THE COUNCIL FOR FINANCIAL STABILITY

MINUTES OF MEETING HELD ON 14 JANUARY 2010

Council Principals:
Right Honourable Alistair Darling MP, Chancellor of the Exchequer (chairman)
Lord Turner, FSA Chairman
Mervyn King, Governor of the Bank of England

In attendance:
Lord Myners, Financial Services Secretary to the Treasury
Hector Sants, Chief Executive Officer, FSA
Paul Tucker, Deputy Governor of the Bank of England
Sir Nicholas Macpherson, Permanent Secretary to the Treasury
Tom Scholar, Second Permanent Secretary to the Treasury
Jonathan Taylor, Managing Director Financial Services, HM Treasury
Sophie Dean, Private Secretary to the Chancellor
Lottie Murphy, Secretary to the Council, HM Treasury

Observers:
Dan Rosenfield, Principal Private Secretary to the Chancellor
Andrew Hauser, Private Secretary to the Governor of the Bank of England
Ruth Smith, Private Secretary to the FSA Chairman

The following items were discussed at the meeting:

1. Financial Stability Report
2. Remuneration
3. Recovery and Resolution Plans

ITEM 1 – FINANCIAL STABILITY REPORT

The Council considered the Bank of England's latest Financial Stability Report, published in December.

Introducing the issue, the Governor noted that the flow of news about financial markets and the financial system since the previous Financial Stability Report had been positive. Activity had resumed in a number of financial markets and spreads in money and corporate bond markets had returned to close to pre-crisis levels. Balance sheets in many sectors and across many countries nevertheless remained impaired. The degree of leverage among global banks was still high by historical standards; and, despite improvements in funding markets, the refinancing burden on many banks remained considerable.

The longer-term challenges to reforming the financial system remained considerable. The Report set out a number of actions the Bank of England believed would provide greater resilience against the near-term risks, and a range of medium-term measures structured around the three-legged stool of regulation, structure and resolution of banks, primarily aimed at dealing with the 'too important to fail' issue.

In the near term, banks needed to continue the process of deleveraging and balance-sheet repair. But if this was done by curtailing lending to the non-financial economy, those repair efforts would ultimately be counter-productive. The key challenge for the authorities would be to help navigate banks along a prudent trajectory for capital accumulation and their funding arrangements, including exiting the Special Liquidity Scheme and other official sector funding schemes. More than £1 trillion needed to be refinanced in private markets in the next five years and banks internationally have considerable work still to do to deal with this issue. The UK authorities should require all banks to draw up concrete refinancing plans. International co-operation would be required to monitor progress.

Banks had benefited from windfall gains during 2009. The Bank believed that there was a strong case for limiting distribution of those profits in the immediate period ahead, to front-load balance sheet repair. The FSA was already in discussion with the UK banks about end-year distributions, but ensuring that the level of overall distributions did not impair banks' capital positions would be an important question for the three authorities.

Looking further ahead, an integrated package of reforms should be delivered in the areas of regulation, structure and resolution of banks. Amongst other things, that should include taking forward work on recovery and resolution plans (to be discussed later in the meeting); taking further steps to bolster the use of contingent convertible capital instruments; and accelerating efforts to develop sounder and more transparent structures for securitisation markets.

The Deputy Governor noted that the FSR also highlighted the need for increased collection and publication of data on the financial system, in particular to bolster the authorities' efforts on macroprudential oversight.

The following points were made in discussion:

- The Chancellor welcomed the key messages of the FSR. As the report noted, recent news in financial markets had been broadly positive, in sharp contrast to several periods in the last couple of years: this was welcome, and was testament to the work the authorities had done working together. In recent months the focus had moved from resolving immediate financial stability risks, to a more strategic longer-term view of preventative measures to ensure the continued stability of the financial system. There were three main strands of work: an orderly exit from government and central bank schemes designed to underpin financial stability; continuing the repair work and monitoring the health of the financial system; and structural change which needed to strengthen the banking system while continuing the flow of credit to the real economy.

- The FSA Chairman agreed with the Governor that banks needed to increase capital reserves and decrease leverage steadily. FSA stress tests had already had an impact and would continue to do so. On regulation, the FSA was, in some areas, anticipating likely future international requirements, but was committed to global standards, and would review its own requirements in the light of the final agreements.. Progress had been made, but we now faced the challenge of agreeing critical issues such as the calibration of capital ratios. Like the Governor and the Chancellor, the FSA Chairman said striking the right balance would be critical so that lending was not curtailed. This would imply the need for careful consideration of the timing of higher capital requirement changes in respect of the banking book, with increases in trading book capital requirements as the short-term priority.

- The FSA Chairman supported the Governor and Chancellor's view that the major UK banks should produce an exit strategy from Government support. The major banks should also, he argued, develop longer term funding plans. The FSA Chairman thought that a revived securitisation market would be beneficial. This would require simpler and less risky forms of securitisation than in the pre-crisis years.

- The Chancellor said that it was important that the mistakes of the recent past were not repeated, and that we should be vigilant as the securitisation markets developed.

- The FSA Chairman pointed to some important ideas emerging, for example the use of contingent capital to create loss-absorbing capacity while firms are still going concerns. The international debate on resolution processes might result in banks being required to install firewalls between different parts of the business or face higher capital requirements.

- The Financial Services Secretary to the Treasury (FSST) said that the pace of change in regulation was critical and we needed to be alert to its impact on competitiveness. He agreed that it was right for the UK to be at the forefront of the debate but noted that it would be important that the UK did not become detached from the actions taken in other countries. He thought there was a risk that other countries weren't moving at the same pace.

- The Chancellor noted that there were several groups discussing these issues internationally, including the G20, the Financial Stability Board (FSB), the Basel Committee and committees within the European Union. Strong cooperation internationally, as well as among domestic authorities, was therefore critical. The Governor said that the challenges of reaching international consensus should not be underestimated: the UK, for example, was closer to the US than some of the other larger European countries in arguing for higher capital and liquidity requirements. The FSA Chairman said the FSA was aiming to steer a middle path by being at the forefront internationally, but not getting too far ahead of other countries.

- The FSST raised two further issues. On governance, he highlighted the importance of pursuing David Walker's recommendations. Secondly, he referred to an important recent Treasury consultation, prepared in conjunction with the FSA and the Bank, on non-bank finance. Paul Tucker agreed that non-bank finance was an important part of the medium term reform agenda. However, the authorities would need to take care not to facilitate the development of a bigger and riskier shadow banking system outside the regulatory framework.

The Council agreed that the authorities should continue to work together on these issues and to discuss progress that the major banks had made in producing exit strategies from Government and central bank support, as well as considering longer-term funding plans, at the next quarterly Council meeting. The Council also agreed to discuss progress at the international level on issues such as the calibration of capital requirements at that meeting.

ITEM 2: REMUNERATION

The FSA Chairman noted that the FSA had received remuneration plans from the priority firms covered by the FSA code. After lengthy discussions, the FSA had reached the final stages of sign off of the 2009 remuneration reviews for these firms. The FSA Chairman explained that the UK is at the forefront of implementation of the full range of the FSB's implementation standards for 2009, while some other countries were less advanced. The FSA had required a number of changes to the plans that the banks had submitted, but the FSA Chairman was confident that the firms would comply with the Code for the 2009/10 year. Acknowledgement was made that potential issues could arise if other countries failed to follow the UK's implementation of the FSB code in time for the 2010/11 remuneration round.

On capital, FSA interventions had made sure that in some critical cases the amount and/or form of firms' payouts had been adjusted to be more consistent with future known or likely capital requirements, for instance those coming from changes to trading book requirements and anticipated changes to the definition of capital.

The FSA Chairman also noted that the FSB was carrying out a thematic review of the implementation by countries and by firms of the FSB's Principles and Implementation Standards. Countries were being asked to complete a detailed questionnaire, which would be used as a basis for a report to the FSB Steering Committee in March. It was hoped that this would lead to a clear view of progress on implementation and the opportunity for further pressure on countries to increase international alignment. The FSA Chairman thought that the UK would be seen in this review as a leader in implementation.

The following points were made in discussion:

- The FSA Chief Executive said he had had some constructive discussions with their international counterparts who supported the FSA approach, but that a number of major jurisdictions had not imposed the FSB code in relation to the 2009/10 remuneration round. There needs to be an internationally agreed practical way to further the commitments made at the G20 meeting.

- The Chancellor agreed and added that it was important to maintain momentum at the domestic and international levels.

In view of the forthcoming bank remuneration announcements expected to continue through February and the report of the FSB's Thematic Review, expected in March, the Council agreed to review developments again at the next quarterly Council meeting.
.

ITEM 3: RECOVERY AND RESOLUTION PLANS

The FSA Chief Executive noted that there had been good progress to date on this work. The FSA were in the process of running a pilot scheme with four firms. All four firms were engaging constructively and work continued on schedule.

The following points were made in discussion:

- The FSA Chairman explained that there were two reasons for undertaking this work: first, to provide a mechanism to prepare for orderly bank resolution; and second to identify plans which make it more likely that firms could recover from financial stress, avoiding the need for resolution.

- The FSA Chairman noted that there was a trade off between doing detailed analysis of all the factors that might affect resolution processes and holding more strategic discussions with the banks focused on the major steps which could be taken to increase resolvability and the ability to recover from stress. The FSA Chairman, Governor and the Deputy Governor thought that it was important to identify and remedy the structures and other factors within each organisation that currently make resolution difficult. It was therefore important that discussions on this topic took place at senior management levels within the banks, and did not become too focused on detail. In order to remove the implicit guarantee and address the issue of moral hazard, it had to be clear to bank management, executives and creditors that the authorities would be willing to take action to enable orderly resolution. The Chancellor stated that it was important for the banks to understand that it was as much in their interest as in the interest of the authorities to have the plans in place. He said that ensuring recovery plans are in place was of the utmost importance.

- The FSST acknowledged the importance of UK work being aligned with international developments but thought that it was equally important for the UK to influence the international debate. Progress had been made on resolution of investment banks at an international level, including through the Government's latest consultation paper entitled 'Establishing resolution arrangements for investment banks', which should make the UK a more attractive place to operate. Paul Tucker noted that a key forum for this work was the FSB's Cross Border Crisis Management Working Group, which was currently facilitating an exercise with the 25 or so largest banks in the world.

The pilot firms were scheduled to submit draft recovery and resolution plans to the FSA by the end of the first quarter. Therefore, the Council agreed to discuss this topic at the next quarterly Council meeting.