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RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING

14 SEPTEMBER 2012

This is the record of the Interim Financial Policy Committee meeting held on 14 September 2012.

It is also available on the internet:

<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1209.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, including its objectives for growth and employment. In September 2012, HM Treasury issued a consultation document on the Committee's powers of Direction.

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 21 November and the record of that meeting will be published on 4 December.

**RECORD OF THE INTERIM FINANCIAL POLICY COMMITTEE MEETING HELD
ON 14 SEPTEMBER 2012**

The Committee judged that the risks to financial stability had not altered sufficiently since its previous meeting to warrant a change to its current set of policy recommendations, as set out in its June 2012 *Financial Stability Report*.

The full set of recommendations as set out in the June 2012 *Financial Stability Report* is attached as an Annex to this Record, and will be reviewed formally by the Committee at its November meeting.

1. At its meeting on 14 September, the Committee discussed its latest view of the outlook for financial stability, including the progress made in implementing its previous recommendations; and, separately, the next steps in the development of its statutory macroprudential toolkit.

The macroeconomic and financial environment

2. The Committee noted that market perceptions of the near-term probability of acute stress in the euro area had fallen somewhat, not least following recent policy announcements by the European Central Bank. The improvement in market sentiment had also reduced perceptions of risks to UK banks – for example, five-year CDS premia for the major UK banks had declined by an average of around 40 basis points since the June 2012 *Financial Stability Report*.

3. At the same time, underlying concerns about sovereign indebtedness, banking sector resilience and imbalances across the euro area had persisted. And data suggested a weaker outlook for activity, both domestically and in a range of key markets for UK banks internationally. In common with others around the world, UK banks had reduced their direct exposures to sovereigns, banks and the non-bank private sector in the most vulnerable euro-area countries during 2012. But exposures remained large, at an average of about 70% of major UK banks' core Tier 1 capital. And progress by UK banks in building capital against current threats had been slow. There had been no material issuance of external capital, and earnings had continued to be constrained by a number of factors, including the impact of weak economic activity and redress for mis-selling financial products and other conduct issues. The Committee judged that these factors were likely to provide a continuing drag on banks' earnings, diminishing their ability to build capital internally.

4. Domestic credit growth had remained weak. But a number of recently announced domestic policy measures – in particular the Funding for Lending Scheme (FLS) – were designed to have a positive impact on domestic credit conditions looking ahead. The Monetary Policy Committee had also provided a further monetary stimulus via an extension of its asset purchase programme.

Against this backdrop, the Committee discussed progress made in response to its previous recommendations.

Previous FPC policy recommendations

Resilience, capital and lending

5. The Committee noted that over the past year it had been pursuing two aims: seeking to increase the resilience of the UK banking system to the current exceptional threats emanating from the euro area; and, subject to that, supporting the availability of credit to the UK economy during the current slowdown. There was a range of views amongst Committee members about the existence, strength and timing of any trade-off between these aims. Some actions which boosted the resilience of individual banks could adversely affect near-term credit availability, for instance if requirements to increase capital ratios provoked deleveraging focused on UK lending. But banks could increase their resilience and still support lending if they focused their deleveraging on other assets, or raised equity. Over the medium run, reasonable steps to enhance resilience should sustain credit availability by lowering funding costs and reducing banks' vulnerability to unanticipated events. And higher lending, where it supported a return to more sustainable growth rates, could help to improve the performance of banks' loan books, enhancing resilience.

6. Members agreed, however, that the challenge of boosting both resilience and credit availability was particularly complicated in the current conjuncture. If the Basel III capital regime had already been in place, and banks had built up a countercyclical buffer over time, the FPC would now be in a better position to consider whether or not to release those buffers, thus underpinning credit growth without threatening resilience. As it was, capital ratios in the UK banking system as a whole needed to rise towards the new, higher, level mandated by Basel III over a period of years, and in the near term to protect from the heightened risk from the euro area.

7. With respect to capital, in its past recommendations the Committee had identified a three-part strategy. First, the Committee had asked the Financial Services Authority (FSA) to work with the banks to increase the level of capital by various means, rather than constraining lending. Second, the Committee believed that approach should be underpinned by encouraging banks to review the valuation of their assets, in order to reduce any residual uncertainty over their true balance sheet positions. And, third, the Committee had asked banks to identify ways to mitigate

their exposures to risks in the euro area. Specifically, the Committee had recommended in June that:

- **Taking into account each institution's risk profile, the FSA works with banks to ensure they build a sufficient cushion of loss-absorbing capital in order to help to protect against the 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.**
- **The FSA 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.**
- **Banks should work to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area.**

8. The Committee reviewed progress against these recommendations. The FSA was working with the major UK banks individually on options for building additional capital in the near term. Banks had made some limited progress in generating capital internally and should continue to limit cash distributions to build capital further. But given that earnings growth was likely to remain low, the scale of potential further capital generation through this route was limited. Therefore the Committee believed that banks should supplement internal capital generation by seeking opportunities to raise capital externally. Recent improvements in market conditions should help in that respect, with the options including debt conversion and the issuance of suitable contingent capital instruments as well as conventional equity.

9. The Committee believed that capital needs could be better clarified, and the task of attracting fresh external capital facilitated, if steps were taken to reduce uncertainty about valuations of on-balance sheet assets. One of the factors likely to be depressing price-to-book ratios was market doubts about current valuations of bank assets. The FSA was continuing to encourage banks to improve provisioning practices and to mark assets on their balance sheets

more prudently, working within the constraints of existing accounting standards. It agreed to provide an update on this work at the Committee's next round of meetings.

10. The Committee noted and supported steps taken by the FSA to structure its guidance for capital buffers for individual banks so as to avoid imposing impediments to additional lending to the UK real economy. This would help support the aims of the FLS. Committee members noted that the calibration of the guidance chosen by the FSA had implied a judgment that the reduction in macroprudential risk from increased lending to the UK economy, in terms of higher growth and reduced credit risk on existing loans, would help to offset any increase in microprudential risk from reduced capital requirements against new lending. That was something which the Committee and the FSA would need to monitor closely.

11. In common with their international peers, UK banks had reduced direct exposures to the most vulnerable euro-area economies and were working to assess and manage the risks arising from their euro-area exposures. The Committee re-iterated its advice to banks to continue to focus on these specific risks, and noted that any improvement in market conditions, such as that seen recently, should be used to facilitate orderly risk reduction.

12. Taken together, the Committee considered that its three capital recommendations in June remained an appropriate response to the current complex challenge of increasing resilience while also underpinning UK credit availability and growth. It therefore reconfirmed them for the immediate period ahead. Members were, however, conscious that the position of individual banks, including their ability to generate capital either externally or internally, varied widely across the sector, which might call for different sets of actions. There was some discussion about whether it might be useful to make the recommendations for the banking system somewhat more precise in terms of quantities and timing. The Committee agreed to return to a discussion of these challenges at its November meeting in light of the FSA's further studies, and to determine whether additional steps were required.

Liquidity

13. In June, the Committee had recommended that **the FSA make clearer to banks that they were free to use their regulatory liquid asset buffers in the event of a liquidity stress, especially in light of additional contingent liquidity being made available to banks by the**

Bank. The Committee also recommended that the FSA consider whether adjustments to microprudential liquidity guidance were appropriate, taking some account of this additional liquidity insurance.

14. In response to the Committee's recommendation, the FSA had altered its liquidity guidance to banks to take some account of banks' potential access to central bank liquidity via pre-positioned collateral. It had also clarified that a portion of banks' liquid asset buffers could be used in a liquidity stress without supervisory intervention. In addition, the FSA had confirmed that in the future it did not intend to tighten, across the industry, the interim liquidity regime in advance of the implementation of internationally agreed liquidity standards.

15. The Committee welcomed the FSA's general approach. The actions were expected to reduce the incentives for banks to hold excessive liquid asset buffers for precautionary motives, thereby freeing up balance sheets and potentially supporting credit availability. It was likely that the combined effect of the FSA's changes had increased the perceived usability of banks' existing liquid asset holdings, though by how much across different institutions was as yet unclear, and it was too soon to assess the overall scale of the impact on lending. Members noted that the new framework provided a basis for monitoring liquidity going forward.

Disclosure

16. **In November 2011, the Committee had recommended that the FSA should encourage 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 Committee re-confirmed this recommendation, but wished to emphasise that the recommendation related only to disclosure, and did not entail meeting any leverage ratio standard by the beginning of 2013. A number of banks had expressed concerns about the scope for misunderstanding in financial markets on this point, noting that the Basel agreement allowed banks a transition period in which to replace capital instruments no longer classed as loss-absorbing. In order to avoid that risk, and to place the data in a broader context, the Committee saw merit in banks publishing leverage ratios using both end-point and transitional definitions of capital. The FSA would take this forward in discussion with the banks.

Other international policy developments

17. The potential for banks to assign significantly different risk weights to otherwise identical asset portfolios had been discussed by the Committee at its November 2011 meeting, and remained a matter of concern as it contributed to market uncertainty about the underlying position of banks. Members noted the recent recommendation by the Swiss National Bank that the largest Swiss banks should calculate and disclose risk-weighted assets calculated on a standardised approach, in addition to the model-derived reports already in place. Extensive work was underway internationally on the extent of this problem, and the best way to tackle it, and the Committee agreed to return to these issues at its November meeting.

18. The Committee also discussed recent developments in the regulation and supervision of US money market funds. Given that these funds had been a significant source of US dollar funding for UK banks and many of their counterparties, instability in this sector in the United States could spill over to the United Kingdom. Hence the Committee would continue to follow developments closely, and agreed to return to them at a future meeting.

Macroprudential policy tools: powers of Direction

19. The Committee noted that HM Treasury would shortly be publishing a Consultation Document on its proposals for the statutory FPC's initial powers of Direction over the Prudential Regulation Authority and the Financial Conduct Authority. Those proposals, and the draft secondary legislation that accompanied them, had been informed by the Committee's earlier advice, published on 23 March. There would be a period of public and Parliamentary scrutiny.

20. The Committee noted that the Financial Services Bill included a provision requiring the statutory FPC to prepare and maintain a written statement of the general policy that it proposed to follow in relation to the exercise of each of its powers of Direction. The Government had separately indicated that this statement should set out how the Committee expected each tool to work, including its likely impact on financial stability and growth, and the circumstances in which the FPC might expect to use the tool. The interim FPC would be expected to publish drafts of these policy statements on its proposed Direction tools in time for them to be considered alongside Parliament's scrutiny of the secondary legislation.

21. As it moved towards drawing up these draft statements, the Committee identified a number of high-level considerations that would shape its approach. First, a balance would need to be struck between giving sufficient guidance about when and how each tool would be used to ensure the Committee could be held to account, while at the same time building in enough flexibility to allow for the fact that financial stability risks could crystallise in many different and sometimes unexpected ways. The Committee agreed that it would be important to give concrete examples, drawn from the past, of the way in which each tool might be used. A similar consideration also applied when setting out the financial and economic indicators that would guide the use of each tool. The Committee would want to identify a relatively short list of core indicators that it would review regularly, which had proved helpful in identifying previous periods of financial instability. But no single set of indicators could ever provide a perfect guide to future risks or the appropriate policy response, given the complexity of financial interlinkages, and the tendency for the financial system to evolve over time. It would be vital to avoid giving the impression that there was a mechanical policy rule; judgment would play a material role. To support that judgment, the Committee would also need to monitor a much wider and time-varying set of measures, depending on the emerging risks. These would need to be discussed in detail in future *Financial Stability Reports*.

22. Finally, the Committee noted that it would need to give an assessment of the likely impact of its Direction tools on resilience and growth. The impact on resilience would depend on a range of factors including the extent of regulatory arbitrage and other leakages. And, as the Committee had earlier discussed, the relationships between resilience and credit conditions, and between credit conditions and growth, were complex. These and other matters would need to be set out more fully in the Committee's draft policy statements.

The following members of the Committee were present:

Mervyn King, Governor

Paul Tucker, Deputy Governor responsible for financial stability

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

Jonathan Taylor 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.

Charles Bean, Deputy Governor responsible for monetary policy, was unable to be present, but contributed to the Committee's discussions.

ANNEX: FPC RECOMMENDATIONS AS PUBLISHED IN THE JUNE 2012 FSR

Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '11/Q3/3' refers to the third recommendation made at the 2011 Q3 meeting.

11/Q3/3: The Committee urged HM Treasury to continue its efforts to ensure that developments in European legislation did not provide an impediment to the ability of the Committee to use macroprudential policy instruments in the interests of financial stability in the United Kingdom, as envisaged in the consultation documents proposing the establishment of the FPC.

11/Q4/3: 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.

12/Q2/1: The Committee recommends that, taking into account each institution's risk profile, the 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.

12/Q2/2: 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.

12/Q2/3: 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.

12/Q2/4: 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 micro-prudential liquidity guidance are appropriate, taking some account of this additional liquidity insurance.

12/Q2/5: The Committee recommends that UK banks work with the FSA and the British Bankers' Association to ensure greater consistency and comparability of the Pillar 3 disclosures, including reconciliation of accounting and regulatory measures of capital, beginning with the accounts for the current year.