5 Prospects for financial stability

The outlook for financial stability has deteriorated materially since June. Over the past three years, UK banks have strengthened their resilience. But progress in building capital has slowed and recent strains in term funding markets are increasing refinancing risk. The deteriorating situation in the euro area presents the most significant and immediate threat to UK financial stability. Market concerns about the sustainability of debt positions have spread from the periphery to some other euro-area countries, interacting with vulnerabilities in banking systems and a weakening growth outlook. These stresses could lead banks across Europe to tighten credit conditions further, exacerbating an adverse feedback loop of weakening economies and deteriorating bank asset quality.

- Following its recommendation from September, and given the current exceptionally threatening environment, the Committee recommends that, if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months.

- The Committee reiterates its advice to the FSA to encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy.

- The Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.

Sections 1–3 of this *Report* outline developments in the economic and financial environment and short and medium-term risks to financial stability. Section 4 provides an update on previous FPC recommendations and how they have contributed to maintaining financial stability. This section records the decisions taken by the Committee in the light of its conclusions about the outlook for financial stability.

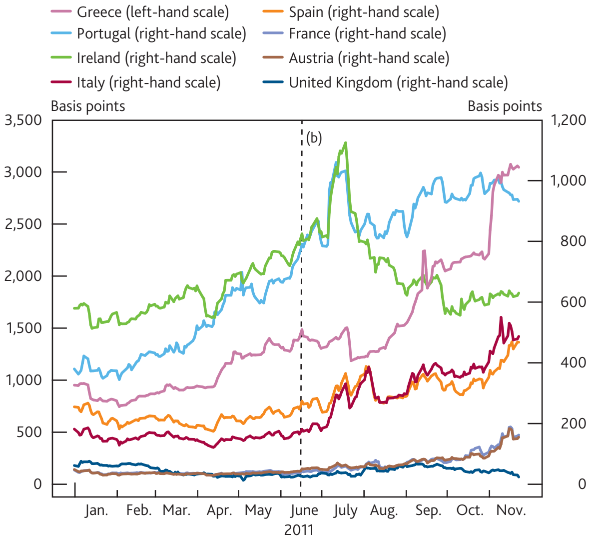
5.1 The outlook for financial stability

The outlook for financial stability has deteriorated materially since the previous *Report*, principally as a result of an intensification of stresses in the euro area.

Risks to the financial system

Sovereign and banking risks emanating from the euro area have intensified and remain the most significant and immediate threat to UK financial stability. Against a backdrop

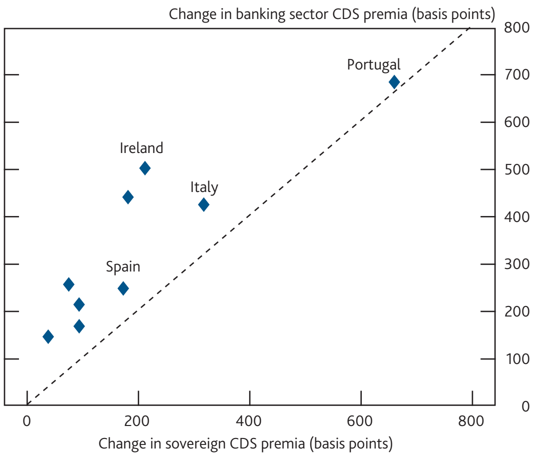
Chart 5.1 Selected European government bond spreads[a]



Sources: Thomson Reuters Datastream and Bank calculations.

(a) Yield to maturity of benchmark ten-year government bond less yield to maturity of benchmark ten-year German government bond.
(b) June 2011 *Report*.

Chart 5.2 Changes in sovereign and banking sector CDS premia[a][b][c][d]



Sources: Capital IQ, Markit Group Limited, Thomson Reuters Datastream and Bank calculations.

(a) The change is measured from 22 November 2010 to 22 November 2011.
(b) The other countries included, in addition to those labelled on the chart, are Austria, Belgium, France, Germany and the Netherlands.
(c) Banking sector CDS premia are asset-weighted.
(d) Five-year senior CDS premia.

of deteriorating global growth prospects, market concerns about the sustainability of external and public debt positions have broadened from smaller euro-area economies, such as Greece and Portugal, to some larger euro-area economies. This has been particularly evident in sovereign bond markets where spreads on some government bonds over German bunds have increased to historically high levels. The spreads on Italian and Spanish debt relative to German bunds have increased by an average of around 260 basis points since the previous *Report* (**Chart 5.1**). Wider contagion effects have also started to be seen, including in Austrian, Belgian, Dutch, Finnish and French sovereign bond markets.

Euro-area banks hold large amounts of debt issued by euro-area governments and, in some cases, are perceived to rely on support from these governments. Partly for these reasons, the creditworthiness of some European sovereigns and many euro-area banks have been closely intertwined (**Chart 5.2**).

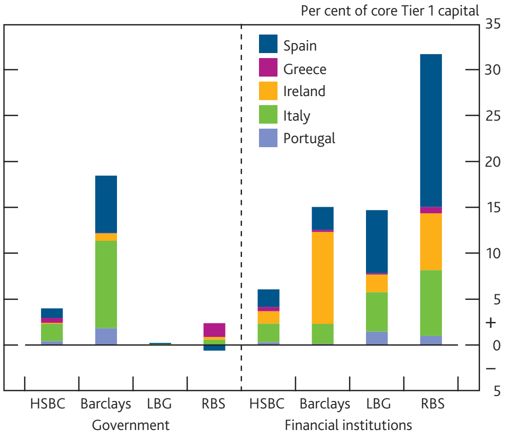
The European authorities announced a package of measures in October 2011 to stem the crisis, including a nominal discount of 50% on notional Greek sovereign debt held by private investors, proposals to allow the resources of the EFSF to be leveraged up to €1 trillion, and an increase in the core Tier 1 capital ratios of European banks to 9%, after accounting for the market valuation of sovereign debt, by end-June 2012. At that time, if this were to have been achieved by an increase in capital rather than reducing balance sheets, it would have required additional capital of €106 billion. Market reaction, however, suggests that there are concerns about how easy it will be to implement these measures and/or how effective they will prove to be. It should be noted, however, that if this calculation were to reflect recent rises in sovereign bond spreads, the implied recapitalisation needs of European banks would be significantly greater.

UK banks' direct exposures to the sovereign debt of the most vulnerable economies are limited (**Chart 5.3**) and fell in Q3. But they have larger exposures to the private sectors of some of the weaker euro-area countries, such as Italy, Spain and Ireland (**Chart 5.4**). They also have significant exposures to Germany and France, which in turn have large exposures to weaker euro-area countries (**Chart 5.5**). A continuing deterioration in the euro area would weaken banks' asset quality and profits. That would also increase uncertainty in funding markets, reducing the availability, or increasing the cost, of term refinancing.

Resilience of the financial system

Since the events of Autumn 2008, UK banks have made significant progress in improving their capital and funding resilience. Capital ratios and the level and quality of capital are all considerably higher than in 2008. Leverage has been reduced (**Chart 5.6**) and wholesale funding requirements are

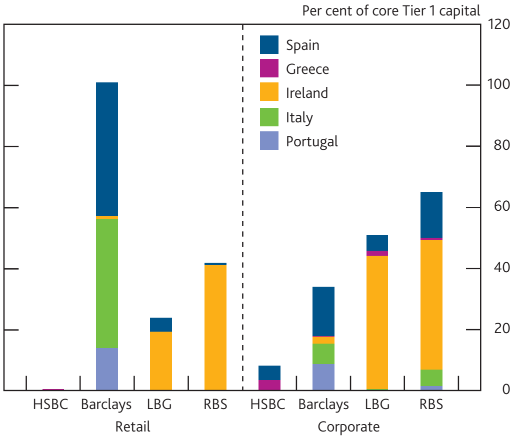
Chart 5.3 Major UK banks' exposures to governments and financial institutions of vulnerable euro-area economies(a)(b)



Sources: Published accounts and Bank calculations.

(a) All data are as at end-September 2011.
(b) Trading book positions are reported on a net basis. Where this results in a net short position, this is recorded as a negative value.

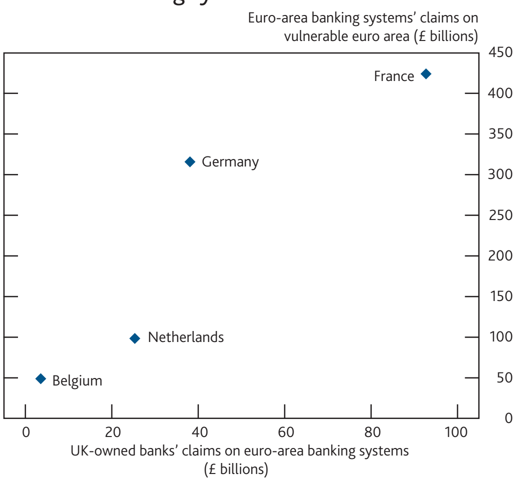
Chart 5.4 Major UK banks' exposures to corporate and retail sectors of vulnerable euro-area economies(a)



Sources: EBA, published accounts and Bank calculations.

(a) All data are as at end-September 2011 except HSBC which is as at end-December 2010. Gross of provisions.

Chart 5.5 Claims on vulnerable euro-area countries via euro-area banking systems(a)(b)



Sources: BIS consolidated banking statistics and Bank calculations.

(a) All data are as at end-June 2011. Converted from US dollars into sterling using end-June exchange rate.
(b) X-axis shows consolidated ultimate risk basis foreign claims by UK-owned banks on the banking systems of selected euro-area countries. Y-axis shows consolidated ultimate risk basis foreign claims on all sectors of Greece, Ireland, Italy, Portugal and Spain by selected euro-area banking systems.

smaller. But progress on building capital in the UK banking sector has slowed in recent quarters. Capital levels over the past year have been broadly flat for the majority of the major UK banks (**Chart 5.7**), with increasing reliance on cutting risk-weighted assets to boost capital ratios. Looking ahead, the outlook for UK banks' profits has deteriorated since the previous *Report*, particularly since the start of October (**Chart 5.8**), which would limit banks' ability to build capital without taking other actions.

While banks met most of their term wholesale funding targets for 2011 earlier in the year, progress in building funding resilience has been set back in recent months. Issuance of term unsecured funding has been very weak since May (**Chart 5.9**). Banks have £140 billion of term funding due to mature in 2012, with maturities concentrated in the first half of the year. At the same time, banks face significant competition in retail funding markets.

Banks' CDS premia have risen for virtually all banking systems. While UK banks' CDS premia generally remain below those of many euro-area banks, they are mainly higher today than in 2008 (**Chart 5.10**). This indicates ongoing concerns about UK banks' solvency and the weakening outlook for banks' profitability.

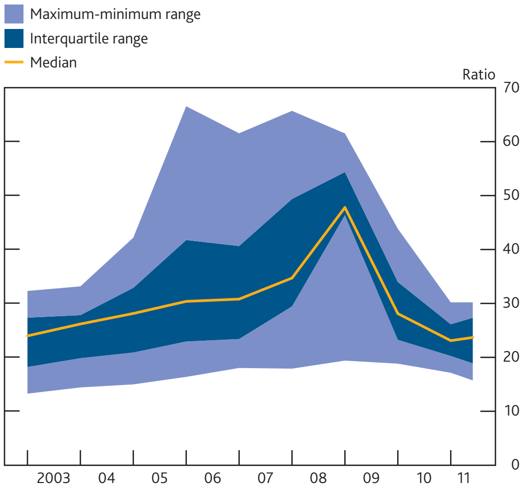
The Committee also remains concerned that the current strains are being amplified by ongoing structural vulnerabilities in the financial system, particularly the high degree of intra-financial sector lending discussed in Box 2. Problems arising from interconnectedness would be magnified if recovery and resolution arrangements for clearing infrastructure were to come under stress. Concerns about capital adequacy continue to be exacerbated by opacity, including overly complex regulatory risk-weight calculations and inconsistent and incomplete disclosure, as discussed in Section 3.

Credit conditions

The current funding pressures facing banks could lead to a renewed tightening in credit conditions for real-economy borrowers. Credit conditions could also tighten if banks' ability to raise capital internally is reduced by higher credit losses, including from exposures to the euro area.

As discussed in Section 2, a renewed tightening in credit conditions appears to be already under way in the euro area. Furthermore, contacts also suggest that some banks plan to respond to the EBA's capital strengthening exercise by reducing assets, through what is described as 'optimisation' of risk-weighted asset calculations (for instance through changes to internal risk models) and through the use of public funds, with only a small contribution to raising capital ratios from new external private capital raising. Deleveraging by banks is likely to lead to a further material tightening of credit

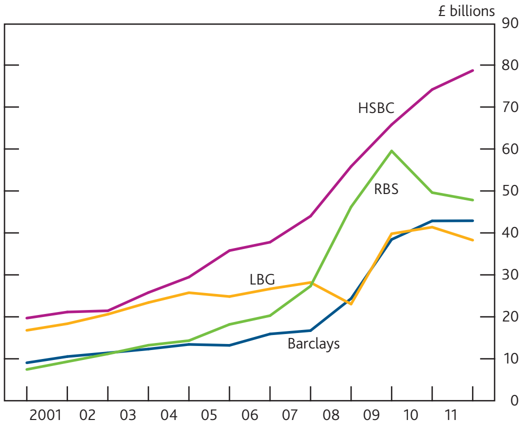
Chart 5.6 Major UK banks' leverage ratios[a]



Sources: Published accounts and Bank calculations.

(a) For explanatory notes see **Chart 2.4**.

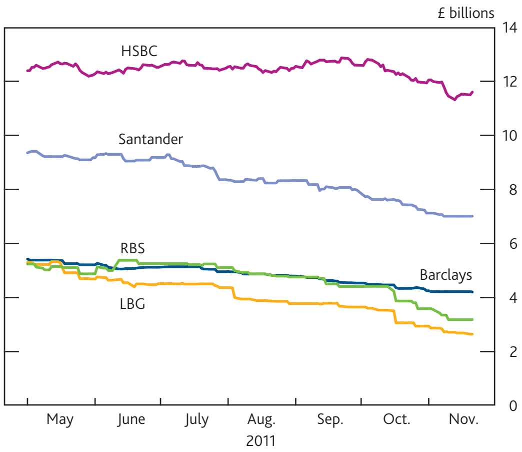
Chart 5.7 Major UK banks' level of core Tier 1 capital[a]



Sources: Bank of England, published accounts and Bank calculations.

(a) 2011 data are as at Q3.

Chart 5.8 External analyst forecasts of UK banks' 2012 net income



Source: Bloomberg.

conditions in European economies, while adjustment of risk-weight calculations may not result in any improvement of underlying resilience.

UK banks have reported that higher funding costs have started to feed through to their internal transfer prices, although, as yet, the effects on loan pricing for corporate and household borrowing have been relatively muted. This comes against an existing backdrop of weak growth of lending by UK banks (**Chart 5.11**), particularly to smaller businesses (**Chart 5.12**). These factors could exacerbate an adverse feedback loop of weak macroeconomic activity and deteriorating bank asset quality, which could ultimately harm the financial system's resilience.

5.2 Mitigating risks to financial stability

This section summarises the policy steps which, in the Committee's view, are needed to help support financial stability in the current environment.

Capital levels

The Committee discussed whether there were measures to mitigate the immediate risk that a further deterioration in conditions in the euro area could lead to a significant disruption to UK financial stability and hence to the supply of credit to households and firms. This could feed back through the economy to increase pressure on the financial system.

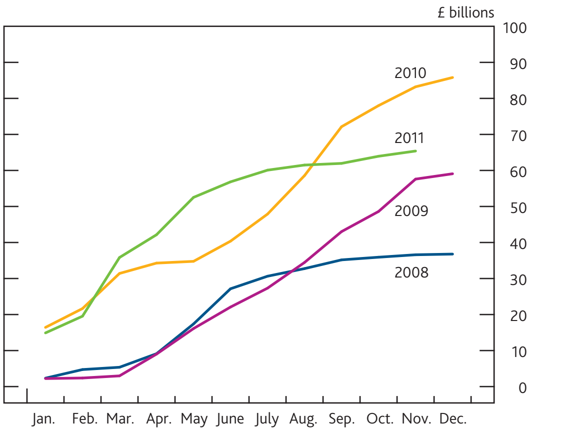
At its meetings in June and September, the FPC had made policy recommendations aimed at encouraging banks to build their capital levels in order to enhance their resilience and increase their capacity to absorb future shocks, without constraining lending to the wider economy (see Section 4 for an update on the progress of previous FPC recommendations). In the light of the exceptionally threatening environment, and the weaker outlook for banks' profits, the Committee judges that stronger action is needed to build the resilience of the UK financial system. There was an increased risk that banks would respond to pressures by accelerating the reduction in their balance sheets in ways that would exacerbate economic or financial fragility. Success in raising capital levels could maintain the confidence of funding providers and the lending capacity of the system.

Recommendation 1

Following its recommendation from September, and given the current exceptionally threatening environment, the Committee recommends that, if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months.

The Committee also noted that the continued use of performance metrics, such as return on equity targets, that

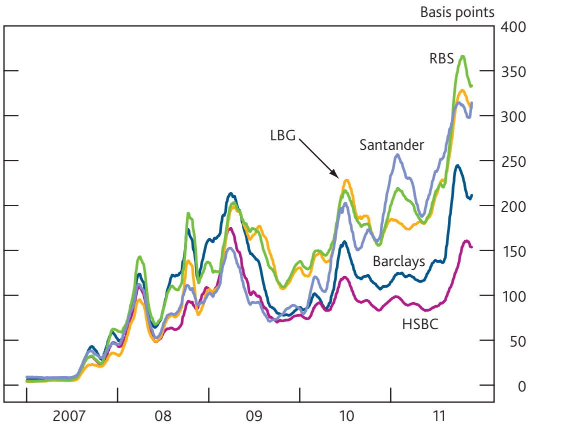
Chart 5.9 Major UK banks' cumulative senior unsecured term debt issuance in public markets[(a)(b)]



Sources: Bank of England, Dealogic and Bank calculations.

(a) Includes securities with an original contractual maturity or earliest call date of at least 18 months issued in all currencies, converted into sterling values.
(b) Excludes securities issued under HM Treasury's Credit Guarantee Scheme.

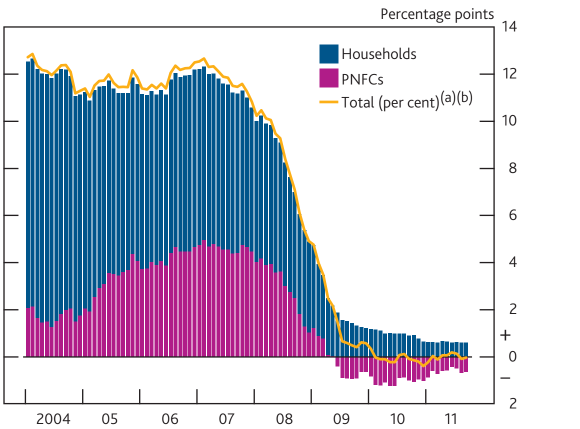
Chart 5.10 Major UK banks' CDS premia[(a)(b)]



Sources: Markit Group Limited and Bank calculations.

(a) Five-year senior CDS premia.
(b) Chart plots a 30-day moving average.

Chart 5.11 Contributions to changes in sterling lending to UK households and private non-financial corporations



Sources: Bank of England and Bank calculations.

(a) Percentage change on a year earlier in the stock of sterling lending.
(b) Growth rates of components may not sum to total growth rate due to rounding.

take little account of the risks taken to achieve them could be distorting banks' incentives to boost their capital levels (as discussed in Section 3). Given the importance the Committee attaches to this issue, it agreed to consider it in greater depth at a future meeting. It would consider, among other things, the extent to which such performance metrics influence shareholder expectations, business strategies, remuneration and other distributions.

Banks' balance sheet management

In the light of the immediate risks, the Committee discussed whether banks could manage their assets in ways that improved their resilience to shocks, while supporting their ability to maintain the supply of lending.

In September, the Committee had advised the FSA to encourage banks, via its supervisory dialogue, to manage their balance sheets in a way that would not exacerbate market or economic fragility. This implied that, where possible, banks should scale back intra-financial sector claims that might be associated with spillovers if risks crystallised. But they should avoid taking actions that would reinforce the strains in financial markets or the adverse feedback loop between the financial sector and the real economy.

The FSA was continuing to have such a dialogue with banks. Given the current market conditions, that dialogue is likely to focus on elements of the balance sheet that face considerable funding risk in dislocated markets. The FPC also requested that the FSA should collect granular information and intelligence to enable the Committee in future meetings to examine such structural vulnerabilities, including those stemming from chains of exposures, more closely.

Recommendation 2

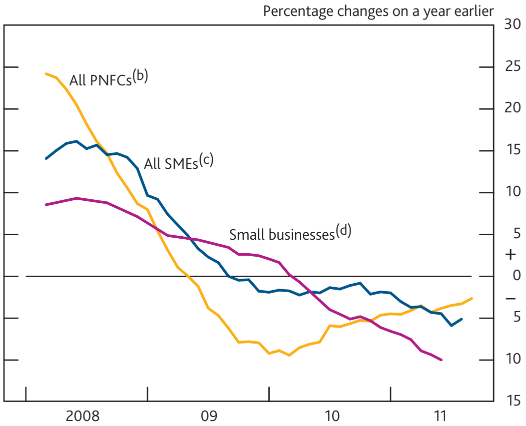
The Committee reiterates its advice to the FSA to encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy.

Longer-term balance sheet management incentives

A key influence on the way banks choose to manage their balance sheets in the medium term are the risk weights assigned to different types of exposures in the current regulatory framework. These risk weights determine how much capital banks have to hold against different exposures. But there are a number of weaknesses in the way that risk weights are currently determined.

The methods used by banks to calculate risk weights, particularly those calculated using internal models, are opaque to investors. Market intelligence suggests that this opacity has led to a lack of confidence in risk-weighting methods and could be undermining market confidence in the capital adequacy of banks. That suggests there is a potentially useful

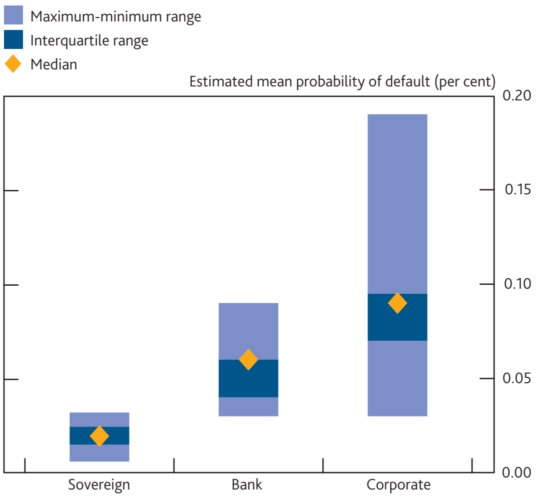
Chart 5.12 Lending to UK businesses by size(a)



Sources: Bank of England, British Bankers' Association (BBA), Department for Business, Innovation and Skills (BIS) and Bank calculations.

(a) Rate of growth in the stock of loans. Data are non seasonally adjusted.
(b) Data cover both sterling and foreign currency loans. The latest observation is September 2011.
(c) BIS data and Bank calculations. Stock of sterling and foreign currency lending, expressed in sterling terms, by four UK lenders to enterprises with an annual bank account debit turnover of less than £25 million. The latest observation is August 2011.
(d) BBA data. Stock of sterling lending by seven UK lenders to commercial businesses with an annual bank account debit turnover of up to £1 million. Data are quarterly until September 2009 and monthly thereafter. The last observation is June 2011: www.bba.org.uk/statistics/article/small-business-support-december-2010/small-business/.

Chart 5.13 Variation in estimated probabilities of default on common hypothetical portfolios(a)(b)



Sources: FSA and Bank calculations.

(a) Hypothetical portfolio exercise for credit risk in the banking book in 2009.
(b) Ten, thirteen and seven banks rated the sovereign, bank and corporate portfolios shown in the chart, respectively. The portfolios include 17 sovereign borrowers, 34 bank borrowers and 13 corporate borrowers.

role for a leverage measure that does not attempt to adjust for the riskiness of banks' exposures, as an alternative to risk-sensitive measures of solvency. A leverage ratio is due to be introduced under Basel III. As well as being an alternative solvency metric which may be useful to investors, it can play a useful backstop role to existing risk-sensitive capital requirements. The Basel III implementation timetable requires banks to calculate their leverage ratio from 1 January 2013 and to disclose it from 1 January 2015, with the aim of the leverage ratio migrating to Pillar 1 on 1 January 2018.

Recommendation 3

The Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.

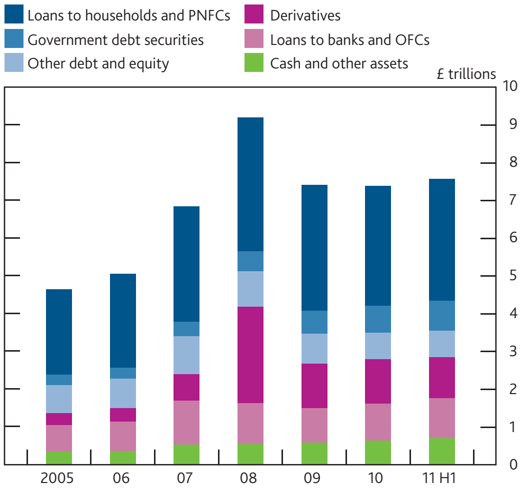
Another flaw in the way risk weights are currently determined is that different banks can assign significantly different risk weights to the same portfolios of assets (**Chart 5.13**). The FSA had already undertaken a number of reviews of the variability and comparability of risk weights among UK banks and the FPC encourages the FSA to continue this work. Moreover, attempts are under way internationally to try to improve the reliability and consistency of risk-weighted asset calculations. For example, the Basel Committee on Banking Supervision (BCBS) is currently undertaking a longer-term review of risk-weighted asset measurement. As part of that work it would be appropriate to consider whether to supplement model-based calculations with minimum risk weights for specific categories of assets.

Methods for calculating risk weights also do not currently account for some wider — macroprudential — costs and benefits associated with different types of exposures. They are largely calibrated from a microprudential perspective. In this context, the Committee noted that a sharp rise in intra-financial system assets (**Chart 5.14**) had added to systemic fragility and contributed to considerable opacity. In the past, however, little capital had been set aside to cover these risks. Moreover, lending to the real economy can have wider benefits, particularly at this point in the cycle, that are not captured in risk weights. The issue of the adequacy of intra-financial sector weights is likely to be mitigated in part by reforms of trading book capital requirements currently being considered by the BCBS. Nevertheless, the Committee will consider further at future meetings the issue of the relative risk weights applied to intra-financial sector and real-economy exposures. The Committee will also consider whether banks should be required to disclose further details of their risk weights for specific asset categories.

Asset encumbrance

Just as opacity about risk weights might be obscuring the picture on capital adequacy, so investor uncertainty about the

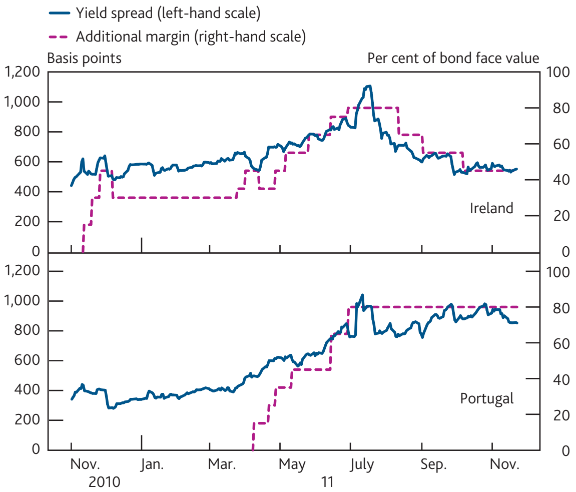
Chart 5.14 Major UK banks' total assets[(a)]



Sources: Bank of England, published accounts and Bank calculations.

(a) See footnotes (a) and (b) in **Chart A** on page 26.

Chart 5.15 Yield spreads and additional margin under LCH.Clearnet Ltd sovereign risk framework[(a)]



Sources: Bloomberg, LCH.Clearnet Ltd and Bank calculations.

(a) Spreads of ten-year government bonds over benchmark basket of AAA-rated sovereign bonds. From 12 October 2011, spreads for Ireland use the Irish nine-year bond.

level of banks' asset encumbrance — the degree to which banks' assets are not available to unsecured creditors in the event of a default — could be hindering debt investors' ability to assess the value of their claim on banks. As discussed in Section 2, market intelligence suggests that there are concerns about the extent to which banks' assets are encumbered. This may have contributed to the increase in unsecured funding costs and could have hindered primary issuance.

The FSA recently completed a survey of major UK banks' levels of asset encumbrance. The Committee intends to work with the FSA to review this exercise and the appropriate level of transparency in this area.

CCPs

As discussed in Box 1, the increased use of central clearing prospectively gives rise to significant risk-reduction benefits and enhances systemic resilience. But it may also increase CCPs' systemic importance. The likely impact of CCP distress or failure is greater now than in the past due to the expansion of central clearing to new products and markets. So robust arrangements are needed for managing losses while maintaining the continuity of clearing services. Most CCPs do not, however, have proven arrangements for managing losses that exceed their margin and other financial resources.

Previous *Reports* have highlighted that the contribution central clearing can make to overall financial stability is critically dependent upon the adequacy of CCPs' risk management. This is especially important in the current conjuncture. Collecting additional margin can be a prudent method for CCPs to manage their risk. But margining and collateral policies should also aim to avoid procyclical effects, notably by limiting where possible cliff-edges associated with particular price or rating triggers (**Chart 5.15**). These cliff-edges could exacerbate instability by triggering liquidity problems in the wider system.

The Committee notes that more forward-looking margin rules could reduce procyclicality, for example by ensuring that margins do not fall to too low a level during periods of low market volatility. This highlights the potential importance of macroprudential policy tools which could enable authorities not only to set a floor to margin requirements but also to vary them as conditions change, for both CCP and bilateral trades. The FPC notes that the draft CPSS-IOSCO principles for financial market infrastructures, which will apply internationally, require CCPs to adopt to the maximum extent that is prudent, forward-looking, conservative margin requirements that avoid the need for destabilising, procyclical changes[(1)] and supports the FSA and Bank's work to ensure that such principles are agreed.

(1) See Principle 6 (Margin) of the CPSS-IOSCO 'Principles for financial market infrastructures — consultative report', page 43.

It is not practical for CCPs to hold sufficient financial resources to eliminate entirely the possibility that they will be exhausted, for example in the event of multiple member failures at the same time as unusually volatile market prices. Yet CCPs do not generally have formal arrangements for allocating losses that exceed their default resources. In this circumstance, the CCP would be faced with insolvent liquidation. If a CCP were to fail in this way, residual losses would fall on participants (as creditors) and it is likely any allocation would occur in a way that was difficult to predict with certainty and could take a considerable period of time. This highlights the importance for CCPs of introducing loss-allocation rules and for governments of establishing effective resolution tools. It is preferable for CCPs to embody loss-allocation requirements within their own rule books as this would provide transparency to CCP participants.(1)

In this context the FPC welcomed ongoing work to ensure that UK CCPs have robust arrangements to manage potential losses, which should include rules for allocating among their participants, and therefore absorbing, losses that are not covered by margin, default fund and other financial resources.

The FPC also notes that, given their systemic importance, it is as vital to have resolution regimes for CCPs as it is to have them for banks. In that context, the Committee welcomes the considerable international work under way to develop appropriate frameworks that attempt to tackle these issues, for example by CPSS-IOSCO, at FSB and in the European Commission.(2) Any resolution arrangements need to be especially robust in the growing number of cases where CCPs operate across jurisdictions.

(1) CPSS-IOSCO has also identified the importance of CCPs having rules for allocating credit losses that are not covered by margin, default fund and other financial resources. See CPSS-IOSCO draft principles (Key consideration 7 to Principle 4 (Credit risk)) 'An FMI (financial market infrastructure) should have clear and transparent rules and procedures that address how potentially uncovered credit losses would be allocated'.
(2) See footnote 3, page 5 of www.financialstabilityboard.org/publications/r_111104cc.pdf.

Box 3
The final report of the Independent Commission on Banking

The Independent Commission on Banking (ICB) released its final report on 12 September. The report, on which the Government is due to respond by the end of the year, makes two main financial stability-related proposals:

- Banks' most critical retail activities should be ring-fenced in legally, economically and operationally separate subsidiaries.
- Systemically important banks (including large ring-fenced banks) should have additional loss-absorbing capacity beyond Basel III requirements.

The FPC welcomes this report and supports its main conclusions. This box sets out the initial views of Committee members on the limited question of the ICB's key recommendations.

Motivation and objectives

The ICB's recommendations are designed to:

- make banks better able to absorb losses;
- make it easier and less costly to resolve banks that still get into trouble; and
- curb incentives for excessive risk-taking.

In so doing, the ICB aims to reduce the 'too important to fail' problem. That arises when a government is unable to commit credibly not to rescue a troubled bank because its failure would impose high costs on the rest of the financial system or the wider economy. In recent years, large amounts of public money have been used to avert the failure of banks and other institutions.

The expectation of government support entails an implicit funding subsidy by taxpayers. Expectations of support have begun to fall only recently and remain high on most estimates (**Chart 3.11**).

The subsidy provides an incentive for banks to over-expand their balance sheets, take on excessive leverage and become more complex and interconnected. This issue is particularly relevant for the United Kingdom, given the large size of UK banks and the concentration of the industry.

The ICB's proposals

The establishment of the ICB and the publication of its findings are important steps towards dealing with the too important to fail problem. The ICB's ring-fencing and loss-absorbency proposals build on, and complement, other regulatory initiatives such as Basel III and work by the Financial Stability Board (FSB).

The Government will need to consider fully the costs of the proposals as well as the potential benefits. Transition issues are also relevant. Although the stability benefits are hard to quantify, they are likely to exceed by far any costs.

Ring-fence design

The ICB's ring-fence proposals comprise a set of principles that define the height and location of the ring-fence. The ICB also sets out provisions designed to ensure that banks can continue to undertake essential treasury activities and manage their own balance sheet risk. For the ring-fence to be effective, the key characteristics of its design need to be defined in legislation. This is properly a role for Government, ensuring the legitimacy of the reform.

Height and location of the ring-fence

The ICB recommends a 'high' ring-fence, with strict operational and economic separation between ring-fenced banks and other group entities. The relationship between ring-fenced and non ring-fenced entities should be treated no more favourably than third-party relationships.

Clear and enforceable separation — legal, economic and operational — is essential to the effectiveness of the proposal in enhancing stability. With clear separation, ring-fenced banks would be smaller, less complex, and less interconnected within the financial system. This would increase transparency and improve the ability of managers, supervisors and investors to monitor and manage ring-fenced banks' risk-taking. Strict separation would also reduce contagion to the real UK economy from global financial shocks and make banks easier to resolve by carving out banking services that need to be provided continuously.

The ICB specifies two categories of banking services: *mandated* services that *must* be located in a ring-fenced bank; and *prohibited* services that *must not* be. There is a large third category of *permitted* services that may be carried out either inside or outside the ring-fence. These categories are designed to distinguish between functions that customers need to access continuously throughout the resolution of a bank, such as current accounts, and those which could be interrupted — though these would still need to be wound down in an orderly way. Importantly, the ICB envisages that both the ring-fenced and non ring-fenced banks should be resolvable without Government solvency support.

The only mandated services specified by the ICB are taking deposits from and extending overdrafts to individuals and small and medium-sized enterprises (SMEs). The inclusion of overdrafts is important, particularly for SMEs, as customers may be reliant on access to committed lines of credit. The set of prohibited services is wider, including all the functions typically associated with investment banks. This leaves lending to individuals and SMEs, as well as taking deposits from and lending to larger corporates, among the set of permitted services.

This model should be effective in safeguarding continuous provision of critical retail deposit-taking and payments functions, by making them easier to resolve without recourse to taxpayers' funds. Some flexibility in the ring-fence boundary is desirable, though the design of the ring-fence should perhaps ensure continuity in some forms of credit intermediation beyond the provision of overdrafts. In particular, disruption to the flow of SME lending by a major provider could entail high economic costs.

It was also noted that some macroprudential tools could, if appropriate, be targeted at the level of ring-fenced banks rather than at groups as a whole.

Managing banks' balance sheet risk

The ICB's principle on 'ancillary activities' permits ring-fenced banks to assume interbank exposures and engage in some otherwise prohibited activities in the course of their provision of permitted services. Such activity would be subject to backstop exposure limits and other safeguards.

This principle should permit banks to undertake essential treasury and risk management activities. But separating legitimate treasury and risk management activities from profit-making trading activities will be a complex exercise. And calibrating and policing backstop exposure limits will be crucially important in maintaining the integrity of the ring-fence.

The ICB also recommends that the governance of the ring-fenced bank should be independent of the parent group, with its board having a specific duty to uphold the 'spirit' of the ring-fence. This is important, since separate governance and risk management should help to improve the monitoring and management of risk.

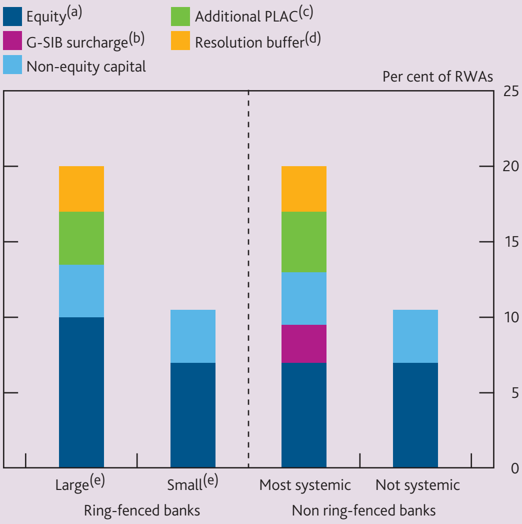
Supervision and enforcement

Subject to the key design characteristics being set out in legislation, it is crucial that the regulator is given appropriate scope to exercise judgement in enforcing the principles of the ring-fence. This is consistent with the supervisory approach articulated by the Prudential Regulation Authority (PRA).(1) For example, the PRA could set an expectation that certain permitted activities would be located in ring-fenced banks. Banks would then be required to justify any decision not to do so.

Loss-absorbency requirements

The ICB proposes measures to enhance banks' loss-absorbency beyond Basel III levels (**Chart A**).

Chart A ICB loss-absorbency recommendations



Source: Independent Commission on Banking (2011), *Final Report: Recommendations*.

(a) The equity requirement includes the Basel III conservation buffer of 2.5% RWAs, but not the countercyclical buffer.
(b) It is proposed that global systemically important banks (G-SIBs) be required to hold an additional equity buffer, ranging from 1% to 2.5% of RWAs. This chart assumes the maximum 2.5% surcharge for 'most systemic' banks.
(c) Additional primary loss-absorbing capacity.
(d) The 3% resolution buffer is only imposed at the discretion of the supervisor.
(e) 'Large' banks are those with RWAs greater than 3% of UK GDP, 'small' banks are those with RWAs less than 1% of UK GDP.

The largest ring-fenced banks would be subject to:

- A common equity requirement of 10% of risk-weighted assets (RWAs) — that is, an additional 3% requirement above the Basel III minimum.(2)
- A requirement to hold additional common equity, non-equity capital or 'bail-inable' bonds(3) so as to maintain total 'primary loss-absorbing capacity' (PLAC) of at least 17% of RWAs.
- Where not readily resolvable, an additional 'resolution buffer' of up to 3% of RWAs, the size and composition of which would be at the discretion of the supervisor.

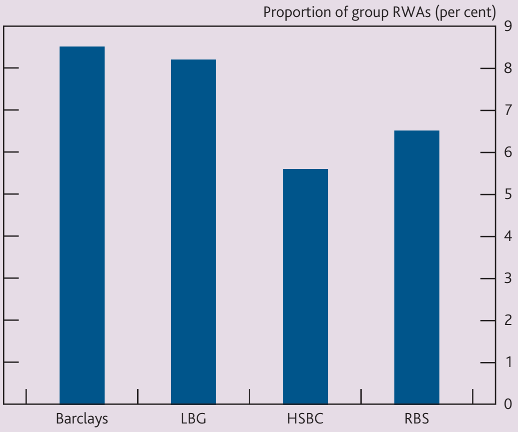
For non ring-fenced banks, overall PLAC requirements for the most systemically important banks would include the same 17% minimum and 3% resolution buffer. Common equity requirements would be largely tied to international standards. Under the approach proposed by the FSB and Basel Committee, the current most systemically important banks globally will be required to hold additional common equity of 2.5% of RWAs.(4)

In addition, as a backstop, the ICB recommends a Tier 1 leverage ratio of at least 3% for all UK-headquartered banks and all ring-fenced banks, rising to just over 4% for the largest ring-fenced banks. This is potentially an important element of the loss-absorbency proposals, given the wide variation in banks' estimates of risk weights (Section 3).

It is crucial not only that all banks and dealers are subject to the statutory resolution regime, but also that resolution can occur without significant disruption to financial stability. Particular emphasis should therefore be placed on permitting sufficient flexibility in applying the 'resolution buffer' to increase loss absorbency for banks that could otherwise impose high economic costs were they to fail in a disorderly way. In some cases, a buffer in excess of the proposed 3% may be appropriate. As the ICB proposes, supervisory discretion to determine the composition of the buffer, as between equity, other forms of capital or 'bail-inable' debt, is also important. This should reflect the propensity for spillovers either at or before resolution.

In practice, banks are likely to satisfy the non-equity component of the PLAC requirement with Tier 2 capital instruments and/or unsecured debt that could be bailed in to provide loss-absorbency when a bank enters resolution. Indeed, most of the largest banks currently have more than enough senior unsecured debt in issue to meet the requirement at group level (**Chart B**).[5]

Chart B Senior unsecured debt in issuance from the four largest UK banks[(a)(b)]



Sources: Autonomous (2011), *UK banks: the ICB catalyst*, Dealogic and Bank calculations.

(a) Estimates of senior unsecured debt as a proportion of RWAs. Based on 2010 RWAs, adjusted for the expected impact of the change from Basel 2.5 to Basel 3 in 2012/13. Debt issued by UK entity only as a percentage of group RWAs.
(b) Stock of publicly issued unsecured long-term (greater than 18 months) debt issued from 1 January 1980 to present, with a contractual maturity beyond 25 October 2012. Maturity is based on contractual maturity at date of issuance. Data do not take account of buybacks. Excludes government-guaranteed debt.

The ICB's proposal to include bail-inable debt in PLAC is supported by a proposal to introduce 'bail-in' into the Special Resolution Regime (SRR). If implemented, these proposals would help to reduce the social cost of a disorderly bank failure, and by introducing a credible threat of loss they should improve market discipline. The proposals are broadly consistent with FSB-led initiatives on resolution arrangements for systemically important institutions.[6]

The ICB also proposes to strengthen the credibility of bail-in by distinguishing between a 'primary' and a 'secondary' power. The former would apply to bail-inable debt only; the latter to all other unsecured liabilities. As with the ICB's recommendation on depositor preference, this approach would provide greater transparency over how losses would be allocated in resolution, but may require changes to the creditor hierarchy in liquidation.

Systemic risk outside the ring-fence

The ICB's recommendations are focused on the UK banking sector. However, systemic risk can still arise from the activities of international banks and non deposit-takers. The FPC's proposed responsibilities include mitigating systemic risks across the financial system and making recommendations to HM Treasury on the regulatory perimeter.

The potential for systemic risk to arise outside the ring-fence strengthens the case for extending bail-in and the full range of stabilisation powers under the SRR to non deposit-taking institutions. It also highlights the importance of other complementary financial reform measures. It is vital that momentum is maintained in the implementation of international agreements, including those recently concluded on greater loss-absorbency and resolution arrangements for systemically important banks.

Citing competitiveness concerns, the ICB concluded that non ring-fenced institutions should be subject only to globally agreed capital requirements — as long as they were adequately resolvable. Achieving orderly resolution of complex cross-border investment banking and trading activities is likely to be challenging, at least until recent international agreements have been implemented. Therefore, it may be that in some cases a higher resolution buffer will be required outside of the ring-fence than inside.

Summary and conclusions

The Committee welcomes and supports the ICB report. It notes that the ring-fence proposal will need to be translated into enforceable rules, with key ring-fence design characteristics settled as part of the legislative process. The Committee shares the ICB's view that additional loss-absorbency is required. In particular, it stresses the importance of a flexibly applied resolution buffer to ensure that ring-fenced and non ring-fenced banks alike can be resolved in an orderly manner.

(1) See www.bankofengland.co.uk/publications/other/financialstability/uk_reg_framework/pra_approach.pdf.
(2) The Basel III minimum, as quoted here, is taken to include the capital conservation buffer. Ring-fenced banks that are part of a wider group should meet all requirements on a solo basis. For smaller ring-fenced banks (with a ratio of RWAs to GDP less than 3%), the additional requirements would be proportionately lower. For banks designated as globally systemically important and subject to additional equity requirements under Basel III rules, the increase over the Basel III requirement would be smaller.
(3) The ICB defines these as senior unsecured debt with residual maturity of at least twelve months.
(4) See www.bis.org/publ/bcbs207.htm.
(5) For HSBC, estimates depend on whether debt issued in its non-UK subsidiaries will count towards group PLAC requirements.
(6) See www.financialstabilityboard.org/publications/r_110719.pdf.