Publication date: 6 December 2011

RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

23 NOVEMBER 2011

This is the record of the Interim Financial Policy Committee meeting held on 23 November 2011.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1112.pdf

In June 2010, the Chancellor of the Exchequer set out a plan for fundamental changes to the system of UK financial regulation. In July 2010 and February 2011, the Government published consultation documents on the proposed changes, and in June 2011 issued a White Paper. The proposed reforms include the establishment of a Financial Policy Committee (FPC) charged with identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

The Government intends the FPC to be a Committee of the Bank of England's Court of Directors, and in February 2011 the Court created an interim FPC to undertake, as far as possible, the future statutory FPC's macroprudential role. Although lacking the proposed statutory powers of Direction and Recommendation of the statutory FPC, the interim FPC contributes to maintaining financial stability by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. It also carries out preparatory work and analysis in advance of the creation of the permanent FPC.

The Committee meets at least four times a year and a record of each meeting is published within six weeks.

The next meeting of the FPC will be on 16 March and the record of that meeting will be published on 28 March.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 23 NOVEMBER 2011

The interim Financial Policy Committee unanimously agreed the following policy recommendations:

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.**

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.**

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.**

The macroeconomic and financial environment

1. The Committee began its meeting by reviewing recent financial system and economic developments as set out in the December 2011 *Financial Stability Report*. Sovereign and banking risks emanating from the euro area had intensified and remained the most material and immediate threat to UK financial stability. Against a backdrop of deteriorating growth prospects internationally, market concerns about the sustainability of external and public debt positions had broadened from smaller euro-area economies, such as Greece and Portugal, to some larger euro-area economies. This had been particularly evident in sovereign bond markets where spreads on some government bonds over German bunds had increased to historically high levels. Spreads for Italy and Spain had increased by an average of around 250 basis points since the June *Report*. Wider contagion effects had also started to be seen, including in Austrian, Belgian, Dutch, Finnish and French sovereign bond markets.

2. Capital market functioning had deteriorated and many risky asset prices had fallen sharply. For example, equity prices had fallen by over 10% in the United Kingdom since the June *Report,* and by almost 25% in the euro area. Risk capital had been reallocated, as investors had sought to reduce exposures to vulnerable euro-area countries and to riskier assets more broadly. There were some reports of banks retreating from international lending. On some measures, risk appetite was as low as in 2009.

3. Euro-area banks collectively held large amounts of debt issued by euro-area governments and, in some cases, were perceived to rely on support from these governments. Partly for these reasons, the creditworthiness of some European sovereigns and many euro-area banks had been closely intertwined.

4. The European authorities had announced a package of measures in October to stem the crisis. These included a discount of 50% on Greek sovereign debt held by private investors and proposals to allow the resources of the European Financial Stability Facility to be leveraged up to around €1 trillion. Also as part of the package, the European Banking Authority (EBA) was requiring European banks to raise their core Tier 1 capital ratios to 9%, after accounting for the market valuation of sovereign debt, by end-June 2012. Market reaction, however, suggested that there had been concerns about how easy it would be to implement the package and/or how effective it would prove to be.

5. UK banks' direct exposures to the sovereign debt of the most vulnerable economies were limited and had fallen in 2011 Q3. But they had larger exposures to the private sectors of some of the weaker euro-area countries, such as Italy, Spain and Ireland. They also had significant exposures to major European banking systems, which in turn had large exposures to weaker euro-area countries. If the deterioration in the euro area were to continue, banks' asset quality and profits would weaken further. That, in turn, would also exacerbate uncertainty in funding markets and reduce the availability, or increase the cost, of term refinancing.

6. Since the events of Autumn 2008, UK banks had made significant progress in improving their capital and funding positions. Capital ratios and the level and quality of capital were all considerably higher than in 2008. Leverage had been reduced and wholesale funding requirements were smaller. But progress in building capital in the UK banking sector had slowed in recent quarters. Capital levels over the past year had been broadly flat for the majority of the large UK banks, with increasing reliance on cutting risk-weighted assets to boost capital ratios. Looking ahead, the outlook for UK banks' profits had deteriorated since the last *Report*, particularly since the start of October, which would limit banks' ability to build capital without taking other actions.

7. While UK banks had met most of their term wholesale funding targets for 2011 earlier in the year, progress in building funding resilience had been set back in recent months. Public issuance of term unsecured funding had been very weak since May and banks had a large amount of debt maturing in the first half of 2012. There was also significant competition amongst banks in retail funding markets, which had raised funding costs.

8. In the light of recent developments, CDS premia had risen in virtually all banking systems. While UK banks' CDS premia generally had remained below those of many euro-area banks, they were mainly higher today than in Autumn 2008. That primarily reflected increasing concerns about the vulnerability of UK banks to current developments.

9. The reduction in banks' access to term funding if sustained was likely to lead to a renewed tightening in credit conditions for households and firms. Market intelligence was consistent with that. Credit conditions could also tighten if banks' ability to generate capital internally was reduced by higher credit losses.

10. A renewed tightening in credit conditions appeared to be already under way in the euro area. Contacts had suggested that some banks planned to respond to the EBA's required capital ratio raising by reducing assets and through what was described as 'optimisation' of risk-weighted asset calculations (for instance, through changes to internal risk models), with only a small contribution to raising capital ratios coming from new equity. Reducing assets was likely to lead to a further material tightening of credit conditions and/or falls in asset prices in European economies, while adjustment of risk-weight calculations was unlikely to result in any improvement of capital adequacy. Some of the reduction in assets was likely to come about through lower cross-border lending, adding to the risk of a global economic slowdown, which would further raise risks to banks.

11. To date, the impact of higher funding costs on loan pricing for corporate and household borrowing had been relatively muted. But if funding stresses persisted, credit conditions could be expected to tighten materially in 2012. That came against an existing backdrop of already weak growth of lending by UK banks, particularly to smaller businesses. These factors could act to exacerbate an adverse feedback loop of weak macroeconomic activity and deteriorating bank asset quality, which would harm the financial system's resilience.

Previous policy recommendations

12. Before turning to consider potential new recommendations, the Committee reviewed progress against its previous policy recommendations, as set out in Section 4 of the December *Report.*

13. The Committee decided that a number of its previous recommendations could be considered completed. For example, the FSA had compiled data for the euro-area sovereign and banking sector exposures of those UK banks that had not taken part in the EBA's EU-wide stress testing exercise. On 25 July it had published an aggregate estimate, which had confirmed that those banks and building societies had only limited direct exposures to sovereigns and financial institutions in Greece, Ireland, Italy, Portugal and Spain. That was likely to have reassured investors somewhat about the resilience of smaller UK institutions.

14. The FSA had also extended its review of forbearance and associated provisioning practices by collecting and analysing quantitative data on UK residential mortgage and commercial real estate loan portfolios and qualitative information on other material UK and

non-UK retail and corporate loan portfolios. This work had found evidence of understatements of provisions against forborne loans in the UK residential mortgage and commercial property sectors, but the FSA judged that, by themselves, these were unlikely to be systemically important at present. In light of that, the Committee welcomed the FSA's plans to continue monitoring banks' forbearance and associated provisioning practices, including analysis of some leveraged loan and commercial real estate portfolios internationally and asked that any material findings be reported to the Committee.

15. The FSA had also reported the results of a review of risks associated with some opaque funding structures, namely collateral swaps and similar transactions employed by exchange-traded funds. The work had identified a number of ways in which these funding sources could create threats, although they were noted to be a small funding source at present for UK banks.

16. Other recommendations that the Committee had made at previous meetings would be subject to continuing work. For example, further extensions of disclosure would be considered by the Committee in the future. And while HM Treasury had continued its efforts to ensure that developments in European legislation did not impede the ability of the Committee to use macroprudential instruments in the interests of financial stability in the United Kingdom, discussions at the European level on the relevant draft EU texts had yet to be concluded.

17. The other recommendations issued by the Committee at previous meetings related to matters which, given recent economic and financial developments, the Committee wished to consider further and on which new recommendations were made during the remainder of its November meeting.

New policy recommendations and areas for further consideration

18. As an important part of the backdrop to its decisions on potential new recommendations, the Committee discussed the contingency arrangements which were being put in place by the UK authorities in case spillovers from the problems in the euro area began to undermine UK financial and economic stability. HM Treasury was establishing contingency plans for the recapitalisation of UK banks. It was also putting in place arrangements to support UK banks in raising term funding, which it could deploy if needed to forestall rapid or disorderly deleveraging. The Bank confirmed that it had arrangements in

place to supply sterling liquidity through an extended collateral term repo facility should they be required. Finally, HM Treasury was finalising instructions to Parliamentary Counsel in case emergency legislation was required to establish a regime for the resolution of a central counterparty (CCP). The Committee's discussion of, and decisions on, further steps to mitigate risks to the UK financial system were predicated on the understanding that these various measures would continue to be developed and could be activated at short notice, if required.[1]

Capital

19. At both its June and September meetings, the FPC had made policy recommendations aimed at encouraging banks to build their capital levels in order to increase their capacity to absorb future shocks, without constraining lending to the wider economy. In the light of the exceptionally threatening environment, the Committee discussed whether stronger action to build the resilience of the system was required. Such action could help to mitigate the risk that a further deterioration in conditions in the euro area would lead to a significant disruption to UK financial stability and hence to the supply of credit to households and firms.

20. Committee members agreed that banks should step up efforts to bolster their resilience given the significant near-term risks. It was important that banks did so, where possible, by raising nominal capital levels. The Committee noted that there were however indications that some euro-area banks were instead reducing their assets, which was leading to tightening credit conditions and reinforcing an adverse feedback loop of weakening economic growth and deteriorating bank asset quality. In contrast, by increasing levels of high-quality capital, banks could strengthen their resilience and enhance their capacity to provide credit to the wider economy now and in the future.

21. The Committee discussed how UK banks might increase their capital. The deterioration in the economic environment had lowered further the likelihood that earnings would allow this, implying the need for some combination of limiting distributions to shareholders and staff, or raising external capital. Committee members recognised that many UK banks had already reduced or eliminated distributions to shareholders and others might view a steady flow of dividends as critical to their ability to raise external capital in the

[1] The text in this paragraph was omitted from the version of the Record that was initially published on 6 December 2011. The Committee agreed at its June 2014 meeting to release this text, for the reasons set out in the Record of that meeting.

future. Nevertheless, in order to boost capital the Committee concluded that dividend policies should be used actively and saw a strong case for limiting distributions to staff, although this might not be costless. The Committee also recognised that there were risks associated with attempting to raise fresh external capital in a stressed market environment. On balance, however, members judged that these concerns were outweighed by the potential benefits from raising additional capital to the resilience of the system as a whole and its ability to maintain the supply of credit to the wider economy.

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

23. A number of members highlighted that the continued prevalence of some types of performance metric – such as return on equity targets – that took little account of the riskiness of the business strategies used to achieve them could be reducing the incentives for banks' management to boost capital levels. In principle, such targets could have affected incentives in a number of ways, for example through investor expectations and through their link to remuneration of senior management. Some Committee members noted in addition that, while return on equity objectives could have a legitimate role in communicating expectations to investors, current targets appeared to have not adjusted sufficiently to reflect the fact that new capital regulations should have made bank investments lower risk, but also inevitably lower return. The Committee agreed that it would have a fuller discussion of this issue at a future meeting.

Balance sheet management

24. The Committee also discussed whether banks could adjust their portfolios in ways that improved their resilience to the immediate risks without adversely affecting the wider functioning of the economy and the rest of the financial system. In September, the Committee had advised the FSA to encourage banks, through its supervisory dialogue, to manage their balance sheets in a way that would not exacerbate market or economic fragility. Committee members recognised that there were likely to be some intra-financial system claims where precipitate action could indirectly, through their impact on other banks, accentuate real economy feedback loops. Conversely, there were other intra-financial sector

claims, such as those supporting pure position-taking activity, which could be scaled back without such risks, and with the benefit of removing complexity and risk from the system. The FSA would need to pursue this recommendation through its continuing supervisory dialogue with individual banks.

25. **The Committee reiterated 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.**

Risk weights

26. An important consideration underlying the Committee's second policy recommendation was that individual banks' decisions about their balance sheet composition could affect the rest of the financial system, either positively or negatively. For example, some intra-financial sector claims could increase opacity and, by making the system more interconnected, were likely to strengthen channels of contagion and add to systemic fragility. Others, however, facilitated the smooth flow of funding amongst financial institutions and helped some of those institutions meet their customers' demand for credit. Moreover, lending to companies and households might more often be associated with the positive externality of supporting growth, particularly in the current conjuncture. By supporting economic activity, and hence improving bank asset quality in general, prudent lending by individual banks could act to reduce risks to the system as a whole.

27. These effects were reflected imperfectly, if at all, in the existing microprudential risk weights applied to individual assets, which determined how much capital banks had to hold against different exposures. Under the existing Basel framework, these weights were ordinarily determined by an estimate of the relative riskiness of different types of asset from the perspective of the individual institution and in a more normal business cycle. In principle, by adjusting the regulatory risk weights associated with particular types of activity over time, macroprudential policymakers could seek to ensure that banks took externalities more fully into account when managing their balance sheets.

28. The Committee recognised that this line of thinking raised some major conceptual and practical considerations. In particular, there were issues about compatibility with Basel III and with the European Capital Requirements Directive. Notwithstanding these challenges,

Committee members viewed the calibration of risk weights as very important – with both near and medium-term implications for macroprudential policy – and agreed that they should return to the issue.

29. The Committee also discussed a range of other issues associated with the existing calculation of risk weights. The methods used to calculate risk weights, particularly those which used banks' own internal models, were opaque to investors and regulators. Market intelligence suggested that this opacity had impaired confidence in risk-weighting methodologies and could have dented market confidence in regulatory capital ratios. That in turn suggested that there was a potentially useful role for a leverage measure that did not attempt to adjust for the riskiness of banks' exposures, as a backstop to risk-sensitive measures of solvency. An obligation to report a commonly defined leverage ratio was to be introduced under Basel III, requiring banks to calculate the ratio from 1 January 2013, to disclose it from 1 January 2015, and for it to migrate to Pillar 1 on 1 January 2018.

30. Given its potential usefulness to investors as an additional solvency metric, **the Committee recommended that the FSA encouraged 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.**

31. Another potential flaw in the way risk weights were determined was that different banks could assign significantly different risk weights to identical portfolios of assets. The FSA had undertaken a number of reviews of the variability and comparability of risk weights amongst UK banks and the Committee encouraged the FSA to continue this work. Efforts in the same direction were also underway internationally for example in the Basel Committee. Some FPC members thought that, as part of that work, it would be appropriate to consider whether model-based calculations should be supplemented by minimum risk weights for specific categories of assets. These could then act in a similar way to the overall leverage backstop, but on a category-specific basis. Committee members also discussed the potential desirability of requiring banks to disclose information on the average risk weights by category of asset. These issues would be part of the ongoing international debate.

Encumbrance

32. Just as opacity about risk weights might be obscuring the picture on capital adequacy, so investor uncertainty about levels of banks' asset encumbrance – the degree to which

banks' assets were not available to unsecured creditors in the event of a default – could be hindering the assessment of some debt investors' claims on banks. Encumbrance was rising, in part because unsecured credit had become more expensive and less available, especially at longer maturities. Heightened uncertainty about encumbrance levels in turn might have further contributed to the increase in banks' unsecured funding costs and could have hindered primary debt issuance. The FSA had recently carried out a survey of major UK banks' levels of encumbrance. The Committee agreed that it should review the results of this survey before considering further whether additional transparency in this area might be helpful in mitigating risks to banks' funding models.

Central counterparties (CCPs)

33. The Committee noted that the increased use of central clearing was a means of enhancing systemic resilience by monitoring, managing and reducing system interconnectedness. But the contribution that central clearing could make to overall financial stability was critically dependent upon the effectiveness of CCP risk management. This was especially important in the current conjuncture. Collecting additional margin could be a prudent method for CCPs to manage their risk. But the design of margining and collateral policies should also aim, where possible, to limit pro-cyclical effects on the system and so to reduce cliff-edges associated with particular price or rating triggers. These cliff-edges could exacerbate instability by triggering liquidity problems in the wider system.

34. The Committee noted that margin rules could be made less pro-cyclical by ensuring that margins did not fall too low during periods of low market volatility. This highlighted the potential importance of macroprudential policy tools which could enable the authorities not only to set a floor to margin requirements but also vary them as conditions changed. The Committee noted that the draft CPSS-IOSCO Principles for Financial Market Infrastructures, which would apply internationally, required CCPs to adopt to the maximum extent that was prudent, forward-looking conservative margin requirements that avoided the need for destabilising, pro-cyclical changes. It supported the FSA and Bank's work to ensure that such principles were agreed.

35. Maintaining financial stability also required robust arrangements for managing losses at CCPs while maintaining the continuity of clearing services. The Committee agreed that it was not practical for CCPs to hold sufficient financial resources to eliminate the possibility

that they would be exhausted, for example in the event of multiple member failures at the same time as unusually volatile market prices. Yet CCPs did not generally have formal arrangements for allocating losses that exceeded 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. It would be likely that any allocation would occur in a way that was difficult to predict and could take a considerable period of time as well as involving a cessation of the provision of systemically important clearing services. This highlighted the importance of CCPs introducing loss-allocation rules as that would provide transparency to CCP participants, but as a backstop legislatures would also need to establish effective resolution tools for financial market infrastructures. The Committee welcomed the ongoing work in these areas by CPSS-IOSCO, the FSB and the European Commission, and the UK authorities would continue to monitor progress.

The following members of the Committee were present:

Mervyn King, Governor
Paul Tucker, Deputy Governor responsible for financial stability
Charles Bean, Deputy Governor responsible for monetary policy
Hector Sants, Chief Executive of the Financial Services Authority, Deputy Governor designate for prudential regulation and CEO-designate of the Prudential Regulation Authority
Adair Turner, Chairman of the Financial Services Authority
Alastair Clark
Michael Cohrs
Paul Fisher
Andrew Haldane
Donald Kohn
Robert Jenkins
Jonathan Taylor attended as the Treasury member.

Martin Wheatley, Managing Director of the Financial Services Authority's Consumer and Markets Business Unit and CEO-designate of the Financial Conduct Authority attended as an observer.