatory regime seeking to improve financial stability, an objective which the Practitioner Panel ("the Panel") wholeheartedly supports.

The Panel believes that the Bank of England faces a significant challenge as it develops its approach to macroprudential policies. In addition to the technical challenges around how these tools will work in practice, they could also have significant economic and social effects which in certain scenarios could result in pressures being brought to bear on the Bank at precisely the time that the measures are needed. The Panel therefore believes it is a very positive step for the Bank to stimulate a discussion on these tools via the paper so that, as far as possible, consensus can be reached on the tools in advance of their implementation.

The paper invites comments on three questions – should the Financial Policy Committee ("FPC") be considering additional tools; whether the FPC focused on the right instruments at its Sep 2011 meeting; and whether the selection criteria for the tools are sensible and sufficient. Before addressing these questions specifically, the Panel wishes to raise certain more general matters for further discussion.

First, the Panel's overriding concern is around the practical impact of the proposed macroprudential tools given they are all relatively untested, the transmission mechanisms are not fully understood and there might be adverse and unintended consequences. *We believe the number of tools should be reduced and as much as possible should be done to engage with industry to "road test" the proposals before they are used.*

Secondly, the Panel believes that the proposed macroprudential tools will interact directly and indirectly with the UK's (changing) microprudential and conduct regulations. *This reinforces the need for coordination between regulators to avoid duplication and potentially conflicting initiatives, including the macroprudential tools.*

Thirdly, *the Panel would prefer to see further development of internationally coordinated macroprudential tools* rather than progressing too many country specific tools. Ideally, the tools themselves should be developed in international fora of macroprudential regulators from various countries; implementation of the tools would clearly need to be tailored to the particular circumstances and position in the economic cycle of individual countries. It is also worth noting that planned EU legislation may impact actions being considered, and that the timing of implementation of new policy may impact firms' ability to comply with material accounting changes.

Fourthly, the Panel would like to see a *strengthening of the need for the FPC to take account of the proportionality principle* via cost benefit analysis required before the use of the tools.

Finally, the paper mentions that the procedure for introducing new powers of Direction in the future needs to be both clear and expeditious. Whilst appreciating this, the Panel *would nevertheless also like to see a commitment to consultation on any new powers that are introduced at a later date (although in certain circumstances this might need to be after the event).*

The remainder of this response covers the specific questions raised by the paper.

2. <u>Answers to Specific questions</u>

2.1 Need for additional tools?

In the Panel's view, *there is probably no need for additional time-varying/counter-cyclical tools.* Although the paper refers to the FPC focusing on a "relatively narrow set of Directive tools", the main paper has 12 (see table 3A on p17, and one or two of them could be viewed as a combination of tools) and there are five more in Annex 2. Given that everyone acknowledges that these tools are largely untested in a developed economy, *there is a strong case for narrowing this list significantly.*

Essentially, there are two ways of looking at the potential macro-prudential toolkit. One viewpoint is that using a relatively small set of instruments (predominantly time-varying capital) to build up buffers to increase resilience or moderate the worst excess of boom and bust cycles is the key aspect of the tools. The other viewpoint is that a much more comprehensive view is a better approach– monitoring many indicators and then adjusting lots of levers to try to "fine tune" the various elements of financial stability. We favour the former view, even if it can be characterised as blunt or simplistic. We simply do not yet understand enough about cause and effects to start with an approach which could be characterised as "tinkering here, there and everywhere".

However, we also believe *there is a need for more consideration and explanation of cross-sectional tools,* of which there are only really two - use of Centralised Counter Parties ("CCPs") plus design and use of trading venues. There is insufficient consideration of resolvability and Recovery and Resolution Plans ("RRPs"), which ought to be key to any reduction in systemic risk. Taken to extreme, if any bank, regardless of size, can be resolved painlessly, then much of the problem is solved. In the meantime, there is the proposed SIFI surcharge – a key tool, but one which is relegated to the Annex in the paper. Arguably, this deserves greater prominence, although in so doing the Panel would not wish to see too frequent revisions to this regulation given its impact.

2.2 Did the FPC focus on the right instruments at its meeting in September 2011?

Based on the record of the September meeting, the FPC focused then on the same set of 12 tools that are explored in the main body of the December paper. On this basis, our answer to this question is that *the FPC is probably taking too broad a view and should narrow down the set of tools*, as outlined above, for the following reasons:

- the selection criteria (see next section) emphasises that a key criterion is "effectiveness", and in connection with this the paper notes that the FPC will place particular importance on tools for which there are clearly articulated transmission channels. The Panel's view is that relatively few of the tools meet this test – the "blunt instruments" of capital and leverage ratios are the most clearly articulated, with variable Loan to Values ("LTVs) possibly also covered (given that they have been used in other countries);

- at present, there is only one instrument for which there is a reciprocity arrangement, namely the Basel counter-cyclical capital buffer. The paper does however hold out the hope that it might be possible to conclude bilateral or multi-lateral reciprocity arrangements for other macro-prudential tools, a laudable aim which the Panel supports, but one with considerable challenges. Given that the effectiveness criterion refers to the risk of international leakage, it could be argued that the FPC's first priority should be trying to reduce the perceived disadvantages of the time-varying capital buffer tool (set out on p20), because at present it is the only instrument which seems to reduce the risk of international leakage;

- there is considerable overlap in outcomes between the different tools. For example, time-varying capital buffers, time varying risk weights, time-varying provisions and restrictions on distributions could all have the same ultimate effect – they increase the amount of capital that is held at the top of the cycle and thereby resilience and may have some dampening effect on asset prices, credit growth etc as a secondary effect. The difference is in the metric or underlying variable that drives the amount of additional buffer that is built up. This is implicit in the paper, but could be recognised more explicitly. It's also unclear to us whether the selection criteria will really enable the FPC to distinguish between two "competing" tools. (The last paragraph of p30 does acknowledge some of this difficulty: "But degrees of overlap between different tools for targeting similar risks should be taken into account when deciding between them.")

- some of the disadvantages of the Annex 2 tools, which we are assuming have a lower priority status than those set out in the main paper, apply equally to those main paper tools. For example, tighter Large Exposure ("LE") limits could be ineffective if it is not possible to define sectors sufficiently tightly or if risk is shifted or redefined into other sectors. Decisions which single out particular sectors could also become heavily politicised as they might have distributional effects (p30). However, such disadvantages also apply to varying the risk weights on particular asset classes, yet these appear not to be mentioned in that section (p21). Consideration may also need to be given to the effect of changes to some core capital instruments in terms of the possibility that this may introduce riskier practices in other areas.

2.3 Selection criteria

The paper puts forward four sensible criteria: effectiveness, efficiency, transparency and the tool's coverage and independence. *These seem along the right lines to the Panel with one exception around whether the tools can be reversed* (see below). However, these four will also *need to be set out in rather more granular form if they are to be used to make difficult choices between competing or overlapping tools*, as outlined above.

The Panel also wishes *to stress the vital importance of Cost Benefit Analyses* ("CBAs"). This is certainly covered under the efficiency criterion, which is welcome, but there appears to be no mention of the fact that the draft legislation proposes a general duty on the FPC to have regard to the principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction. *The Panel places great reliance in this proportionality requirement.* We believe the draft legislation does not permit a choice here (with the usual caveats that this is a legal question); if so, this should be recognised as making it different to some of the other criteria, which are not set out on the face of the draft legislation.

Our suggestion on additional criteria is around the extent to which the tool can be reversed. The language of the selection criteria section is all about taking the punchbowl away, rather than - as Don Kohn recently put it - "spiking" it in bad times. There is a strong case for arguing that a further selection criterion should be an assessment of the extent to which the tool can be put into reverse when the circumstances warrant it – for example, as the paper recognises, will market counterparties allow capital buffers to be used when the FPC says they can be released? On this basis, some of the less transparent tools may work better when it comes to releasing them (for example, variable risk weights). This feature could be added to the effectiveness or efficiency criteria or added in its own right (our preference).

The paper mentions that the procedure for introducing new powers of Direction in the future needs to be both clear and expeditious. Whilst appreciating this, the Panel would nevertheless *also like to see consultation on any new powers that are introduced at a later date*.

APPENDIX 1

ROLE AND REMIT OF THE PRACTITIONER PANEL

1. The role of the Practitioner Panel is to advise the Financial Services Authority on its policies and practices from the point of view of the regulated community. It has statutory status under the Financial Services and Markets Act 2000 (FSMA). As such, the Practitioner Panel is given access to the FSA's plans for new regulatory policies, and so is able to provide an important sounding board for the FSA before the ideas have been made public.

2. Members of the Practitioner Panel are drawn from the most senior levels of the industry, with the appointment of the Chairman being formally approved by the Treasury, to ensure independence from the FSA. The members are chosen to represent the main sectors of the financial services industry as regulated by the FSA. The Panel currently has senior practitioners from the retail and investment banks, building societies, insurance companies, investment managers, financial services markets, custodians and administrators.

3. The Chairman of the FSA's Smaller Businesses Practitioner Panel (SBPP) sits ex officio on the Practitioner Panel to ensure co-ordination, but debate on issues specifically affecting smaller firms are covered by that Panel.

4. The names of the members of the Practitioner Panel as at 10th February 2012 are as follows:

Russell Collins (Chairman)	Partner, Deloitte LLP
Graham Beale	Chief Executive, Nationwide Building Society
Joe Garner	Head of UK Retail Bank & Deputy Chief Executive, HSBC Bank plc
Paul Geddes	Chief Executive, RBS Insurance
Colin Grassie	CEO, Deutsche Bank UK
Mark Harding	Group General Counsel, Barclays Bank PLC
Simon Hogan	Managing Director, Institutional Equity Division, Morgan Stanley
Garry Jones	Group Executive Vice President & Head of Global Derivatives, NYSE Euronext
Guy Matthews	Chief Executive, Sarasin Investment Funds (SBPP)
Helena Morrissey	Chief Executive Officer, Newton Investment Management
John Pollock	Group Executive Director, Protection & Annuities Legal & General
Malcolm Streatfield	Chief Executive, Lighthouse Group
Paul Swann	President & Chief Operating Officer, ICE Clear Europe
Doug Webb	Chief Financial Officer, London Stock Exchange Group