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# RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

# 22 JUNE 2012

This is the record of the Interim Financial Policy Committee meeting held on 22 June 2012.

It is also available on the internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1207.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 January 2012 introduced the Financial Services Bill to Parliament. The legislation will establish a Financial Policy Committee (FPC) charged with a primary objective of 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. In June 2012, the Chancellor announced that the Government would amend the Bill to give the FPC a secondary objective to support the economic policy of the Government.

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 14 September and the record of that meeting will be published on 27 September.

**RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 22 JUNE 2012**

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

1. **The Committee recommends that, taking into account each institution's risk profile, the Financial Services Authority (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.**

2. **In addition, the Committee reiterates 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.**

3. **The Committee recommends 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.**

4. **The Committee recommends 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.**

5. **The Committee recommends 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.**

**The macroeconomic and financial environment**

1. The Committee reviewed recent financial system and economic developments as described in the June 2012 *Financial Stability Report*.

2. The outlook for financial stability had deteriorated, particularly in light of heightened uncertainty about how, and when, euro-area risks would be resolved. Official policy measures, including the ECB's longer-term refinancing operations (LTRO), had led to improved bank funding conditions and reduced market volatility in 2012 Q1. But underlying concerns about sovereign indebtedness, banking sector resilience and imbalances across the euro area had persisted and the improvement in sentiment had proved temporary. For example, spreads on Spanish sovereign debt relative to German bunds had increased to historically high levels and bond yields of several other euro-area governments remained elevated and volatile.

3. Market strains had re-emerged reflecting rising financial distress and political tension in the euro area, particularly regarding Greece and concerns that the country might require further debt restructuring and/or leave the euro area. A number of developments had reinforced perceptions of strong links between the creditworthiness of European sovereigns and euro-area banks, such as the efforts of the Spanish authorities to recapitalise the Spanish banking sector. Increasing concerns about sovereign balance sheets had manifested themselves in a sustained redistribution of international capital, with growing evidence of capital flight from some euro-area banks and capital markets and a reluctance by investors to hold some euro-area assets.

4. The Committee noted that major UK banks' exposures to the most vulnerable euro-area economies' sovereigns and banks were not high, totalling 6% and 14% of core Tier 1 capital respectively. But UK banks had significantly larger exposures to private sector borrowers in many of these countries. And, although some banks had made sizeable provisions, the risk of further significant losses persisted while the macroeconomic backdrop remained adverse. Banks in other EU countries were also exposed to vulnerable euro-area countries, leading to the potential for indirect losses for UK banks. If contagion were to spread, there would likely be significant disruption through secondary channels, such as increased counterparty risk and stresses in funding markets, with adverse feedbacks to the macroeconomy.

5. These concerns prevailed against a backdrop of deteriorating global growth prospects. In particular, some larger emerging economies had experienced rapid credit growth and there were signs of overvaluation in some Asian property markets. A disorderly unwinding of asset prices

could result in direct losses on UK-owned banks' exposures to the region, which for some banks were significant.

6. Efforts by UK banks to build resilience through higher capital and stronger funding structures had provided some insulation from strains in the euro area. In aggregate, the four largest UK banks had increased their nominal core Tier 1 capital levels by £90 billion over the past four years. But progress in building capital levels had slowed recently – since the start of 2011, increases in capital ratios had been largely driven by a reduction in risk-weighted assets, with capital levels remaining broadly flat. Following previous FPC recommendations, some UK banks had limited distributions. But earnings had continued to be constrained by a number of factors, including structural balance sheet changes, redress for mis-selling of financial products and squeezed net interest margins due to elevated funding costs. These factors were likely to provide a drag on future earnings for some time. None of the large UK banks had issued equity, except for the purpose of paying dividends or bonuses.

7. UK banks had continued to reduce structural funding vulnerabilities, with deposit growth and non-core asset disposals limiting banks' need to access wholesale funding markets. Banks had also taken advantage of the window of opportunity provided by the ECB's LTRO to accelerate their wholesale funding programmes for 2012. Recent reviews by Credit Rating Agencies of the ratings of banks had added to uncertainty in the short term, although the outcome had not been as bad as some market participants had feared. Funding costs had remained high, partly due to investors' concerns about potential losses.

8. UK banks' holdings of high-quality liquid assets had tripled since the end of 2008, helping to protect them against potential future funding strains. And UK banks had pre-positioned over £265 billion of collateral for use in the Bank's Discount Window Facility (DWF) as of end-March 2012. After applying appropriate haircuts, this meant that the Bank could lend around £160 billion through this facility. Pre-positioned collateral could also be used to obtain sterling liquidity in the Bank's Extended Collateral Term Repo (ECTR) facility. The recent activation of this facility had been intended to mitigate risks arising from any prospective market-wide shortage of sterling liquidity, by lending regularly to the banking system against a wide range of collateral.

9. Credit growth in the United Kingdom had remained weak. The stock of lending to the UK corporate sector had fallen since the December 2011 *Report*, having contracted since 2009.

Growth in both secured and unsecured lending to UK households remained sluggish. The Bank's 2012 Q2 Credit Conditions Survey suggested a further weakening in the coming quarter.

10. The tightness of credit conditions over the past few years was likely to have reflected both supply and demand factors. More recently, the role of tight supply conditions in weak credit growth appeared to have strengthened. Banks had been passing through higher funding costs to the interest rates on both corporate and secured household lending. Ongoing uncertainty around euro-area outcomes posed risks of a further round of credit tightening. That highlighted the potential for an adverse feedback loop to develop, were the economy to weaken and the quality of banks' assets to deteriorate. One of the intentions of the proposed 'funding for lending' scheme was to help ease credit conditions to the UK real economy by reducing the cost of funding loans.

**Previous FPC policy recommendations**

11. The Committee reviewed progress against its previous policy recommendations. It decided that its June 2011 recommendation to the FSA on disclosure of sovereign and banking sector exposures by major UK banks had been implemented. Action was underway in response to a recommendation to HM Treasury in September 2011 to ensure that EU legislation did not constrain the Committee's use of macroprudential policy instruments and in response to a recommendation to the FSA in November 2011 to encourage banks to disclose their Basel III leverage ratios by the start of 2013. The Committee reviewed five further previous recommendations on balance sheet management and capital building by banks. It agreed that these had been superseded by subsequent recommendations in these areas. Section 4 of the June 2012 *Financial Stability Report* set out the activity of the Committee and the progress in implementing its recommendations over the past six months.

12. The Committee received an oral update on the UK authorities' contingency planning work. It agreed that its initially private recommendation to HM Treasury from September 2011 on contingency planning should remain in place given that the work was ongoing. HM Treasury would prepare a further report, updating on progress, ahead of the Committee's next meeting in September 2012.

13. There was a case for publishing the recommendation, along with associated redacted text from the FPC Record of 20 September 2011, and from the FPC Record of 23 November 2011 to clarify and reassure that work was underway to manage a range of tail risks, including options for restructuring bank liabilities. But publication now, when serious threats remained, might further

undermine already fragile market sentiment if it created a perception that the authorities had not done enough. In addition, changes to the resolution regime were now envisaged: the introduction of the relevant legislation might be a natural point to review publication. For these reasons the Committee concluded that publication of this material at this time would be contrary to the public interest. In line with the terms set out in the Financial Services Bill (section 9R(1)), it would keep that judgement under review and would publish the relevant text as soon as doing so was no longer judged to be against the public interest.[1]

14. The Committee noted that the FSA were conducting further work relating to earlier, closed recommendations, in particular those highlighting the need for monitoring of forbearance and associated provisioning practices and on banks' use of opaque funding structures. The FSA had committed to report back so that the Committee could review whether this challenged earlier conclusions.

**Recommendations by the European Systemic Risk Board**

15. Before turning to consider its own policy decisions, the FPC agreed that in future it should consider recommendations issued to the United Kingdom by the European Systemic Risk Board (ESRB) – the EU macroprudential body. An exception would be any ESRB recommendations that pertained to the macroprudential regime, which was a matter for HM Treasury.

16. Since its establishment, the ESRB had issued three recommendations on: (a) national macroprudential mandates; (b) US dollar funding; and (c) lending in foreign currency. The ESRB had requested a response from member states to each recommendation by end June 2012. Consistent with the agreed approach, the first recommendation on macroprudential frameworks was not discussed by the FPC. The Treasury member noted that this recommendation would be implemented via measures contained in the Financial Services Bill and in the new EU Capital Requirements Regulation and Directive.

17. On the second recommendation, to monitor banks' use of and dependence on US dollar funding, the FSA reported that it already monitored the vulnerability of the largest UK banks to such risks via its regular liquidity stress tests. Data were collected on UK banks' funding sources by currency and separately by counterparty. On proportionality grounds, the FSA did not propose

[1] The text in this and the preceding paragraph were omitted from the version of the Record that was initially published on 6 July 2012. The Committee agreed at its June 2014 meeting to release this text, for the reasons set out in the Record of that meeting.

adopting the ESRB recommendation to collect data for all UK banks split by both currency *and* counterparty as the main risks were covered as part of its supervisory dialogue.

18. In its discussion, the FPC stressed the importance of US dollar funding risks, including those relating to funding from US Constant Net Asset Value Money Market Funds. The US authorities had proposed reforms to this industry, although progress had slowed. Authorities internationally were considering how to contain risks from bank dependencies on this source of funding if reforms were not forthcoming. The FPC noted and endorsed the FSA's planned response to the ESRB. Given the systemic importance of the issue, the FPC asked the FSA to report back on progress ahead of its September 2012 meeting.

19. The FSA had considered its approach to foreign currency lending risks and determined that changes to its rules or guidance were not needed. The Committee viewed this risk as unlikely to be systemically important for the United Kingdom.

**FPC secondary objective**

20. The Committee discussed the Chancellor's earlier announcement that the Government would seek to amend the Financial Services Bill to give the FPC a secondary objective to support the economic policies of the Government, including its objectives for growth and employment. It was noted that the primary objective, to protect and enhance resilience, and the new secondary objective were compatible. Indeed, the Committee's recommendations on capital and balance sheet management over the past year had been specifically designed to build resilience while supporting lending and growth. The new secondary objective would, though, put more onus on the Committee to articulate the rationale for its policies at any given time.

**New policy recommendations**

*Bank capital*

21. At its November 2011 meeting the Committee had recommended that UK banks should raise capital levels so that they would be better able to absorb losses and so to sustain lending if severe risks crystallised. At its June meeting the Committee reviewed whether its previous policy position remained appropriate.

22. The Committee considered that progress by UK banks in raising capital over recent years had helped to insulate them from the funding strains experienced by some banks in the euro area. Major UK banks' capital ratios left them reasonably well placed to enable them to meet minima

that would be required as part of the extended official transition to the Basel III standard from 2013 to 2019. It was impossible, however, to be sure how events would unfold. The Committee was concerned that in especially severe, but plausible, adverse scenarios in the euro area some UK banks could face large losses both on direct exposures to the region and via a range of indirect channels. While the position of individual institutions varied significantly, the Committee judged that the overall capitalisation of the banking system was unlikely to be sufficient for stability to be assured and so to sustain an adequate supply of financial services to the economy should such losses crystallise.

23. In its previous recommendations, the Committee had specified that banks should seek to bolster resilience primarily by raising their capital levels, so as to avoid deleveraging in ways that would damage the economy and so increase default risk. Some banks, given their individual circumstances, were reducing non-core assets, which could also bolster their resilience.

24. The Committee discussed whether it should signal more explicitly that banks could also use a proportion of additional capital raised to support new lending to the real economy. It was important that banks were not constrained by regulatory capital requirements from expanding lending, including that financed by the proposed 'funding for lending' scheme.

25. In the light of these considerations, **the Committee recommended that, taking into account each institution's risk profile, the FSA work 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.**

26. Members agreed that the intention of this recommendation was to encourage banks opportunistically to build a temporary cushion of capital to increase resilience to current exceptional threats. While some additional capital could be used to support lending immediately, their expectation was that this policy would lead to a temporary increase in banks' capital ratios. That in turn might enhance market perceptions of resilience and reduce funding costs. The period over which higher capital should be held was directly linked to the persistence of current threats – the Committee was explicitly not expecting banks to meet higher ongoing minima or to accelerate

the transition to Basel III requirements. If current risks crystallised, any additional capital accumulated would absorb losses. At that point, or if the risks receded, banks' capital ratios could fall back to minimum supervisory requirements associated with the official transition path to the Basel III standards.

27. The required scale, and most appropriate means, of capital raising would vary across institutions. The weak profit outlook for banks would make it difficult to raise sufficient additional capital solely by limiting cash dividends and compensation. Banks might also issue equity, or contingent capital instruments on terms approved by the FSA, incorporating high triggers for conversion. Some banks also had scope to bolster capital positions via debt-for-equity swaps or other liability management operations.

*Banks' balance sheet management*

28. At its meetings in September and November 2011 the Committee had made policy recommendations aimed at encouraging banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy. The FSA had worked with individual banks on their plans to manage down positions that created particular funding risks. The Committee also discussed steps that banks could take to strengthen resilience in the light of current threats. In particular, concerns about valuations of euro-area banking book exposures and potential redenomination risks were contributing to a lack of investor confidence in banks around the world. Depressed price-to-book ratios suggested that market participants remained uncertain about banks' asset valuations or earnings capacity. The Committee noted the importance of banks' senior management tackling these risks promptly, with due regard to the impact of their actions on market conditions and lending.

29. **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.**

30. **The Committee also 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.**

*Bank liquidity*

31. The Committee discussed whether there was a case for reviewing current liquidity guidance from the FSA in light of the recent deterioration in the outlook for financial stability and announcements on the availability of public liquidity insurance via the ECTR facility, as well as from the existing DWF.

32. The introduction of quantitative microprudential liquidity standards by the FSA in 2010 had played a major role in increasing banks' resilience. Prior to the crisis, UK banks' liquid asset holdings had been very low. Individual liquidity guidance (ILG) – expressed in terms of a ratio, for each bank, of liquid assets relative to stressed outflows over a three-month period – had encouraged banks to hold higher levels of liquid assets and to reduce their reliance on flighty short-term funding. The increase in holdings of liquid assets by UK banks since 2010 had put them in a stronger position to weather short-term liquidity pressures over the past year. The guidance also provided a bridge to any future international requirements on liquidity.

33. But members were concerned that microprudential regulatory liquidity guidance might inadvertently be contributing to tight credit conditions. Banks were holding buffers on top of the ILG buffers: UK banks' liquid asset holdings were well in excess of current regulatory guidance. Funding supporting liquid assets could potentially be used instead to finance lending. And while banks had increased their resilience by holding liquid, but lower-yielding, assets and by competing for more stable and expensive sources of funding, it was also possible that that had pushed up the pricing of loans. At its meeting in June, the Monetary Policy Committee (MPC) had discussed the possibility that regulatory liquidity requirements might be increasing the demand for reserves, attenuating the impact on the economy of the MPC's asset purchase programme and the associated increase in the supply of reserves.

34. The Committee considered whether the FSA's liquidity guidance was acting as a significant constraint at present on banks' willingness to lend. Banks' liquid asset holdings were well above regulatory guidance so it was possible that market pressures may lie behind banks' desire to maintain high holdings. Banks' choices over their liquid asset holdings might reflect uncertainty about the impact on their funding of ratings downgrades, which could result in significant contractual or behavioural outflows, and/or stress in severe euro-area scenarios. Banks might also be looking to self-insure if they were uncertain about their access to liquidity from the

Bank. For these reasons, there was no guarantee that relaxation of regulatory guidance would lead to a fall in banks' holdings of liquid assets.

35. Against that, market contacts had suggested that investors' expectations of banks' liquidity holdings were, in part, framed by regulatory minima. And even if regulatory guidance was not a constraint at present, it could become so in periods of severe stress. For these reasons, the Committee agreed that it should reinforce the previous messages from the FSA that ILG ratios were not hard floors and liquid asset holdings were useable in times of market strain for the duration of the stress.

36. Members considered whether there was a case for going further by recommending the suspension or easing of the current guidance. Suspension might provide the clearest possible message to banks that they could reduce their liquid asset holdings. Given, however, the uncertainty about how far regulatory requirements were the key constraint, and recognising the benefits that had accrued from the regime over recent years, including in incentivising safer funding structures, this option did not command support in current circumstances. On pure microprudential grounds – viewing banks on an individual basis in isolation – the FSA would not choose to loosen the guidance applied to banks. The Bank, though, had underlined the availability of liquidity insurance by activating the ECTR and publishing the scale of pre-positioned collateral. There were also macroprudential grounds for banks using their liquid asset holdings to facilitate greater lending, with positive consequences for the economy and in turn resilience over the medium term. While members placed differing weight on these considerations, there was consensus that the FSA should consider ways in which it might modify its liquidity guidance.

37. The Committee considered a number of broad ways in which the FSA might adjust its regime, including changes to the level of ILG ratio guidance, recalibration and/or redefinition of the liquidity buffer. A range of views was expressed on the efficacy of these approaches. Implementation was a matter for the FSA, but it would be important to send a clear signal of guidance having been loosened.

38. **The Committee recommended that the FSA make 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 recommended that the FSA consider whether adjustments to**

**micropudential liquidity guidance are appropriate, taking some account of this additional liquidity insurance.**

*Disclosure*

39. The Committee had previously identified disclosure as an area for ongoing work. A box in the June 2012 *Financial Stability Report* set out the Committee's current thinking on this issue.

40. In discussing immediate actions on disclosure, members noted that uncertainty about the risks faced by individual banks and the capital that should be held to cushion unexpected losses could be reduced by improved Pillar 3 disclosures. Market participants had indicated that the effectiveness of these disclosures has been hampered by the lack of comparability in definitions of metrics across banks and by the difficulty in reconciling these disclosures to information in annual accounts. As a result, Pillar 3 disclosures were receiving less attention among market participants than warranted, despite the cost of making such information available.

41. **The Committee recommended that UK banks work with the FSA and 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.**

42. The Committee identified a number of other areas where it would be useful to think through whether enhanced disclosure could support financial stability. Potential areas for future work included disclosure by banks around system-wide stress test results, asset encumbrance levels, risk weights and intra-period metrics, as well as disclosures by institutions outside the regulatory perimeter.

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
Andrew Bailey, Head of the Prudential Business Unit of the Financial Services Authority
Adair Turner, Chairman of the Financial Services Authority
Alastair Clark
Michael Cohrs
Paul Fisher
Andrew Haldane

Robert Jenkins
Donald Kohn
Tom Scholar attended as the Treasury member.

Martin Wheatley, Head of the Conduct Business Unit of the Financial Services Authority and CEO-designate of the Financial Conduct Authority also attended in a non-voting capacity.