

Bank of England

Financial Stability Report Q&A
24th June 2011

Jennifer Ryan, Bloomberg News: I wanted to ask you about your assessment of the risks to the UK from the euro area debt crisis. Does your assessment assume that Greece avoids default? And does it assume that banks now have enough capital to weather a default by Greece or any other country in Europe?

Mervyn King: As I said in the opening statement, the direct exposures of UK banks to Greece are really remarkably small. There is a chart in the Report, near the beginning - page 19, 2.4. And you can see these give the range of exposures of UK banks as a percent of core tier one capital for a range of European euro area countries, both for their exposures - for each country you've got two bars - one exposure to public sector and bank lending and the other for exposures to non-bank, private sector in those countries.

If you look at Greece, left hand side of that chart, the direct exposures are really very small indeed. Now the difficulty here is that there are indirect exposures, as I said in the opening statement. UK banks, you can see from this chart 2.4, are quite heavily exposed to France and Germany. If banks in France and Germany, to which they have exposures are themselves exposed to Greece - and clearly their exposures are much greater than that of UK banks - then there's an indirect exposure. And if UK banks are exposed to banks in France which are themselves exposed to a bank in Germany, which is then exposed to Greece, that's another indirect exposure.

And there's an infinite regress here. So if you remember your days of input output studies, there's a matrix capital A reflecting this, you can work out that $I-A^{-1}$ will give you the impact of all these direct and indirect exposures; just as you would do in calculating an effective exchange rate, inverting the matrix for an input output system.

And that's the mechanical link. That will give you mechanical exposure of banks to possible consequences of default of any particular percentage in any of the other euro area countries.

But I don't think that's the main issue here at all. The main problem is that, even if you could calculate some mechanical exposure in this way, at present they can change very rapidly. This matrix changes from week to week. And that at any given point there is always uncertainty about the scale of exposures and which counterparties out there are the ones which are heavily exposed.

And that uncertainty can lead, at various points, for the funders of banks - people who are willing to think of funding banks - to draw back. And there can be a crisis of confidence and sentiment in which people just say - I simply don't understand the complexity of the interconnectiveness of these exposures, and just won't take the risk of lending.

And that is the bigger risk I think. It's not - the direct links you have to monitor very carefully, and there's no reason at all for us to be concerned about the exposures of our banks directly to those countries that could be in serious difficulty. But it's the indirect exposures and the generalised loss of confidence that could result if there were serious problems.

There is no way in which you can do a mechanical calculation to work that out. What you have to do is to keep suggesting and probing, not only our banks, but try to encourage those responsible for dealing with this problem, to go to the heart of the problem, to resolve the underlying tensions in the area that are creating the concerns in the first place.

But the direct exposures to Greece of UK banks are far too small, even if you take into account the exposures to, not just Greek sovereign, but also banks and the non-bank private lending as well. The direct exposures are very small.

Michael Robinson,
File on 4, BBC Radio:

The Committee's made it very clear your view that the complexity and opacity of synthetic ETFs could pose a risk to the financial system, yet you are recommending more monitoring. Given the risk, isn't it worth the regulators considering some restriction on the use of swaps and derivatives, these complex instruments, inside ETFs? Isn't that an easy win?

Mervyn King:

Well, obviously the Committee at present cannot issue directions to regulators; that's a power that will come when the legislation is passed and takes effect at the beginning of 2013. But I think it's important to recognise that the initial objective of ETFs was a very good one; it was to enable many investors to be able to invest in a wide range of shares and index in such a way that they would reduce the transactions cost that would be associated if they tried to diversify their portfolios themselves. And that's a very welcome and beneficial development for investors.

And where the company in which the original investor puts their money simply holds holdings of the underlying shares, then there's no problem. It is the use of that to engage in collateral swaps or to take risks, which means that the investor in the ETF is exposed not just to the risk of the index to which he or she thought they were exposed, but is also has a counterparty risk to the institution running the ETF fund.

Now that is the principle involved, and we have said very clearly in this recommendation that we want the regulator to look carefully at this in order to monitor whether certain aspects of this

use of the funds invested in ETFs are being directed towards opaque and complex funding structures. It's not that we want a blanket ban on them, but we do think that this has to be monitored. And I think the principle of what the Committee is trying to achieve is very clear in the recommendation; it is now up to the regulator to look at that.

So perhaps I could ask- can I say in general all of these recommendations have been accepted by FSA. After all, Hector and Adair are on the Committee, and we can debate with them, and discuss what the actual practical steps the regulators will take. So perhaps we can ask Hector to say something about how this can be done.

Hector Sants:

Thank you, Governor. Just to reiterate the opening point that we're fully supportive of fully implementing all these recommendations of the Committee.

On the particular point of ETFs, I should make the point that in general the main banks which are in that marketplace are located outside our immediate regulatory net, so I think the right transmission mechanism here to address these risks is through the European structure, through ESMA which is the new European regulator responsible for the securities market. And we will indeed be actively pushing, through the ESMA process, suggestions that proposals that the rules should be tightened, particularly in relation to the synthetic ETFs which, as the Governor has explained, I think is our principal focus here.

And indeed personally I think there are grounds to be saying - which is a consumer protection issue - but from the investor's point of view, the retail investor's point of view, I think there are question marks over whether synthetic ETFs really are appropriate for all types of the retail marketplace.

Adair Turner:

Can I just add one key point to that. I think it's important to understand, under this issue of ETFs, there are both issues relating to what we would call conduct and consumer/investor protection to the investors of these adequately understand the risks, and there are issues relating to the prudential risks that are created for the banks involved in this, where the particular categories of devices that they are using here, which essentially enable them to create mechanisms to fund themselves, are part of a wider set of issues to do with the way that complicated swap and secured lending markets can be used to create funding for banks. And as we go forward we will look at both of those categories of things, and particularly on the conduct side, as Hector has suggested, we will look at the full range of possibilities. That could include concluding that some categories of synthetic risk are not - ETF - are not appropriate for retail investors.

On the prudential side we have to look at it very carefully and in an integrated fashion with all the other complex ways that banks can create funding.

Mervyn King:

There's a very good box on pages 14 to 15 of the FSR which explains the synthetic and the direct instruments used for stock lending too.

Chris Giles, Financial Times:

Can I take you back to the European sovereign debt crisis which is clearly the biggest risk out there for financial stability which the document highlights? If British banks are like a sandcastle on a beach, and you want to have some more transparency, you build some scaffolding round them, making them a little bit more secure so they might withstand an earthquake. But out there there's a huge tsunami coming of a confidence crisis, which comes after a blow-up in the euro zone. What advice or what help - your scaffolding will have no effect whatsoever. What is it

that the euro zone should do to ensure we don't get the earthquake in the first place?

Mervyn King:

Well I'm not going to give a model for the euro zone to decide how to deal with it, but I make one general comment which is - right through this crisis, from the very beginning when we were concerned about financial institutions, right up to now when we're more concerned with sovereigns, an awful lot of people wanted to believe that it was a crisis of liquidity. It wasn't; it isn't; and until we accept that, we'll never find an answer to it.

It was a crisis based on solvency or, to be more precise, the build up of very large amounts of debt where concerns crept in about the ability of the borrowers to repay that debt - initially financial institutions, and now sovereigns. So whatever is the answer, provisional liquidity can buy only time. That time has to be used, it has to be used to go right to the heart of the underlying problems, and in the case of sovereign debts it needs to recognise that any country with a significant amount of external debt has to find a way of servicing that debt.

And there are basically only two routes. One is to receive gifts or transfers from other countries that will enable the country to continue running a current account deficit and yet be able to service the debt, or there has to be a mechanism for finding a significant improvement in competitiveness, which enables that current account deficit to be turned into a surplus so that the external debt can be financed.

Now there are different ways in which this can be achieved in practice, but those principles are the ones on which a solution has to be based. And simply the belief that, oh, we just lend a bit more will never be an answer to a problem which is essentially one of solvency. It can buy time, and at opportunities like this,

maybe that time is useful, but only if it is used to put in place a more fundamental solution.

Now that's I think a position which everyone would agree on. The reason why it is difficult to handle the crisis in practice is not so much because of a failure of crisis management, but because the different actors involved have different views about the right long-run solution.

But that's the challenge - to come to a view about what is the right long-run solution and to put in place a transition to it which will give confidence to markets that ultimately this problem will indeed be tackled.

Tadhg Enright, Sky News:

You speak of the importance of in good times having banks build up their capital reserves at the expense of shareholders and potentially employees. Given that we as taxpayers in the case of RBS and Lloyds all have an interest in the welfare of shareholders and the ultimate hope of getting a profit on our investment in those banks, and perhaps using some of that profit to pay off the deficit, would you suggest that perhaps it's compensation for employees and compensation in the form of bonuses that should be first in the firing line in this effort to build up capital?

Mervyn King:

No, I don't think we would draw a conclusion about that. I think our focus is very clearly on the need in good times to build up capital. I don't think that's to the detriment of shareholders - far from it. I mean, whether a bank pays out the money to shareholders' dividends or puts it back into the bank, either way it still belongs to the shareholders.

The point that we're making here is that when times are good, that is no moment to be complacent about the need to build greater

resilience and build up buffers of capital above the regulatory required minimum.

And the point of doing that is that there will be times when times aren't so good. And you will then want to be able to run down that buffer in order to maintain lending. And we are not suggesting in any way, shape or form that banks get to the new Basel minima faster than is in the transition put in that new framework. In fact the UK was a country that took the lead in arguing for a long transition to the Basel requirements, precisely to avoid putting undue pressure on banks to deleverage too quickly and hence damage lending.

But in the period between now and say 2019 there will be some good times and some bad times, and when the good times come that's the moment for banks not to relax and say - oh let's just pay out a big dividend and a lot of compensation, but just to remember that times won't always be good and to make sure that that money is ploughed back to build up stronger capital buffers.

And I think that the regulators can play a very important role in making sure that banks know that if they heed this advice they won't be the only bank heeding this advice; they won't be on their own. And that's quite important, encouraging banks to make sure that this is a sensible strategy to follow.

David Enrich, Wall Street Journal: I'm wondering exactly what you'd like to see in terms of enhanced disclosures from banks about their sovereign and banking exposures, and how that goes above and beyond what the banks are already doing, and what they'll be required to do as part of the current stress tests?

Paul Tucker: The first step will be disclosures, when the EBA stress tests are published. And the question for us and for every other country in

Europe will be whether those disclosures go far enough, and it's too early to judge that yet. But the standard is not what banks have been publishing to date; it's what is needed to provide reassurance and much greater transparency around the complex web of exposures.

As the Governor said earlier, and going back to Chris's question about the threat of a tsunami, the worst possible outcome would be a crisis of confidence that was more severe than it needed to be because of insufficient transparency about the resilience of banks. And you can see two of our recommendations as fitting together. We are saying that, while the weather outside is so threatening, when the banks earn good profits, tuck a bit more away because of that inclement weather; and secondly, be transparent about their exposures so there isn't an unnecessary threat to confidence if banks have got a good story to tell.

And of course going forward, if it's understood that banks should be more transparent about their exposures, then in the generality of things banks will be more careful about the exposures that they take on.

Peter Thal Larsen,
Reuters Breaking Views:

Just to push you a bit on that question of capital retention, we've been talking about this for a couple of years now, and arguably as far as banks are concerned, they have had a couple of good years, and maybe this capital retention hasn't gone quite quickly enough. It seems to me you have a sort of collective action problem.

And I wonder, beyond making generalised statements, you seem to have discussed in the Committee this idea of having a kind of cap on dividend distributions. I can see the arguments for and against that, but should you be trying to at least trying to state

publicly some sort of goal or at least communicating in some sort of public way what is a desirable level of distribution?

And is that going to be lower than it was - your opening statement implied that you wanted that to be lower than it was before the crisis.

Mervyn King:

No, one of the reasons for this statement on recommendation is - relates to some words that you used - a collective action problem. And we can't be certain there's a collective action problem, but there certainly seems to be good reasons to suppose that there might be; in which case a very clear public recommendation from the FPC, which in future would be a direction, but is now just advice, accepted by the FSA, should give comfort to banks that if they pursue this strategy they won't be on their own.

Now the reason for not wanting to put a numerical limit on either compensation of dividend pay-out ratios is that the objective here is not dividends or compensation, it's the obverse. It's the retention of capital. So what we want to do is to focus on the need to put capital in. Now what that means for pay-out ratios or compensation is bound to vary from bank to bank. And the idea that you could have some kind of uniform numerical limit here would not take into account the circumstances of each bank.

That is what Hector and his team will have to do when having their conversations. And that's what they should be doing, and they will. But it doesn't make sense I think to try and put in place an arbitrary numerical limit. What matters is to focus on putting in the capital. That's what we're interested in. We're not interested as such in constraining dividends or compensation; that might be a by-product in some cases. But what we are interested in is taking advantage of good times to build up capital.

Adair Turner:

Can I just add one thing to that which is that there is a good argument against certainly having any permanent rule on dividends versus retention, which is - there has to be a level of capital ratio which, once it is achieved, you would then be perfectly happy for a high level of dividend pay-out. And so anything about a constraint on a dividend pay-out rate has to be as part of a transition to a high level of capital. Otherwise in a different point of the cycle we could be in danger of creating strong incentives for over-rapid balance sheet growth because you would be telling a bank that there are no circumstances in which it should pay out its profits as dividends; it has to put it into more capital. In which case you'd be creating incentives for it to always expand the balance sheet.

So the appropriate approach does have to vary through the cycle, and it also, as the Governor says, has to reflect the significant heterogeneity of the present position of our banks in relation both to what their current pay-out rates are and where their capital is. And it's fairly obvious that you'll look at it, but if you start with a situation where some of the higher pay-out rates are banks which are relatively high in capital, it would be slightly odd to produce a one quantitative rule. But we think it is quite workable for the FSA to take this principle and in our detailed engagement with banks to help overcome the collection action problem by making sure that they are all thinking, and they're all simultaneously thinking, about the need to retain capital in good years so that there is this buffer that they can keep on the path to Basel III, even in bad years, without that taking the form of deleveraging and constraining lending.

Sam Fleming, The Times:

Could I ask a question about forbearance? Your box on this says that more information is required about the extent of forbearance and methods employed and associated provisioning practices. It's quite striking how little we actually know about this. How did

we get to this point effectively where we seem so ignorant about the extent of forbearance? And is it possible at this stage, given the information we do have, to say which particular sectors of the economy this is most acute a problem in?

Mervyn King:

Let me ask Andy Haldane to answer first, and then perhaps Hector could comment on the FSA perspective.

Andy Haldane:

Two parts to that question, so on the issue of how did we arrive in this state, I think one of the things we say in the report is that it's likely that the extent of forbearance has been somewhat greater over the last few years than it may have been hitherto. So to some extent forbearance will always have been with us, but in a low interest rate environment, with collateral values having fallen as far as they have, I think it's more likely that incidences may have picked up. And that's certainly in line with our anecdote and our conversations externally.

In terms of the sectors which might be particularly subject to this, the FSA survey which, Adair, I'd hoped you might speak about, spoke to the mortgage market. I think in the Report we speak about some of the evidence we have on forbearance within the commercial property market, which strikes me as very likely given how far collateral values have fallen. The estimates there suggest anywhere between 30% and 80% of loans could be subject to some degree of forbearance.

But outside of that the corporate sector more broadly, small businesses, I think there's an unanswered question - no more than that - an unanswered question about how widespread it is there too. I should say, just for completeness that, as the Governor said in his opening statement - this is really as much or more about provisioning for loans for which there has been forbearance as it is about forbearance itself. It's perfectly

legitimate to cut a borrower some slack - it may make sense for both borrower and lender. But in doing so the firm needs to be cognisant of the risk; it has importantly to set aside some money in impairments for that risk.

Hector Sants:

Yes, maybe it's just to re-emphasise if I may that last point. The issue is not per se forbearance, and indeed in the mortgage market, in the retail mortgage market, that clearly brings benefit to consumers. It is a question of the balance between forbearance and the right level of provisioning.

In terms of your question as to - how has this problem emerged - just to again echo and give a bit more colour to Andy's remarks there. This is a problem which has primarily emerged since the crisis and since the recession. So I think we see this as a problem in relatively recent years, and we did therefore commence work in the area that looked the most likely to have problems and issues with, which is the mortgage market. We commenced that work in 2009 as these problems began to emerge, and we published in May of this year, 2010 [sic], the work we'd done in that area which we deemed to be the most at risk.

I think that work, however, quite rightly, does demonstrate that there is a question. There's a question as to whether there are problems elsewhere, and therefore I think we are very supportive of the Committee having come forward with the recommendation that we should extend that work into particularly the corporate market both in the UK and indeed globally in respect to UK banks. So that piece of work will now be carried out over the coming months. But it builds on the earlier work that we published in May.

Jill Treanor, The Guardian: As you know there's been much talk in the market that the Greek crisis is actually the next Lehman moment, do you think that when you talk about loss of confidence you're actually concerned that there is a new Lehman moment in the market?

Mervyn King: Sorry, a new -?

Jill Treanor, The Guardian: Lehman, Lehman.

Male: Lehman moment.

Mervyn King: Well, I don't like to use that phrase because I'm not sure that the sovereign crisis now and what happened in the case of Lehman Brothers have much in common, other than the fact that it's a mess. But what is relevant here is - just focusing directly on the fact that if there is uncertainty about exposures and a lack of transparency, and people simply do not know which other institutions could be at risk because of their direct and indirect exposures, then there is always the risk that people may feel it's just not worth continuing to roll over funding to institutions if there is that degree of uncertainty.

And that's why in response to Chris Giles' question I said that what matters more than anything else is to set out a very clear map for what is the long-run solution, so that it is then possible for those in financial markets to think through the consequences of that and to work out where the risks may lie. And it's the sheer uncertainty of knowing which direction things will go that creates the risk, no more than that. But it is one that is quite difficult to protect against, other than decisive action to set out a course to deal with the crisis. And as I said, right through this crisis, from 2007 onwards, that decisive action always had to be to deal with the solvency and not the liquidity aspects of it.

Michael Watt, Risk:

You mentioned that - a couple of times so far, I just wanted to get your thoughts on how the banks - how you feel the banks in the UK are progressing on the implementation of Basel III and also on the capital and liquidity standards especially? And also, whether the Committee is concerned by international divergences on those standards. I'm particularly referring to the recent CRD 4 Draft from the EC which pursued quite a different - or quite a significantly looser standard of liquidity of highly liquid assets in the LCR, the liquidity covered ratio and the contention by some market players in the US that European banks are quite lax on their calculation of risk weighted assets?

Mervyn King:

Well there are lots of different aspects that are wound up in that, and in a minute I'll ask Adair to comment on the position of UK banks. Both he and I will be going to Basel this weekend to carry on the discussion of this in terms of the meeting of central bank governors and heads of supervision.

There is a concern I think that we have in Europe that there will be, or could be, attempts to try to prevent the United Kingdom from imposing the level of capital requirements that we think is necessary to make our system safe. Now obviously in a single market there's a very strong case for having a minimum capital requirement, and indeed there's a very strong case worldwide for having minimum capital requirements. That's how we got into Basel I and that's what the basis of the Basel II and now III discussions were all about.

But right through those discussions there was never any suggestion that if a country felt, as clearly some already have, like Switzerland and Sweden, that if those countries felt that they needed to impose higher capital requirements to make their system safe, that was not in any way inconsistent with the operation of the harmonised agreement to have minima. The

operation of the single market requires a common minimum; it does not require a common maximum.

And I think this is an argument that is being debated, the Commission have not made up their mind yet and I very much hope that when they publish their proposals they will take account of the views expressed by, I think, a growing majority of countries in Europe, that it is appropriate to have harmonisation on the minimum, but not on the maximum.

Let me ask Adair to comment on the UK banks.

Adair Turner:

Well I'd like to make two comments on the UK banks, but first of all can I pick your point up about the risk weighted assets point of view. Within Basel III a lot of work was done on the capital side, both in relation to the definition of the numerator of what we count as capital and obviously in relation to what the minimum ratio should be in the conservation buffer, etc, and we have further work to complete on that in terms of the ratio as it relates to the capital surcharge for systematically important banks.

But I think as we've done that, we have increasingly realised that the issue of the definition of risk weights is incredibly important. The integrity of this whole system depends on us really being confident that when we rate something as risk rate 0.25 in an American bank, thus the equivalent risk in a Brazilian bank is also at 0.25 and in an Indian, and a German, and a UK, etc. And I think we've all realised that the processes that we have for ensuring that - we need to place a lot of attention to. And therefore I think there is a major project for the Basel Committee and the international authorities to really focus on the commonality of risk weights.

Now I think what one has to be wary of in this area is simplistic points which are sometimes made which draw attention to differences between total leverage - gross leverage ratios - and risk weighted capital ratios at the level of a whole banking group. And you say, well Bank X appears to have average risk weights of 0.25 and Bank B has average risk weights of 0.5; isn't something funny going on there?

You can't really do this analysis at the level of an overall banking group, because there may be very, very major differences in the categories of assets. What you have to do is dive in and compare what are the risk weights for comparable categories of assets, for mortgages of a certain quality, for commercial real estate loans of a certain quality. And that is the exercise that I think we need to do, and I think it is a major priority which is now being put on the table for the Basel Committee to take forward.

As for the position of the UK banks, I think both on capital and liquidity we feel good about the progress towards the Basel III standards. You can see that in the figures, particularly on capital, the capital positions have hugely improved. There is more progress to go because you can't just focus on the ratios. Because of the changing definition, the tightening of the definition of the numerator, even some of the banks that look as if they have a higher ratio have more to do, but overall we are happy about that progress.

On terms of liquidity, very significant improvements have been made in the liquidity of our major banks, both in the sense of building up various categories of liquidity buffer under our existing regime, and indeed repaying the Bank of England's Special Liquidity Scheme.

But there is more progress to be made there, it varies significantly by banks - but again there is more progress to be made. We are holding them to standards today, in our own regime which we believe are reasonably equivalent to the LCR which will emerge, but we're also confident that with further steps they can meet that LCR, but in some cases there is more progress still required; but we are confident that they will progress to those higher standards over time.

Brooke Masters, Financial Times: Back to forbearance. Since the problem with forbearance is not the fact that you're helping out borrowers, but whether the banks are adequately provisioning, what can you tell us about what your look at the residential mortgage market told you about provisioning. Are banks that are using forbearance making adequate provisions?

Mervyn King: I'll ask Hector to answer that, but I think the key point to focus on is not residential mortgages, but commercial property, that is where we think the problem is likely to be the most severe. Hector?

Hector Sants: Yes, so as our work has shown our principal concern is more at the level that we are not comfortable that their systems and controls are adequate to necessarily ensure that they are addressing this problem in a consistent and an informed and considered way as they should. So if you look at our May document you'll see a series of recommendations which we've made to them, to ensure that the framework whereby they manage this process is more robust in the future than it has been in the past.

Obviously the concern has to be that if the framework isn't as robust as we would like it to be, that there may be some gaps and some issues, but as the Governor said, I think our feeling is that in

the context of this Committee, i.e. are they systemic risk, are they putting the soundness of the individual institution at risk? No, but this does certainly merit the need for further work to identify whether there are problems in other segments.

Trond Sundnes,
Norwegian Business Daily:

A question about transparency, it seems to be important in several of your recommendations here. Would transparency, greater transparency in the financial markets, could that avoid, or at least minimise consequences, the effects of future crises?

Mervyn King:

Well, greater transparency will help. And I think one of the problems that arose in the financial crisis, both with individual institutions and now with sovereign debt, is that the risk that people will suddenly withdraw funding is increased if there is rather little transparency about the exposures or the assets on the balance sheets of the people to whom they've lent or were used to funding.

I think it would be naive to think that there is a magic answer here, because one of the things that occurs in financial crises is that people's beliefs about the underlying values of the asset can change very radically. And that means that your perception of the solvency, or the risk of levels of indebtedness can change from being one in which you are rather sanguine about the levels of indebtedness to one in which you suddenly become very concerned. And if that is a common change of perception in the minds of investors then you will simply see a run-out of the flow of debt finance to the indebted institutions.

So I think we feel that transparency will help, but in the end there is always going to be a risk if you have fairly high levels of indebtedness, and there always needs to be a recognition that if you are justifying high levels of indebtedness on the basis of

current asset values, just be very aware of the fact that current asset values can go down as well as up.

Ben King, Channel 4 News:

If you're getting tougher on banks which offer forbearance, will that make it harder for them to show forbearance to their customers?

Mervyn King:

What we've been saying is we're not being tough on banks that show forbearance; we want to make sure that where banks do exert forbearance, that they are taking proper account for that in their provisioning and in their profit and loss accounts. What you don't want is for banks to engage in what might seem a sensible forbearance strategy, but then at the same time to admit the need, to recognise that one of the side effects of that forbearance strategy may be that they ought to be putting aside money to account for expected losses in the future. And our point here is that we need to know more about the extent to which banks are indeed provisioning, in the context of forbearance, and we don't know very much about that.

Jennifer Hughes,
Financial Times:

You talk in the recommendations about the need for the FSA to monitor closely the risk associated with opaque funding. Now, are you talking about deliberate opacity on behalf of banks in the way they're doing their funding? And how exactly do you propose to monitor that and keep an eye on it closely?

Mervyn King:

There's a rather good box in the report which gives examples of how that opaque funding structure can come about. But let me ask Paul Tucker to speak to that point?

Paul Tucker:

It's a very broad thing about opaque funding markets, many of you will recall that one of the things that happened during the financial crisis was that, not only banks, but insurance companies

and other asset managers have loaned out low risk bonds for cash and lent out the cash against higher risk collateral, or invested that collateral. And that was used as one of the prime funding markets for the dealer community in global financial markets. And there is almost no transparency around securities lending, or collateral swaps.

And a particular example we've focused on here because of its rapid development has been the way in which ETF portfolios are being used to help fund banks and help fund others. And it's immensely hard for the supervisors to get an aggregate picture of what is going on in maturity transformation in the banking system and in the shadow banking system without a bit more daylight around these markets and a bit more structure around these markets. As the report explains there is a general concern about complexity and opacity and interconnectedness. One manifestation of that is in funding markets and one manifestation of that is in the exchange traded funds market.

Paul Amery, Index Universe:

Governor, you just made the point that, other things being equal, the level of leverage of the banking system, the higher the level of leverage the greater the risk of something going wrong. At the same time, politicians have made it clear that they don't want to see the banking system as a whole reducing lending. So aren't those two objectives to reduce the risk in the system and to maintain lending levels diametrically opposed?

Mervyn King:

Well they're not necessary diametrically opposed but they clearly create tensions. And that's one reason why one has to accept that in a period in which the banking sector is deleveraging it's not likely to be a period in which they're going to be enthusiastic about expanding lending and hence their balance sheets. They're trying to reduce the size of balance sheets and that's exactly what they've done.

The point of the recommendations and the advice in the Report today is to say that there is a path, set out in the Basel Agreement, along which banks should meet their new capital minimum requirements. And what we're saying is that, over and above that, you can do better than just rigidly following that transition path, irrespective of circumstances, and that it will be better if banks take advantage of good times to be slightly ahead of that schedule. So that if times are not so good later on that they don't have to go as fast as they otherwise would, and will in that more distressed set of conditions be able to support lending.

And that is a phenomenon that we think is applicable, not just over the next few years in the transition to the new Basel arrangements, but is a permanent feature of what we'd like to see. And this is part of the counter-cyclical attempt to suggest that banks put money in when times are good, in order that they will be able to run the buffer down when times are not so good.

Adair Turner:

Can I just add one point on the issue of leverage versus lending to the real economy? If you look at bank balance sheets, of course a slice of it is lending to the real economy. A very significant slice is a set of complex inter-linkages within the financial sector from one bank to another. And there therefore is within this concept of deleveraging from an over high leveraged state, seen from the real economy point of view there's a sort of good deleveraging and a bad deleveraging. And one of the aims of regulatory reform, through for instance the reform of trading book capital and also the proposed gross leverage ratio is to lean against some of the, perhaps unnecessary, proliferation of the complexity of intra-financial system claims, which have expanded gross leverage without necessarily expanding the role of lending to the real economy.

Harry Wilson, Daily Telegraph: You state in your report that there's a chance that the published accounts of banks have been overstated. This seems to speak to a wider point on the transparency, but to what extent is there - I guess an information deficit in the market at the moment - a sense that perhaps investors and why the funding markets just don't have a clear picture of the financial health of the banking system?

Mervyn King: Well this is certainly part of the area that we are talking about today, and are clearly focused on and will come back to. But on today's recommendations let me ask Andy Haldane to say something?

Andy Haldane: This speaks to two of the recommendations at least in our Report, that around disclosure and that around forbearance. It is the case that much of the increase in banks' profitability, not just in the UK, but internationally, over the last year or two has been driven by lower impairments, but that more than fully accounts for the increase in UK banks' profitability during the course of last year.

We are not in a position, I think, to say with any certainty that those impairments which have been taken have somehow been systematically under recorded. As others have said, there's a degree of fog around the forbearance question and as much fog around the provisioning against those forborne loans as well. So that speaks to our second recommendation which is trying to remove some of that fog to get a better sense, as Hector said, of whether those loans which have been forborne, and where there is some latent risk, to ensure that those have been adequately set aside some provisions for.

So we don't have clear evidence on this and one of the recommendations speaks to getting some greater evidence, so

that both we, and the market as importantly, has clarity that the published profit position and capital position are truly robust.

Hector Sants:

By the way, the other element of the FSA work which we're proposing to put in place which relates to this is to put in place a mechanism to ensure that the banks can effectively track this internally and report it to us in the future. So I think the other element of the work here is to make sure that the regulator has good visibility of these risks going forward, so if they do become prominent then action can be taken.

Jason Douglas, Dow Jones:

Just to return to your disclosure recommendations, how credible do you think the European stress tests are, given that they don't even require banks to assume a sovereign default?

Mervyn King:

Well I don't think that in itself, you know, poses threats to their credibility because the banks will be asked to publish the information so that you and others will be able to run your own stress tests and add in the affect of exposures to sovereign borrowers.

Clearly there are challenges in doing these stress tests, some banks in some countries are more enthusiastic than others about being open and transparent about the position of their banks. I think all we would do it give very strong support to the EBA and Andrea Enria who is working very hard to make sure these stress tests are indeed credible. And I have great confidence in him and his team. There is a peer review exercise for the first time in which supervisors from other countries will be looking at the books of the banks to make sure that the stress tests are indeed credible. And a great deal rests on this. It is very important that these stress tests, to be published in the next month or so, will indeed be credible, and I would give very strong support to

Andrea Enria in his efforts with his EBA colleagues to make sure that they are.

Facilitator: I think we have time for perhaps one more.

Jennifer Ryan, Bloomberg News: Can you tell me was the vote on each of these six recommendations unanimous and if it wasn't, can you tell me what the dissent was? And if there is dissent in the future will you publish who voted how?

Mervyn King: Right, well let me tell you how the procedure works. In the draft bill it says that the chair is to be taken by the Governor of the Bank; the person chairing the meeting must seek to secure that decisions of the Committee are reached by consensus wherever possible. That means that no one must dissent from the decisions. Where there is no consensus, that is that one or more people dissent from the decisions then a vote is taken of all those members present at the meeting and that vote would be published in the Report.

So the fact is we didn't need to take a formal vote because nobody on the Committee dissented from any of these recommendations; everyone agreed. But in future if there were to be a dissenting voice then that would be a definition that there was not a consensus; there would then be a formal vote, and that would be reported, with names, in the report of the meeting.

Facilitator: Nils, were you trying to ask a question? Okay, last one I think.

Nils Pratley, Guardian: Just on provisioning and impairments again, obviously you're seeking more information, clear information. And I just wondered, is it possible - because you draw attention to the accounting standards, the accounting approach is possibly inadequate - is it

possible that you, the Committee, could advise on a harder, stricter accounting standard for banks?

Mervyn King:

There are many areas in which the Committee could issue recommendations, but I don't want to speculate on where those might be, because that's not for me to do, the Committee will judge that. What I hope you'll see in the record of the meeting is the record of the discussion which led us as a group to move from worrying about the analysis of where all the risks were, to narrow down on this set of six decisions on recommendations that we published today. And that's a very important part of the transparency, to show you how the Committee decided to go from its analysis of - where are the risks? To - which are the areas on which we make recommendations?

But I'm not going to speculate on where we might recommend - on which we might make recommendations in the future, that you will see when I hope as you will you'll return to the next press conference.

Adair Turner:

Can I just add one point on that though, specifically on the issue of accounting methods, we will certainly within the more detailed look on forbearance try to make sure we fully understand the interface between the accounting mechanisms and forbearance. And as you know as the moment IAS 39 does require objective evidence of impairment. And then it's absolutely crucial to understand what is taken as being objective evidence of impairment and if one forbears and therefore there is no failure to pay defined, is that or is that not being caught?

And we will also need to understand how that works very clearly under the existing system and also how it would work under the reforms being brought forward to move to a more expected loss approach in future, which is a major debate that we've had about

moving the impairment provisions to a more forward looking process. So it's certainly an area for detailed analysis within this forbearance project that we'll be doing now.

Facilitator:

Well I am afraid that is all we have got time for, so it only remains to me to thank you all very much indeed for coming.

END