BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

28 August 2013

Prudential Regulation Authority Statement on liquidity

In a speech today, hosted jointly by the CBI East Midlands, Derbyshire and Nottinghamshire Chamber of Commerce and Institute of Directors at the East Midlands Conference Centre, Mark Carney, Governor of the Bank of England, confirmed that the Prudential Regulation Authority (PRA) Board will implement the June 2013 recommendation of the Financial Policy Committee (FPC) regarding the amount of liquidity held by banks and building societies.

Governor Carney said: "for major banks and building societies meeting the minimum 7% capital threshold, the Bank of England will reduce the level of required liquid asset holdings. The effect will be to lower total required holdings by £90 billion, once all eight major banks and building societies meet the capital threshold. That will help to underpin the supply of credit, since every pound currently held in liquid assets is a pound that could be lent to the real economy."

Background

UK banks and building societies have built up large liquid asset buffers in recent years. This has in part reflected the necessary steps taken by micro prudential supervisors to implement a liquidity regime to ensure that the banking system was adequately protected against liquidity shocks. Such steps were all the more necessary given the weakened capital position of some institutions following the crisis, and the need to replenish capital that had been used to absorb losses.

In June 2013 the FPC concluded that there was scope for banks to reduce their holdings of liquid assets. The FPC judged that its capital recommendations should improve banks' ability to fund themselves at longer tenor and lower cost. It also noted that banks continue to have access to central bank liquidity facilities, such as the Bank of England's contingent Extended Collateral Term Repo Facility. The FPC recommended a relaxation in liquidity requirements in order to strike the appropriate balance between achieving resilience and underpinning the supply of credit to the economy.

The PRA is today confirming that it will implement this recommendation, detailing how it will do so and explaining how it will transition to new international liquidity standards that are being implemented as part of the Basel III package of reforms.

The PRA will amend its current liquidity framework[1] such that firms should hold highly liquid assets broadly equivalent to 80% of the 'Liquidity Coverage Ratio' (LCR) agreed by the Basel Committee on Banking Supervision (BCBS) in January 2013. The LCR requires internationally active banks to hold sufficient liquid assets to cover their expected net cash outflows under a 30-day liquidity stress scenario.

The new liquidity standard will be applied to major UK banks and building societies that meet the 7% core equity capital standard set in the recent PRA exercise[2].

That exercise sought to confirm that all major UK banks and building societies held enough capital to ensure they were sufficiently resilient after taking account of expected losses, conduct costs and a more prudent calculation of risk weights. Following that work, the PRA has established that the major UK banks and building societies either meet, or have plans that will enable them to meet, a 7% core equity capital ratio. Where banks and building societies meet this standard of resilience it is possible for the regulator to be more flexible in its approach to liquidity insurance.

While supervisors will retain the ability to set higher liquidity levels for individual banks and building societies, the PRA estimates that, once all of the largest eight UK banks and building societies have met a 7% core equity capital ratio, around £90bn could be released to support lending to the real economy.

The PRA will be writing to affected banks and building societies to set out the exact details of this change in approach.

Detail

Although banks and building societies have been asked to hold significantly increased liquid asset buffers since 2010, there is currently no international liquidity standard in force. In January 2013 the BCBS agreed the design and implementation timeline of the LCR. This requires internationally active banks to hold sufficient liquid assets to cover their expected net cash outflows under a 30-day liquidity stress scenario.

The FPC recommended in June 2013 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."

The European Union (EU) has not finalised its implementation of the Basel LCR standard. All EU firms subject to CRDIV (banks, building societies and certain investment firms) will be required to meet liquidity reporting standards from the beginning of 2014. CRDIV also obliges the European Commission to adopt further legislation by June 2014 that specifies the definition, calibration, calculation and phase-in of a

'Liquidity Coverage Requirement'. The legislation will come into force during 2015. Member states can choose the transition path that their banking sector must follow, but firms will have to meet at least 60% of the LCR standard when it first comes into force, rising to 100% of the requirement by 2018[3].

Until the full EU adoption of the Basel LCR standard at some point in 2015, the PRA will comply with the FPC's recommendation by amending its current Individual Liquidity Guidance (ILG) framework. The ILG for each bank eligible for the new standard will be reduced to be broadly equivalent to an 80% LCR.

Once the EU legislation comes into force in 2015, the PRA intends to consult on switching its liquidity guidance framework to the LCR.

The Basel LCR standard requires a minimum of 60% of a bank's total LCR requirement to be met with Level 1 assets, allowing up to 40% of the requirement to be met with Level 2 assets. Basel LCR Level 1 assets are largely equivalent to the PRA's current liquid assets definition, which includes high quality debt securities issued by a government or central bank, multilateral agency bonds, cash and reserves at central banks. Whilst there is currently no EU definition of Level 2 assets, the Basel definition of Level 2 assets includes certain government securities, corporate bonds, covered bonds, RMBS and common equity shares subject to various conditions.

In order to deliver an outcome that is similar in nature to the Basel LCR, the PRA will allow banks to meet up to 40% of their reduced total liquidity requirement with either the haircutted value of assets pre-positioned at the Bank of England's Discount Window Facility or with certain assets specified by the PRA as Level 2 assets. The remainder of the liquidity requirement must be met with assets currently qualifying as liquid assets.

The PRA will, in due course, publish a definition of Level 2 assets to be used on a transitional basis until EU legislation is in force. From the point of publication UK banks and building societies will be able to use such assets to meet their liquidity guidance.

The PRA is developing an appropriate approach, intended to deliver a broadly similar effect as the changes set out above for the eight major banks and building societies, for smaller banks and building societies not explicitly covered by this announcement.

Footnotes

1. As part of this framework, the PRA provides firms with Individual Liquidity Guidance (ILG) advising them of the amount and quality of liquidity resources appropriate to the firm's circumstances.
2. http://www.bankofengland.co.uk/publications/Pages/news/2013/081.aspx
3. The PRA considers this to be the most likely implementation timetable, but notes that a review clause in CRDIV exists that could delay implementation of LCR at 100% until 2019. Member States may require institutions, or a subset of institutions, to maintain a higher liquidity coverage requirement up to 100% during the phase-in period.