4 Macroprudential policy since the June 2012 *Report*

The Committee has held two policy meetings and issued one additional recommendation since the June 2012 *Report*. During its September meeting, the Committee discussed how it intended to draft policy statements to support the use of powers of Direction by the statutory FPC. During both its September and November meetings, the Committee reviewed progress against its previous recommendations. One previous recommendation has now been implemented and action is under way to implement the remaining recommendations.

This section describes the activity of the Committee and the progress made in implementing its recommendations over the past six months. Each recommendation has been given an identifier to ensure consistent referencing of recommendations within and between *Financial Stability Reports*. An identifier 11/Q3/3 refers to the third recommendation made following the 2011 Q3 FPC meeting, and so on.

4.1 Activity of the Committee

The Committee has held two policy meetings and issued one additional recommendation since the publication of the June 2012 *Report*. A full account of these meetings will be made available in the published Records. The latest recommendation and the conclusions of the Committee's November meeting are outlined in Section 5 of this *Report*.

In September, the Committee discussed how it would approach the drafting of a statement outlining the general policy that the statutory FPC could be expected to follow for each of its powers of Direction. This policy statement would need to consider the circumstances in which those powers might be used and how they might work, with reference to historical examples. It would also need to balance the desire to provide specificity about when the powers would be used — in order that the Committee could be held to account — with the importance of retaining sufficient flexibility to enable policy to respond to a range of risks and uncertainties. The Committee intends to publish a draft of this statement early next year, to assist Parliament's scrutiny of the draft secondary legislation that will provide the statutory FPC with powers of Direction.

In September, the Committee also reviewed progress in implementing its recommendations. It agreed not to change its existing recommendations given that risks to financial stability remained elevated.

4.2 Progress made in implementing recommendations

At its November 2012 policy meeting, the Committee again considered the progress made in implementing each of its previous recommendations, as summarised in **Table 4.A**. The rest of this section describes this progress in more detail and considers the extent to which it has delivered on the Committee's objectives.

Table 4.A Summary of recommendations

Identifier	Short title	Lead	Status[(a)]
11/Q3/3	Flexibility in EU legislation to enable national discretion	HMT	Action under way
11/Q4/3	Disclosure of leverage ratios	FSA	Action under way
12/Q2/1	Build a sufficient cushion of loss-absorbing capital against current risks	FSA	Superseded by 12/Q4/1
12/Q2/2	Improve balance sheet resilience, including through prudent valuation	FSA	Superseded by 12/Q4/1
12/Q2/3	Manage and mitigate balance sheet risks from euro-area stress	UK banks	Action under way
12/Q2/4	Clarify usability of regulatory liquid asset buffers in liquidity stress	FSA	Implemented
12/Q2/5	Work towards consistent and comparable Pillar 3 disclosures	UK banks, FSA and BBA	Action under way
12/Q4/1	Ensure capital position reflects prudence in asset valuations, conduct cost estimates and risk-weight calculations	FSA	New

(a) The status of each recommendation is described as one of: 'New', 'Not implemented', 'Plan agreed', 'Action under way', 'Implemented' or 'Superseded'.

Recommendation 11/Q3/3

'The Committee urged HM Treasury to continue its efforts to ensure that developments in European legislation did not provide an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom, as envisaged in the consultation documents proposing the establishment of the Financial Policy Committee.'

HM Treasury has continued to work with Member States and EU legislative bodies on the proposed Capital Requirements Directive and Regulation (CRD4/CRR) and the European Market Infrastructure Regulation (EMIR).

CRD4/CRR seeks to implement the Basel III agreement in the European Union. 'Trilogue' negotiations between the European Parliament, Commission and the Council to agree the final texts extended into the autumn. At the time of writing, the draft texts provide for some national discretion in the use of macroprudential policy instruments, but the final scope for such discretion has yet to be agreed.

EMIR formally entered into force in August, although many of its provisions will not take effect until supporting technical standards are adopted in early 2013. Among other things, EMIR establishes prudential standards for the calculation of margin requirements by CCPs. But it does not provide scope for national macroprudential authorities to vary minimum margin requirements through the cycle as previously considered by the FPC (see the March 2012 Record). A European Commission review (also involving the European Securities and Markets Authority and the European Systemic Risk Board) to revisit the need for additional measures to reduce procyclicality in margin requirements for CCPs is scheduled for 2015.

Status: Action under way

The timetable for implementing CRD4/CRR remains subject to considerable uncertainty, not least due to the recent move towards a banking union and the creation of a single supervisory mechanism across the euro area. HM Treasury will continue its efforts to ensure that the final legislation gives the FPC sufficient flexibility to use its macroprudential policy instruments effectively.

Recommendation 11/Q4/3

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

The FSA has continued to engage with chief financial officers of the major UK banks and building societies to ensure effective implementation of this recommendation. During these discussions, a number of firms expressed concern that disclosure of leverage ratios in advance of regulatory requirements to comply with minimum standards could have unintended consequences. For example, if investors were to misinterpret the FPC's recommendation and demand immediate compliance with the minimum standards, that could encourage firms to reduce lending to households and businesses.

As noted in the June 2012 *Report* and in the Record of the September 2012 FPC meeting, the Committee is clear that it is not recommending that UK banks and building societies must be compliant with expected future leverage ratio minimum requirements in advance of their coming into force (expected to be in 2018 according to the Basel III timetable). To reinforce this message, the Committee saw merit in firms disclosing leverage ratios using both Basel III end-point and transitional definitions of Tier 1 capital. The FSA has taken this forward in discussions with firms.

Status: Action under way

UK banks and building societies are on track to meet this recommendation with effect from their end-2012 annual reports. This would represent an important first step in helping to reduce investors' uncertainty about firms' resilience, given market concerns about inconsistencies in risk-weighted asset calculations. The Committee's approach to improving disclosure of such calculations is discussed in Section 5 of this *Report*.

Recommendation 12/Q2/1

'The Committee recommended that, taking into account each institution's risk profile, the FSA works with banks to ensure they build a sufficient cushion of loss-absorbing capital in order to help to protect against the currently heightened risk of losses. That cushion may temporarily be above that implied by the official transition path to Basel III standards and would support additional lending to the real economy, including via the planned 'funding for lending' scheme. Banks should continue to restrain cash dividends and compensation in order to maximise the ability to build equity through retained earnings.'

The aggregate core Tier 1 capital ratio of the major UK banks has increased by over 50 basis points since the Committee first encouraged banks to build capital in 2011. But over the same period, the aggregate level of core Tier 1 capital of the major UK banks has increased only marginally, and that is more than accounted for by the retained profits of a single bank. And the outlook for internal capital generation through retained profits remains challenging (as discussed in Section 2).

Against this backdrop, the FSA wrote to the major UK banks in August asking them to provide quantitative estimates of all feasible options for increasing capital levels further or restructuring their business models. Recent supervisory discussions have focused on banks' responses to this letter and actions are being taken as a result of these discussions. These include ensuring that banks' proposals for variable remuneration and dividends are consistent with building capital levels.

In September, the FSA clarified changes to its capital regime intended to support the Funding for Lending Scheme, introduced by the Bank of England and HM Treasury in July 2012. The FSA will make an allowance for the increase in Pillar 1 capital requirements as a result of new lending to households and non-financial companies by reducing Pillar 2 capital planning buffer requirements. The precise amount of this offset will be determined in FSA discussions with banks on their capital adequacy and forward-looking capital plans.

Status: Superseded
The Committee noted the progress made by the FSA in its discussions with banks and the recent steps taken by one bank towards raising external capital.

During its November meeting, the Committee agreed to bring together its existing recommendations to increase the resilience of the UK banking system into a single, new recommendation which is discussed in detail in Section 5 of this *Report*.

Recommendation 12/Q2/2
'In addition, the Committee reiterated its recommendation to the FSA to encourage banks to improve the resilience of their balance sheets, including through prudent valuations, without exacerbating market fragility or reducing lending to the real economy.'

The FSA has continued to take forward this recommendation as part of its ongoing supervisory dialogue with firms. Non-core asset run-off plans are ahead of schedule, with LBG and RBS having shed almost £400 billion of assets since 2008. Market contacts suggest that strong demand from hedge funds and private equity buyers should support further disposals. Intra-financial system exposures have also reduced as firms have begun to narrow the focus of investment banking operations.

The FSA is also heavily involved in the drafting of Binding Technical Standards on Prudent Valuation on behalf of the European Banking Authority (EBA). These Standards, which will seek to define the way in which firms should quantify the inherent uncertainty around point estimates of fair-valued assets and liabilities, are expected to be implemented in January 2014. In the interim, firms have submitted initial Prudent Valuation returns to the FSA. These returns show considerable variation between firms' methodologies. The FSA is therefore considering the need for a programme of work to ensure greater consistency and robustness of these measures.

Status: Superseded
The Committee noted the progress made against this recommendation and supported the FSA's continuing work programme. But it believed that banks could do more to promote confidence in the resilience of the UK banking system by adopting a more conservative approach to the valuation and risk weighting of assets. The Committee's new recommendation, discussed in detail in Section 5 of this *Report*, is intended, in part, to achieve this outcome.

Recommendation 12/Q2/3
'The Committee recommended that banks work to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area.'

The major UK banks have taken a number of steps to meet this recommendation, as part of their contingency planning arrangements. As discussed in Section 2, balance sheets have been adjusted to match local assets more closely with local liabilities to mitigate potential currency risk. Direct exposures to vulnerable euro-area countries have been reduced across all sectors. Exposures to households and businesses in Ireland, Italy and Spain remain significant, however, with household exposures generally slower to change due to the long-term nature of mortgage lending.

While indirect exposures — for example, to other euro-area countries that in turn have exposure to vulnerable euro-area countries — remain significant, these have also been reduced. Many of these exposures arise via core European banks and are at least partially mitigated by collateral.

Status: Action under way
While noting the steps taken by banks to reduce the risk posed by their exposures, the Committee remained concerned about the resilience of the UK banking system in the event of the crystallisation of a stress scenario in the euro area. As such, it encouraged banks to continue their efforts to manage and mitigate this risk.

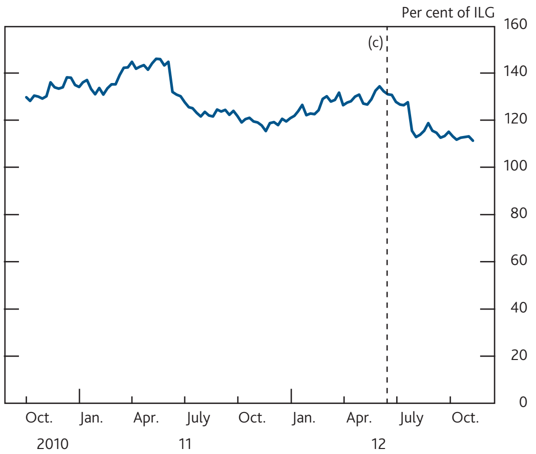
Recommendation 12/Q2/4
'The Committee recommended that the FSA makes clearer to banks that they are free to use their regulatory liquid asset buffers in the event of a liquidity stress. The ability to do so is enhanced by additional contingent liquidity made available to banks by the Bank. The Committee also recommends that the FSA considers whether adjustments to microprudential liquidity guidance are appropriate, taking some account of this additional liquidity insurance.'

The FSA wrote to the major UK banks and building societies in August outlining a number of changes to its liquidity regime. These changes were intended to increase firms' willingness to use their liquidity buffers. They included: some explicit recognition of firms' collateral pre-positioned at the Bank of England; tiering of liquidity guidance intended to increase the usability of the top-tier buffer; and a commitment not to introduce any future industry-wide increases in liquidity guidance prior to the introduction of the Basel III Liquidity Coverage Ratio in 2015. The FSA also emphasised that firms would be given reasonable time to rebuild their buffers after having run them down.

Status: Implemented

Liquid asset holdings of the major UK banks and building societies have fallen by £31 billion since the Committee issued its recommendation and now represent 111% of the FSA's liquidity guidance (**Chart 4.1**). This initial reaction reflects the aggregate impact of a range of individual-firm responses. Most firms have reduced their liquid asset holdings, some while reducing their balance sheet size and reliance on wholesale funding. Firms' reactions have also been driven by considerations of internal risk appetite, market perception and expectations of rating agency activity.

Chart 4.1 Aggregate liquid asset holdings of UK banks as a percentage of FSA Individual Liquidity Guidance (ILG)(a)(b)



Sources: FSA and Bank calculations.

(a) UK 'defined liquidity groups' for Barclays, HSBC, LBG, Nationwide, RBS and Santander as designated by the FSA for liquidity regulation purposes.
(b) Liquid asset holdings for this purpose exclude pre-positioned collateral at the Bank of England's Discount Window Facility in order for the data to be comparable across time periods.
(c) June 2012 *Report*.

Replacing liquid asset holdings with real-economy loans could directly support the supply of credit and thus economic growth. Alternatively, selling liquid assets to buy back expensive debt could boost profits and thus internal capital generation to support resilience and future lending. It is too early to judge the impact of either of these potential responses on the FPC's objectives.

Recommendation 12/Q2/5

'The Committee recommended that UK banks work with the FSA and British Bankers' Association (BBA) to ensure greater consistency and comparability of their Pillar 3 disclosures, including reconciliation of accounting and regulatory measures of capital, beginning with the accounts for the current year.'

Pillar 3 disclosures require banks to disclose key information on capital, risk exposures and risk assessment processes on at least an annual basis to enable market participants to assess banks' risk profile and capital adequacy. The FSA and the BBA have together identified specific areas for improvement in these disclosures — including additional comparative metrics and clearer narratives — and have discussed these in meetings with the major UK banks. The banks generally support the proposed improvements and have considered how to take them forward under the BBA's Code for Financial Reporting Disclosure, together with the disclosure recommendations of the Financial Stability Board's Enhanced Disclosure Task Force and the EBA.

Status: Action under way

The BBA is developing an action plan to deliver the proposed improvements and will meet with the FSA before the year-end to discuss progress made against this plan. Some improvements — including a reconciliation of accounting and regulatory measures of capital under Basel III — will be achievable for the 2012 year-end. Others will take longer to implement due to operational challenges.