Publication date: 1 April 2014

RECORD OF THE FINANCIAL POLICY COMMITTEE MEETING

19 MARCH 2014

This is the record of the Financial Policy Committee meeting held on 19 March 2014.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1404.pdf

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is established as a sub-committee of the Bank of England's Court of Directors.

The FPC will next meet on 17 June and the Record of that meeting will be published on 1 July.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 19 MARCH 2014

At its meeting on 19 March 2014, the Financial Policy Committee made no new recommendations.

The Committee's review of its pre-existing recommendations is set out in this Record. A list of extant recommendations is given in the Annex.

1. The Committee reviewed its assessment of the risks to financial stability and, in light of that assessment, progress against the existing set of recommendations.

Risks to financial stability

2. Overall, conditions had continued to provide support to the stability of the financial system. Since the FPC met in November 2013, the recovery in advanced economies had gained momentum, against a stance of stimulative monetary policy. Within the euro area, there were signs of a continued modest recovery, even in some periphery countries, and steps were being taken with the aim of strengthening the oversight of banks.

3. In the United Kingdom, the economic outlook had improved further, though external and domestic imbalances remained with the current account deficit and public sector net borrowing both over 5% of GDP. The resilience of the banking sector, taken as a whole, had continued to improve. Although there was significant variation across firms, banks' pre-tax profits were slightly larger than in 2012 in aggregate, partly reflecting reduced funding costs which had helped raise interest margins. Most UK large banks and building societies had met the FPC's 7% target for capital ratios by the end of 2013 and funding and liquidity risks to the UK banking system had reduced. However, conduct costs looked to be a larger and more uncertain headwind to capital generation than previously thought.

4. The recent period had seen a number of developments in emerging market economies, including as a consequence of idiosyncratic events. There had been a recent rise in geopolitical risks, notably involving Russia and Ukraine. Although direct exposures of the UK banks to these countries were relatively limited, less direct threats to stability could emerge if tensions were to escalate further and trigger a shift in global risk appetite. Heightened volatility in the Chinese exchange rate and strains in short-term money markets had brought home the challenges the authorities face in managing risks arising from the rapid credit expansion over recent years, including in the non-bank financial system.

5. To date, the impact of these events, in aggregate and individually, on wider financial markets appeared to have been relatively limited. In addition, recent announcements of changes to advanced economy monetary policy had not greatly affected financial markets. Over the period as a whole since the FPC's previous meeting in November, equity indices and risk-free yields in advanced economies were little changed and realised and implied volatility remained low by historical standards across a broad range of financial markets.

6. Nonetheless, members were concerned that there was a risk that this apparent resilience to past developments in advanced economy monetary policy could reinforce risk appetite in a way that did not fully take account of the eventual transition of monetary policy to more normal settings. Low levels of volatility and interest rates were reported to be fuelling a range of carry trade positions. However, levels of leverage in the system were much lower than pre-crisis and credit growth in advanced economies was still relatively subdued. And, unlike in the earlier period, market participants expected a shift in monetary stance at some point in the future. However, the eventual transition could pose challenges in some sectors of the financial markets, particularly if global monetary policy stances were to adjust more abruptly than expected. Changes to the structure and functioning of markets as banks adapted business models to the aftermath of the financial crisis and the resulting regulatory response, including reductions in market-making activity, made it more difficult to judge the likely market impact of unexpected developments from any source.

7. In June 2013 the Committee had recommended that the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), with other Bank staff, assess the vulnerability of borrowers and financial institutions to sharp upward movements in long-term interest rates and credit spreads [Recommendation 13/Q2/1]. The work had suggested that the UK banking sector would be resilient to direct losses caused by the impact of moderate increases in long-term interest rates. But there was significant uncertainty around potential amplification effects operating through the wider financial system. These issues were now at the heart of the FPC’s risk and vulnerability assessments. Staff were in regular dialogue with market participants, and planned to engage further with Chief Risk Officers and other market participants, including hedge funds, in coming months. The ongoing stress test exercise would also provide an opportunity to explore aspects of these issues more fully. Against this background of ongoing work, the Committee agreed that it could close its outstanding recommendation on this issue.

8. There was continued evidence of increasing momentum in the UK housing market, although a number of indicators remained below their long-run average levels. Mortgage approvals had risen by 40% in the year to January, though they remained 20% below their long-run average. Prices had risen by around 10% at a national level over the year to February 2014, according to the average of the Halifax and Nationwide indices, with increases seen in all UK regions in the second half of 2013. According to ONS data for the year to December, the latest available information for the Committee at its meeting on 19 March, prices had risen by 5.5% compared with an average rise of 7.1% in the lenders’ indices over the same period. In a continuation of a longer-term trend, mortgages at loan to income ratios above four times

accounted for a higher share of new mortgages in Q3 than at any time since the data series began in 2005. There was also evidence of a lengthening in the tenor of mortgages. New mortgage lending at high loan to value ratios remained low by historical standards, though the number of mortgage products offering higher loan to value ratios had doubled over the previous six months.

9. In the November 2013 *Financial Stability Report*, the FPC had announced initiatives to reduce stimulus, reaffirmed measures already in train and outlined further instruments it had available to mitigate potential risks from the housing market. Given the increasing momentum, the FPC agreed that it will remain vigilant to emerging vulnerabilities, will continue to monitor conditions closely and will take further proportionate and graduated action if warranted.

10. As set out in November, measures to help maintain stronger mortgage underwriting standards were being put in place by the FCA with effect from April as part of the implementation of the Mortgage Market Review (MMR). In November the FPC had recommended that the FCA require mortgage lenders to have regard to any future FPC recommendation on appropriate interest rate stress tests to use in assessments of affordability required as part of the MMR [Recommendation 13/Q4/1]. The FCA Board had begun a consultation on a proposed change to the mortgage conduct rules to give effect to this recommendation. Subject to consultation and further consideration by the FCA Board, this instrument could be available to the FPC from its June meeting. When in place these changes should help to maintain higher underwriting standards for newly written mortgages, even if prices were to rise further.

11. The FPC welcomed this work. It noted that future consideration of the use of this instrument would take into account: further information on tests currently used by lenders, which market intelligence had indicated may in some cases currently be more stringent than required by the MMR; quantitative analysis on the impact of alternative interest rate stress tests on cohorts of borrowers; and how lenders might react, including by increasing provision of fixed rate mortgages or offering longer amortisation periods. Any recommendation in this area would also need to consider any impact on the advancement by the FCA of its operational objectives: while the FCA's integrity objective meant that financial stability was a shared concern, the FCA also had consumer protection and competition objectives.

12. There had also been a strengthening in the commercial real estate (CRE) sector, particularly in the so-called prime end of the market. Having been broadly flat since 2010, CRE transactions had reached nearly £55 billion last year - just below the pre-crisis peak. A positive development was that transactions appeared to be much less debt-financed than before the crisis: one estimate suggested that 2013 transactions had been three-quarters financed by equity,

compared with only one-quarter in 2007. Occupancy rates also remained relatively low, despite a recent pick up. There were nonetheless signs of some relaxation in underwriting standards: margins on senior lending against prime offices were estimated to have halved since 2010 to around 200 basis points.

Financial stability 'knockout' for MPC Policy Guidance

13. As part of the Monetary Policy Committee's Policy Guidance announced on 7 August 2013, and which remained in force while unemployment was above 7%, the FPC also discussed whether the stance of UK monetary policy posed a significant threat to financial stability that could not be contained by the range of mitigating policy actions available to the FPC, the FCA and the PRA in a way consistent with their objectives. In light of its assessment of the current risks to financial stability, the Committee concluded that the stance of UK monetary policy did not currently pose a significant threat to financial stability that could not be contained by prudential or other regulatory tools.[1]

Previous policy recommendations

14. Against this backdrop, the Committee reviewed progress on its outstanding recommendations in light of the risks to financial stability.

15. <u>Stress testing [Recommendation 13/Q1/6]</u>. Later this year, four large UK banks would be required to assess the impact of a common, EU-wide stress scenario as part of a stress testing exercise co-ordinated by the European Banking Authority (EBA). As agreed with the EBA, national authorities may also incorporate additional elements. Under these arrangements, the Committee noted that the major UK banks and building societies would also be required to assess the impact of a variant of the EBA scenario, with the UK-specific elements designed by the Bank.

16. Against the backdrop of its risk assessment, the Committee discussed the appropriate scenario for the 2014 bank stress testing exercise, with a focus on the UK component. The scenario was not intended to be the FPC's expectation of what would happen, but a coherent tail risk event against which banks' resilience could be tested. A key part of the scenario would examine the resilience of the banks to a housing market shock and to a snap back in interest rates. The 2014 stress test framework would be finalised in conjunction with the PRA Board in due

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[1] This paragraph was released on 23 April 2014 on the day of publication of the minutes of the MPC's April 2014 meeting.

course, with an intention to publish the scenario by the end of April as an additional macroeconomic sensitivity to the EU-wide scenario being developed by the European Systemic Risk Board and the EBA.

17. In framing the exercise, the Committee noted that it was precisely because a stress scenario was severe that investors and supervisors could draw confidence from results that indicated that firms would be sufficiently resilient to severe stress, or that steps were being put in place to improve resilience.[2]

18. An adjustment in interest rates could lead to a significant rise in corporate sector stress, including in the commercial real estate sector. To stretch household balance sheets, a coherent stress scenario would need to include rises in short term interest rates, an increase in unemployment and a very sharp fall in house prices. It was hard to gauge the precise degree of stress to apply to house prices, given the limited domestic experience of material falls in house prices. In previous FSA/PRA 'anchor scenarios', house prices had fallen by around 30% in nominal terms. While that was high relative to previous UK housing market downturns, and given that supply restrictions might act as a brake on falls in house prices, some other advanced economies had seen materially larger falls. And it was noted that house prices had risen further since the most recent 'anchor scenario' had been developed. In addition, in a severe downturn it was likely that banks' losses given default might be increased in the event of forced sales of distressed property exposures. The regional pattern of house price falls could also be important: past downturns had suggested that it was not always the case that regions where house prices rose most strongly subsequently saw the largest price falls.

19. Members discussed that, in setting up the stress test, it would be important to communicate to firms and other stakeholders how the authorities were likely to respond to the outcome of the exercise. In doing so, it would be important to be clear that supervisors would be evaluating the appropriate action for firms on the basis of the entire profile of resilience measures over time, and not only by reference to a minimum threshold at a point in time. Clarity would also be needed on the relative weight to be placed on risk-weighted measures of capital adequacy and leverage ratios.

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[2] This paragraph, and paragraphs 18 and 19 were released on 1 July 2014. In its March 2014 meeting, the Committee decided to defer publication of these paragraphs as it was of the opinion that their publication would be against the public interest due to risks of unnecessary market uncertainty ahead of finalisation of the stress testing framework.

20. Feasibility of calculating capital ratios using the standardised approach to credit risk [Recommendation 13/Q2/5]. In 2013 Q2, the Committee had recommended that the PRA assess the feasibility of major UK banks and building societies calculating their regulatory capital ratios using the standardised approach to credit risk, as well as using an internal ratings-based approach. At its November meeting, the FPC had asked the PRA to assess the costs and benefits of asking firms regularly to calculate and disclose their capital ratios on this basis, alongside other metrics.

21. In its response to the Committee, the PRA noted that reporting and disclosure of banks' capital ratios using the standardised approach to credit risk could help to mitigate financial stability risks arising from the observed loss of confidence by investors in the risk-weighting framework. It provided a consistent and comparable risk-based measure across banks. As such, there was potential merit in making it available to supervisors and investors in due course. However, extensive work was underway internationally to tackle both a number of flaws in the measure and to improve confidence in the risk-weighting framework more broadly. That included work on: the standardised approaches to credit risk, counterparty credit risk and operational risk; revisions to the securitisation framework; interest rate risk in the banking book; and the fundamental review of the trading book. The PRA was also close to finalising its own internal review of firms' models.

22. The Committee then discussed whether, and if so when, lenders should be required to report to the PRA and to disclose their regulatory capital ratios on the standardised approach to credit risk. Members noted the potential benefits of regulators and investors being provided with a range of metrics for assessing banks' capital adequacy. All capital adequacy measures are faced with a range of risks which they seek to capture or address – including capturing the 'true' risk of underlying assets, portfolio or correlation risk whilst avoiding model risk, arbitrage risk or political risk. Different solvency measures do better or worse jobs of reflecting or correcting for these risks. As such, it followed that no single capital adequacy metric could capture all of these risks all of the time.

23. The FPC concluded that it was minded to recommend that firms report and disclose their capital ratios using the standardised approach to credit risk as soon as practicable following the FPC's review in 2015 H1 of the progress made in Basel to improve the standardised approach to credit risk and progress on improving confidence in the risk-weighted framework more generally. Given that, the FPC agreed that it could close its earlier recommendation to the PRA to assess the feasibility of calculating capital ratios.

24. Resilience to cyber attack [Recommendation 13/Q2/6]. In June 2013, the FPC had recommended to HM Treasury and relevant regulators that they instigate a programme of work to assess, test and improve the financial system's resilience to cyber attack. The threat was growing and evolving over time, underlying the need to strengthen protection for institutions at the core of the financial system.

25. Mr Roxburgh (the Treasury member of the Committee) provided an update on progress. A priority over the recent period had been to develop robust and enduring diagnostic tools for core firms. Relevant regulators had issued questionnaires to firms to help formulate benchmarks of resilience to cyber attack, and were also finalising plans for making available a vulnerability testing framework. The latter would help firms to test their resilience to the types of attack to which their business model was most likely to be exposed, marking it out as a more sophisticated approach than that which was currently available within the industry. The extensive work required to provide a detailed and consistent assessment of resilience across the sector would take somewhat longer than the FPC had anticipated. The work in progress would provide a stronger basis for concrete and specific action plans for core firms over the course of the year, as well as a durable vulnerability assessment framework.

26. The Committee welcomed this work and agreed to take stock of progress in 2014 Q4 with a view to closing the recommendation at that point if sufficient progress had been made.

27. The Committee received a summary of progress against its other outstanding recommendations. Recommendations 13/Q1/2, 13/Q1/4 and 13/Q1/5 (all relating to capital management by UK banks and building societies) would be reviewed in Q2 following consideration of the full set of end-year reporting from the lenders. Recommendation 12/Q2/3 regarding the management of balance sheet risks from euro-area stress would also be reviewed in Q2 following the finalisation of the EU-wide stress test scenario. Recommendations relating to disclosure by banks, including on improving the consistency and comparability of Pillar 3 disclosures [13/Q2/3] and on implementing recommendations from the Enhanced Disclosure Task Force [13/Q2/4], would be reviewed in Q3.

28. Contingency planning [Recommendation 11/Q3/4(P)]. The Committee agreed that publication of its initially private September 2011 recommendation to HM Treasury on contingency planning remained contrary to the public interest. Bail-in powers were now included in UK and EU legislation. The FPC was minded to close this recommendation at its June 2014 meeting, and to consider publication of the associated redacted text then, in the light of progress

on commencement of secondary legislation on the relevant special resolution regime powers in the Banking Reform Bill.[3]

29. The Committee reviewed the text that had been redacted from its previous Records relating to a private recommendation on the development of contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. It agreed that publication of the Committee's recommendation and associated text remained contrary to the public interest; this decision would be reviewed once the FSB's contingency planning report had been published.[4]

Medium-term priorities

30. In November 2013, the Chancellor had asked the FPC to undertake a review of the role of the leverage ratio within the capital framework and to agree the terms of reference for that review following the Basel discussions on leverage in January 2014. In discussing the terms of reference the Committee noted that it would not be able to conclude its assessment of the appropriate numerical level of leverage and risk-weighted capital requirements until mid-2015, as part of its medium-term work plans on the capital framework and ending too big to fail, given the timetable for the relevant international initiatives in these areas. The terms of reference would need to make this clear. The Committee agreed the terms of reference, which were published on 27 March.

31. The Committee had set out three medium-term priorities in the November 2013 *Financial Stability Report*: establishing the medium-term capital framework for banks; ending 'too-big-to-fail'; and supporting diverse and resilient market-based finance. At its meeting in March, the FPC agreed that it would focus work over the next 18 months within these three priorities on the following issues:

- Medium-term capital framework: The leverage ratio review; the usability and interaction of capital buffers; and the overall calibration of UK bank capital requirements following progress on relevant international agendas and taking into account FPC discussions on ending 'too-big-to-fail'.

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

- Ending 'too-big-to-fail': The process for identifying Domestic Systemically Important Banks in the United Kingdom; macroprudential objectives to consider when setting the height of the ring-fence; protocols around stays in derivative contracts; policies on resolution and on recovery and resolvability; and the UK framework for 'gone concern' loss-absorbing capacity.

- Market-based finance: assessing and mitigating systemic risks beyond the existing regulatory perimeter (which the Committee had agreed previously to consider on an annual basis, with its first assessment to be set out in 2014 Q2); risks to stability arising from procyclicality in the availability of finance, including via collateral markets; and resilience of market liquidity. Work on securitisation would be taken forward by the Bank Executive, with a discussion paper to be published in 2014 Q2.

HM Treasury's 'Remit and Recommendations for the Financial Policy Committee'

32. The Committee had received a letter and annex setting out the Government's economic policy and a series of recommendations, under sections 9E(1) of the Bank of England Act 1998, at its meeting. The Committee's response to the Chancellor is published alongside this Record.

The following members of the Committee were present at the meeting:

Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Andrew Bailey, Deputy Governor responsible for prudential regulation
Charles Bean, Deputy Governor responsible for monetary policy
Clara Furse
Andrew Haldane
Donald Kohn
Richard Sharp
Martin Taylor
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Martin Wheatley, Chief Executive of the Financial Conduct Authority, was unable to attend the policy meeting as he was overseas.

As permitted under the Bank of England Act 1998, Dave Prentis was also present as an observer in his role as member of the Oversight Committee of Court.

ANNEX: EXTANT FPC RECOMMENDATIONS

Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '12/Q2/3' refers to the third recommendation made at the 2012 Q2 meeting.

Identifier	Recommendation
11/Q3/4(P)	The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.[5]
12/Q2/3	The Committee 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.
13/Q1/2	The PRA should take steps to ensure that, by the end of 2013, major UK banks and building societies hold capital resources equivalent to at least 7% of their risk-weighted assets, as assessed on the basis described in Recommendation 13/Q1/1. Relative to that benchmark, major UK banks and building societies in aggregate currently have a shortfall in capital of around £25 billion.
13/Q1/4	The PRA should ensure that major UK banks and building societies meet the requirements in Recommendations 13/Q1/2 and 13/Q1/3 by issuing new capital or restructuring balance sheets in a way that does not hinder lending to the economy. Any newly issued capital, including contingent capital, would need to be clearly capable of absorbing losses in a going concern to enable firms to continue lending.
13/Q1/5	The PRA should ensure that major UK banks and building societies have credible plans to transition to meet the significantly higher targets for capital and the leverage ratio that will come into effect in 2019 after full implementation of Basel III, the trading book review and surcharge for systemically important banks, and after HM Government's implementation of the ICB proposals, in ways consistent with sustainable expansion of the UK economy.
13/Q1/6	Looking to 2014 and beyond, the Bank and PRA should develop proposals for regular stress testing of the UK banking system. The purpose of those tests would be to assess the system's capital adequacy. The framework should be able to accommodate any judgements by the Committee on emerging threats to financial stability.
13/Q2/3	The PRA should continue to work with the banking industry to ensure greater consistency and comparability of the Pillar 3 disclosures of the major UK banks and building societies, including reconciliation of accounting and regulatory measures of capital.
13/Q2/4	The PRA should ensure that all major UK banks and building societies comply fully with the October 2012 recommendations of the Enhanced Disclosure Task Force (EDTF) upon publication of their 2013 annual reports.
13/Q2/6	HM Treasury, working with the relevant government agencies, the PRA, the

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

	Bank's financial market infrastructure supervisors and the FCA should work with the core UK financial system and its infrastructure to put in place a programme of work to improve and test resilience to cyber attack.
13/Q4/1	The Financial Conduct Authority (FCA) should require mortgage lenders to have regard to any future FPC recommendation on appropriate interest rate stress tests to use in the assessment of affordability.

In this list, the following recommendations were made on a 'comply or explain' basis, under Section 9Q(3) of the Bank of England Act 1998 (as amended by the Financial Services Act 2012): 13/Q2/3; 13/Q2/4.