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RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

16 JUNE 2011

This is the record of the interim Financial Policy Committee meeting held on 16 June 2011.

It is also available on the Internet

http://www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1106.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 published a white paper – '*A new approach to financial regulation: the blueprint for reform'* – outlining further steps towards the legislative enactment of the Government's proposed regulatory framework. 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 will also carry 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 will be published within six weeks.

The next meeting of the FPC will be on 20 September, and the record of that meeting will be published on 3 October.

RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE (FPC) MEETING HELD ON 16 JUNE 2011

At its meeting on 16 June 2011, the FPC agreed the following policy recommendations:

1. **The Committee advises the Financial Services Authority (FSA) to ensure that improved disclosure of sovereign and banking sector exposures by major UK banks becomes a permanent part of their reporting framework, and to work with the FPC to consider further extensions of disclosure in the future.**
2. **The Committee advises the FSA to compile data on the current sovereign and banking sector exposures of other UK banks not subject to the EBA stress tests. If these exposures are significant, then the FSA should publish an aggregate estimate.**
3. **The Committee advises the FSA to extend its review of forbearance and associated provisioning practices across UK banks' household and corporate sector exposures on a global basis.**
4. **The Committee advises UK banks that, during the transition to the new Basel III capital requirements, they should take the opportunity of periods of strong earnings to build capital so that credit availability is not constrained in periods of stress.**
5. **The Committee advises the FSA, as part of its regular supervisory dialogue with banks, to ensure that the proportion of earnings retained is consistent with the advice in the preceding recommendation.**
6. **The Committee advises the FSA that its bank supervisors should monitor closely the risks associated with opaque funding structures, such as collateral swaps or similar transactions employed by exchange-traded funds.**

1 It was noted that the interim Financial Policy Committee (FPC) had two main tasks. First, it would undertake, as far as possible, the future statutory Financial Policy Committee's macroprudential role by identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them. Second, it would carry out preparatory work and analysis in advance of the creation of the permanent Financial Policy Committee. The interim FPC had agreed that it would concentrate primarily on the first of these tasks in its meetings which coincided with the preparation of the *Financial Stability Report* and focus primarily on the second in the others.

2 Against that background, and in the light of the description of the outlook for financial stability contained in the June 2011 *Financial Stability Report*, the Committee judged that sovereign and banking sector strains in some vulnerable euro-area economies were the most material and immediate threat to UK financial stability. Indeed, in the period leading up to the Committee's meeting, market conditions had deteriorated further.

3 It was also noted that the *Report* had also identified that more medium-term risks were potentially posed by inadequate provisioning for loan forbearance. Loan forbearance could take many forms – for example, not taking actions against borrowers in arrears or those in breach of loan to value covenants. While forbearance by lenders had helped to reduce unnecessary foreclosures, it could not be ruled out that inadequate or opaque provisioning of loans subject to forbearance may have masked underlying credit risks and heightened uncertainty among bank creditors about profit and capital positions. Any such possible deficiencies in provisioning could be exposed if subdued economic growth persisted or if market interest rates rose.

4 In this challenging environment, it was welcome that the resilience of the UK banking system had improved in the recent past. Banks had lowered leverage levels and made progress in raising longer-term funding, reducing the extent of their immediate refinancing challenge. But lending growth to UK households and firms had continued to be weak and vulnerabilities remained.

5 There were also vulnerabilities relating to the structure of the financial system itself. In particular, these related to interconnectedness in the financial system and to complex or opaque instrument structures with the potential to amplify or propagate any stresses that emerged. There had been some evidence of these features beginning to reappear.

6 The Committee discussed in turn: sovereign and banking sector concerns; loan forbearance and associate provisioning practices; resilience and lending; and system interconnectedness and instrument complexity.

Sovereign and banking sector concerns

7 As set out in the *Financial Stability Report,* UK banks' direct exposures to the most vulnerable euro-area sovereigns were limited, but they had larger claims on the private sectors of some of those economies. Credit risks could also arise from links between banking systems. There was a risk that a sharp deterioration in vulnerable European economies may have adverse implications for credit conditions in larger European economies which were more heavily exposed, such as France and Germany. In conditions of severe stress in the euro area, this could increase the risk of losses to UK banks given that their combined claims on France and Germany represented around 130% of their core Tier 1 capital, with close to half accounted for by claims on banks. Any escalation of stresses could also be transmitted via interconnected global markets, including via the United States, leading to a tightening of bank funding conditions. Such contagion could be amplified if bank creditors were unsure about the resilience of their counterparties.

8 By providing more information about counterparty risk, greater transparency about banks' exposures to sovereign and banking sector risks could help to limit perception-driven contagion. Although the precise range of additional disclosures that would be made as part of the current European Banking Authority (EBA) stress testing exercise had not been finalised at the time of their meeting, Committee members judged that additional disclosures would be valuable and appropriate in the circumstances.

9 Indeed, there were clear merits to ensuring that such improved disclosures became a permanent part of the reporting framework for major UK banks, including at least those banks participating in the EBA stress tests, but probably a number of others as well. One way in which this could be achieved was by working with the British Bankers' Association to enhance its voluntary Code for Financial Reporting Disclosure.

10 It was important to balance these merits against the additional costs of reporting incurred by banks. Risks stemming from sovereign and banking sector exposures were the most pressing current concerns, but that would not always be the case. That argued against advising all banks to

make such disclosures a permanent part of their routine reporting framework and in favour of a more flexible approach.

11 For a number of members, however, this argued rather for extending routine disclosure of exposures to other sectors. And there were other dimensions in which the information provided to investors could be improved. For example, by ensuring disclosure of intra-period exposures – such as period highs and lows – the authorities could mitigate the risks associated with 'window-dressing' of end-period reporting. And the provision of more information about liquidity risks might also be useful, given fragilities in funding markets.

12 **The Committee agreed to advise the FSA to ensure that improved disclosure of sovereign and banking sector exposures by major UK banks became a permanent part of their reporting framework, and to work with the FPC to consider further extensions of disclosure in the future.**

13 There were no indications from regulatory information that other UK banks' current euro-area sovereign and banking sector exposures were significant. Nevertheless, the extent of the strains in some vulnerable euro-area economies, and the potential for market dislocation, implied that there was a risk that a fairly broad set of banks could face funding difficulties if there were uncertainty about their exposures.

14 **The Committee agreed to advise the FSA to compile data on the current sovereign and banking sector exposures of other UK banks not subject to the EBA stress tests. If these exposures were significant, then the FSA should publish an aggregate estimate.**

15 This was intended as a one-off exercise, designed partly to ensure the other UK banks had the capability to compile such data if it proved necessary in due course.

16 It was also possible for contagion to be amplified if there were doubts about the ability of banks from EU Member States to recapitalise or if mechanisms for dealing promptly with failing banks proved ineffective. The Committee therefore welcomed the recent ECOFIN commitment that all Member States would ensure that detailed and credible mechanisms were put in place to raise capital for all banks, where necessary. Having such a backstop should not be seen as a sign of weakness, but rather as a positive precautionary measure given the current heightened uncertainty in the international financial system.

Loan forbearance

17 Loan forbearance could allow borrowers greater flexibility in meeting their obligations during temporary periods of distress. As such, if provisioned for properly, it could be positive for financial stability and for economic growth. By reducing loan foreclosures, it could protect the resilience of both banks and their customers, and prevent fire sales of assets that could depress prices further.

18 It was possible, however, that forborne loans were not being consistently identified. Moreover, the existing accounting approach under IAS39 for incurred losses required objective evidence of impairment and a measurable loss before provisions could be made. Consequently, it was possible that forborne loans were being inadequately provisioned for. Committee members recognised that this could imply that, in economic substance, banks' profits and capital had been overstated in published accounts. And forbearance could also lead to an overly sanguine view of the debt-servicing capacity of borrowers.

19 The FSA had already collected some evidence on the extent of forbearance and associated provisioning practices in the UK residential mortgage market. The results of this initial work had suggested that, in the year to March 2010, the flow of residential mortgages into some kind of forbearance was around four times higher than the stock of mortgages in possession or in arrears of six or more months' payments. And, as a result of its findings, the FSA had recommended that banks' provisioning practices be improved in order to ensure appropriate recognition of impairments. Members judged that the scale of the issue, especially if it extended to other sectors, could be large enough to affect the Committee's overall assessment of the outlook for financial stability.

20 The Committee considered the case for advising the FSA to broaden its earlier work. There were indications that forbearance was also prevalent in a range of other sectors, such as the UK commercial property sector, while provisioning practices were unclear and, at least for some members, potentially inadequate. It was unlikely that this issue was restricted to UK banks' domestic lending or, indeed, to UK banks. In the absence of better information, it would be difficult for the Committee to assess the overall resilience of the banking system effectively.

21 **The Committee agreed to advise the FSA to extend its review of forbearance and associated provisioning practices across UK banks' household and corporate sector exposures on a global basis.**

22 The Committee recognised that there would be costs associated with extending the FSA's work. These were likely to increase with the scope of any exercise. There were arguments for ensuring that the scope reached beyond the largest UK lenders. History had demonstrated that threats to the resilience of the financial system could arise if a number of small banks got into difficulties at the same time. But that did not imply that the FSA should aim to include all UK lenders. To allow for these competing concerns, the Committee's advice afforded an element of discretion for the FSA to decide precisely which lenders should be involved. Moreover, the FSA would need to prioritise the order in which they looked at different sectors.

23 Committee members requested that the FSA report back to the FPC the progress made on this extended exercise, with any initial results, in time for the Committee's meetings in 2011 Q4.

Resilience and lending

24 It was important for the Committee to assess the resilience of the financial system against the scale of current risks. Given these risks, there was a strong case for banks to build capital further if the opportunity arose to do so without jeopardising lending supply.

25 In particular, it was desirable, therefore, that banks maintained policies, including for the distribution of their earnings both to shareholders and employees, which were prudent and consistent with their medium-term profitability as well as the resilience of the financial system as a whole. Such policies would imply that, if earnings were relatively strong over any particular reporting period, banks should seek to build up capital.

26 Committee members agreed that it was important to emphasise that the purpose of building capital when the opportunities arose was so that banks would be more resilient and could expand credit availability. This did not imply that banks should aim to satisfy the new, higher long-term Basel III capital ratio requirements before the end of the internationally agreed transition period in 2019.

27 **The Committee agreed to advise UK banks that, during the transition to the new Basel III capital requirements, they should take the opportunity of periods of strong earnings to build capital so that credit availability is not constrained in periods of stress.**

28 It was possible that banks currently had insufficient incentives to build up their capital levels when conditions were favourable. That could be the case if, for example, there were pressures from shareholders to deliver short-term returns or incentives from the market for banks to compete with each others' distribution policies. Committee members therefore debated whether such advice should be made more concrete.

29 There was a case for the Committee to set out some qualitative criteria which could be used to assess periods of strong earnings. It would then be possible for the FSA to use those criteria as part of its regular supervisory dialogue with banks about distribution policies. Some members also saw a case for the Committee to set out quantitative guidance for banks' distributions. Such guidance could be useful if, for example, banks were under pressure to match the distributions of their peers in order to signal their relative strength to creditors and equity markets. In these circumstances, it might be possible for the Committee, by advising a relatively low presumptive cash distribution rate for all banks, to make it easier for banks to retain earnings. Such guidance was part of the broad approach adopted in the United States, whereby the Federal Reserve had stated that it expected large banks to limit dividends to 30% or less of anticipated earnings in 2011. The Committee might also encourage banks to pay dividends in the form of new shares, rather than cash. From the firm's perspective this would have the same effect as retaining earnings.

30 There were, however, arguments against each of these options. First, it would be difficult to specify any general guidance that would be appropriate for all UK banks, given their heterogeneous positions. The FSA already gave supervisory guidance to each bank that was tailored to its individual characteristics. Second, there was a danger that simple industry-wide quantitative guidance could have a perverse impact. The banks that expected to distribute a relatively high proportion of their earnings might also be the banks that least needed to build up their levels of capital. Third, it was possible that if the authorities acted to restrain distributions too prescriptively, it could, for example, result in an increase in banks' cost of capital.

31 **The Committee agreed to advise the FSA, as part of its regular supervisory dialogue with banks, to ensure that the proportion of earnings retained was consistent with the advice in the recommendation described in paragraph 27.**

32 Committee members requested that the FSA report back to the FPC on this issue, initially in time for the Committee's meetings in 2011 Q4. The Committee could reconsider this issue in the future if it felt it necessary.

System interconnectedness and instrument complexity

33 Although there had been little evidence of excessive risk-taking on a generalised basis across the financial system, there had been signs of increasing risk appetite in certain financial markets. That was apparent in, for example, segments of the leveraged loan and high-yield bond markets. There were also signs of renewed innovation as financial market participants looked to generate higher returns in the low interest rate environment. In that context, the Committee discussed the example of exchange-traded funds (ETFs), which had previously been highlighted in the June 2010 *Financial Stability Report.* ETFs offered a wider population of investors affordable access to a broad range of instruments in a reasonably liquid form. But the Committee noted that complexity had crept in, including through so-called synthetic structures. The assets held by some ETFs, or by the sponsors of synthetic ETFs, were increasingly being used as a source of funding for a number of banks, through collateral swaps and similar transactions. Although UK banks had not been heavily reliant on this market, little information existed about the terms of such transactions and hence the risks that they might pose to UK financial stability if the market expanded further. Moreover, some European banks appeared to make greater use of such funding structures. And ETFs were just one example of a range of ways that opaque funding structures could be created within financial markets.

34 **The Committee agreed to advise the FSA that its bank supervisors should monitor closely the risks associated with opaque funding structures, such as collateral swaps or similar transactions employed by exchange-traded funds.**

35 The Committee also discussed how recent innovations meant the true nature of some ETF securities may not be fully transparent to investors or participants in financial markets more generally. In some circumstances a lack of transparency about securities could end up posing a threat to the financial system. The Government's consultation document clearly envisaged that, in such circumstances, the FPC might choose to make recommendations to the FSA and, in future, the Financial Conduct Authority. But, despite its rapid growth, the ETF market as a whole seemed unlikely to pose an immediate threat to financial stability. So there was an argument that this should for now be regarded primarily as a consumer protection issue and hence a responsibility of

the FSA rather than the Committee. Moreover, at present, there were relatively few ETFs domiciled in the United Kingdom. It might be hard for the authorities in the UK to ensure appropriate disclosures in isolation.

36 The Committee therefore supported the continuing work at an international level on this issue. Over recent months, the Financial Stability Board, the Bank for International Settlements and the International Monetary Fund had all published separate reports relating to ETFs, to which the Bank of England and FSA had contributed. In Europe, the FSA and HMT were working with the European Securities and Markets Authority and other authorities to promote a strengthening of regulatory risk standards applied to ETFs, particularly concerning improved characterisation and disclosure requirements and collateral and liquidity management. But the Committee agreed that it was unnecessary to issue any other recommendations in this area at its June meeting.

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, Deputy Governor Designate responsible 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
Jonathan Taylor attended as the Treasury member.