

FINANCIAL STABILITY REPORT PRESS CONFERENCE

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Opening Remarks by the Deputy Governor for Financial Stability

Today's *Financial Stability Report* marks a significant milestone. It is the Financial Policy Committee's (FPC) first *Report* since the UK's new regulatory framework came into force on 1 April. The Committee is also publishing this morning its response, required by statute, to the recommendations in the Chancellor's letter of 30 April.

Much of the Financial Policy Committee's work to date has centred on the capital adequacy of the UK banking system given the unusual threats from the international economic and financial environment. In March, the Committee judged that the major UK banks need by the end of this year to achieve a risk-weighted equity capital ratio of at least 7% determined on Basel III end-point definitions and after three sets of adjustments – to valuations, expected costs of conduct redress, and risk weights. Last week the Prudential Regulation Authority (PRA) published the outcome of its work implementing the FPC's recommendations in this area. As we said in March, for the eight major UK banks and building societies¹ covered by the exercise, the three adjustments were equivalent to around £50bn of capital. The PRA Board judged that, as of the end of last year, five of the eight firms had a shortfall in capital relative to the standard set by the FPC, in aggregate amounting to around £25bn. Prior to the PRA's work, firms were already planning actions to close around half of the shortfall over the course of this year. The PRA has now agreed plans for the closure of the remainder of the shortfall, in ways designed to avoid impairing lending to the real economy.

Having got this far, the Committee judges that it is now appropriate to disclose a passage, discussing initial estimates of the possible scale of adjustments to banks' capital, that was omitted from the *Record* of its November 2012 policy meeting. It is in Box 5 of the *Report*.

¹ The banks included in the FPC's capital exercise were Barclays, Co-operative bank, HSBC, LBG, Nationwide, RBS, Santander UK and Standard Chartered. Further details are available at www.bankofengland.co.uk/publications/Pages/news/2013/081.aspx.

Pending implementation of the plans submitted to the PRA, the FPC has decided to keep open the March recommendations on improving the UK banking system's capital adequacy. It will keep progress under review and will conduct a full assessment in early 2014.

The need to assess the system's capital adequacy is not a one off. The Committee has, therefore, also kept open the March recommendation that the Bank, including the PRA, should develop a framework for stress testing the UK banking system's capital adequacy in future years. Today's *Financial Stability Report* sets out some design principles that will inform the development of this framework (Box 6). The Committee has asked Bank staff to publish a Discussion Paper on stress testing in the autumn.

At its latest meeting, the Committee reviewed a wide range of potential threats to financial stability. As we described in the November *Report*, there has been a progressive search for yield in an environment of highly stimulative monetary conditions and low long-term real interest rates. For much of the past six months, that intensified. Those are circumstances in which the authorities need to be alert to whether stability could be threatened by excessive leverage or liquidity risk building up in any potentially vulnerable parts of the financial system. That has been underlined by the abrupt correction in asset prices over recent weeks.

The FPC therefore **recommends that the Financial Conduct Authority (FCA) and the PRA, with other Bank staff, should provide an assessment to the FPC of the vulnerability of borrowers and financial institutions to sharp upward movements in long-term interest rates and credit spreads in the current low interest rate environment. They should each report back to the FPC in September 2013.**

The ability of the UK banking system to weather any marked deterioration in the economic and financial environment will depend not only on its capital resources but also on liquidity.

A new international standard, the Liquidity Coverage Ratio (LCR), requiring banks to hold a minimum cushion of liquid assets, was agreed earlier this year in Basel. Under EU rules finalised recently, banks are required to have an LCR of at least 60% by 1 January 2015, reaching 100% by 1 January 2018. In aggregate, UK banks start off with an LCR above 100%, posing the question of whether or not the industry should be held to the final standard immediately.

From a macroprudential perspective, the Committee has concluded that there is some scope for banks to reduce their holdings of liquid assets in the near term. Access to market funding should be improved by the steps being taken to strengthen capital adequacy, and is underpinned by the continued availability of enhanced central bank liquidity facilities, such as the Bank of England's Extended Collateral Term Repo facility. In those circumstances, the Committee judges that some relaxation in liquidity requirements would strike the appropriate balance between achieving resilience and reducing possible impediments to the supply of credit to the economy. The Committee noted, however, that the microprudential supervisors will also need to consider the position of individual firms.

The FPC therefore recommends that **in assessing the liquidity of banks and building societies, the PRA should employ, among other measures, the Liquidity Coverage Ratio (LCR) as defined in the EU's implementation of the Basel standard. The minimum requirement should be set at an LCR of 80% until 1 January 2015, rising thereafter to reach an LCR of 100% on 1 January 2018. The PRA should consider whether any additional requirements are needed where there are idiosyncratic liquidity risks not captured by the LCR framework or where the adjustments to capital positions described in the existing capital recommendations have not been implemented.**

A theme of the Committee's approach has been the value of public disclosures by banks – to enable market discipline and to support confidence in the banking system. We have made two recommendations in this area.

First, the Committee recommends that **the PRA should continue to work with the banking industry to ensure greater consistency and comparability of the Pillar 3 disclosures of the major UK banks and building societies, including reconciliation of accounting and regulatory measures of capital.**

Second, and building on progress already made, the FPC recommends that **the PRA should ensure that all major UK banks and building societies comply fully with the October 2012 recommendations of the Enhanced Disclosure Task Force (EDTF) upon publication of their 2013 annual reports.**

In reviewing policies on disclosure, the Committee has been conscious of the debate in the market about the risk weights employed in risk-weighted capital ratios. One possible comparator for firms' model-derived risk-weights is provided by what is known as the Basel standardised approach to credit risk, which consists of flat risk weights for different categories of exposure.

The FPC therefore recommends that **the PRA should assess the feasibility of the major UK banks and building societies calculating their regulatory capital ratios under end-point Basel III definitions using the standardised approach to credit risk. The PRA should report back to the FPC for its 2013 Q4 meeting.**

Not all risks to stability are financial in origin. Operational problems, if severe enough, could undermine the system's capacity to provide services to the economy. There is rightly an increasing emphasis across the industry on cyber attacks, as evidenced by the Bank's recent *Systemic Risk Survey*. We need to ensure those efforts are properly focused and co-ordinated.

The FPC therefore recommends that **HM Treasury, working with the relevant government agencies, the PRA, the Bank's financial market infrastructure supervisors and the FCA should work with the core UK financial system and its infrastructure to put in place a programme of work to improve and test resilience to cyber attack.**

Those are the Financial Policy Committee's latest policy decisions. As well as making recommendations to the PRA, for the first time the Committee has made recommendations to the FCA.

In the *Financial Stability Report*, we range more widely, reviewing threats to stability where mitigating actions are part of the international reform programme. We also identify issues that the Committee will need to follow carefully in the future, such as the scale and nature of regulatory arbitrage.

The road to rebuilding the resilience of the financial system, so that it can support our economy as it should, will be long. But a real start has been made, which will help underpin economic recovery in the period ahead.

Finally, therefore, I should take this opportunity to pay the warmest tribute, on behalf of the Financial Policy Committee, to the way that Mervyn King has chaired and led the Committee since its creation. Without Mervyn, the FPC would not have become established as quickly as it has. We look forward to welcoming our new Chairman, Mark Carney, on Monday, and to working with him to develop further the FPC's mission of ensuring financial stability.