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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETING

25 JULY 2016

This is the record of the Financial Policy Committee meeting held on 25 July 2016.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1608.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 a committee of the Bank of England.

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

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 25 JULY 2016

At its meeting on 25 July, the Financial Policy Committee (FPC):

- Recommended to the PRA that, when applying its rules on the leverage ratio, it considers allowing firms to exclude from the calculation of the total exposure measure those assets constituting claims on central banks where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity. The FPC made the Recommendation to the PRA 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).

- Agreed to revoke its existing Direction to the PRA on the UK leverage ratio framework, in order to allow the PRA to implement the FPC's Recommendation with immediate effect. Subject to its planned review of the leverage ratio framework in 2017, the FPC intends to take steps to ensure that the change can be put in place on a permanent basis using its powers of Direction, which will require asking HM Treasury for a change in the relevant statutory instrument.

- Set out its intention to recalibrate the UK leverage ratio standard to adjust for the impact of the exclusion of central bank reserves. It will consult and decide on the appropriate form of this recalibration as part of the 2017 review.

1. At its meetings on 28 June and 1 July, the FPC had completed its first statutory annual review of its Direction to the Prudential Regulation Authority (PRA) to implement a leverage ratio framework in the United Kingdom, including by considering the impact of leverage ratio requirements on market liquidity.

2. Overall, the FPC had concluded that the leverage ratio remained an essential part of the framework of bank capital in the United Kingdom; the full results of the review had been published in the July 2016 *Financial Stability Report*. However, the FPC had considered that there were elements of the design of the leverage ratio that warranted further attention at the international level. The FPC had set out in the July *Financial Stability Report* that:

- There was a potential macroeconomic cost to the inclusion of central bank reserves in the total exposure measure of the leverage ratio, where inclusion affected the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities as necessary. The FPC therefore encouraged the Basel Committee on Banking Supervision to review carefully such possible unintended effects of forthcoming international leverage ratio standards;

- There would be merit in any internationally agreed leverage ratio standard amending the total exposure measure in two respects: netting of cash receivables and cash payables from unsettled sales of securities; and allowing initial margin posted by clients to reduce banks' potential future exposures to a default of those clients in centrally cleared derivatives transactions.

3. At its meeting on 1 July, the FPC had also considered whether to make any of these changes to the UK leverage ratio framework. It had decided in principle to exclude central bank reserves from the exposure measure in the UK leverage ratio framework. It did not, however, take the action to implement this change in practice because of concern that such an announcement would be taken as a signal about the future path of monetary policy. This was outside the FPC's remit and the Monetary Policy Committee (MPC) had yet to meet following the referendum.

4. At its subsequent meeting on 25 July, the FPC was also briefed on the possible impact of stimulative monetary policy measures on financial stability, ahead of the MPC's forthcoming deliberations. It then discussed:

- How and when its decision in principle to exclude central bank reserves from the exposure measure of the leverage ratio could be implemented in practice – including the implications of this change for the calibration of the UK leverage ratio standard;
- Whether to make the amendments related to netting and initial margin to the total exposure measure, in the light of market conditions since the referendum.

Central bank reserves in the exposure measure of the leverage ratio

5. The FPC's decision in principle on 1 July to exclude central bank reserves from the exposure measure of the leverage ratio in the UK framework had been driven by wanting to ensure that the leverage ratio did not act as a barrier to the effective implementation of any policy measures that led to an increase in central bank reserves.

6. As the FPC had set out in its July *Financial Stability Report*, it judged there to be no direct benefit to funding reserve holdings with capital: central bank reserves were a unique asset class because they were the ultimate settlement asset; and, if matched by liabilities in the same currency and of identical or longer maturity, they typically did not represent an exposure to risk.

7. There was, however, a potential macroeconomic cost. In circumstances where banks' balance sheets increased because of an expansion in central bank balance sheets, regulatory leverage requirements could effectively tighten. As an example, major UK banks' leverage exposure measures would increase and leverage ratios would tighten by around 10bp on average for every £100 billion increase in the Bank of England's balance sheet. This could affect the ability of the banking system to cushion shocks, and to maintain the supply of credit to the real economy and support for market functioning.

8. This consideration had become more relevant since the referendum. Central bank reserves could increase as a result of the indexed long-term repo operations that the Bank of England had

announced it would continue to offer on a weekly basis until end-September, for example, or if banks chose to use their pre-positioned collateral to take advantage of these additional liquidity facilities. Future policy measures by the MPC could also lead to an increase in reserves, depending on the nature of those measures.

9. An important issue in deciding how to implement this decision in practice was whether to recalibrate the leverage ratio standard in the UK framework, given the exclusion of central bank reserves.

10. Excluding central bank reserves from the exposure measure – the denominator of the leverage ratio calculation – would, if no offsetting action were taken, mechanically result in a reduction in the nominal amount of capital required by banks to meet the leverage ratio standard. Based on the current level of reserves held across major UK banks, of around £350 billion, the amount of capital required to meet the leverage ratio standard would fall by around £11 billion.

11. In current circumstances, this was a theoretical, not practical, issue. For the vast majority of firms, based on their current balance sheets, the amount of capital required to meet leverage ratio standards was lower than that required to meet risk-weighted standards. So those firms would not currently be able to maintain less capital overall as a result of reducing the leverage exposure measure. However, were the exclusion not to be implemented, firms could be constrained from making use of central bank facilities in the future.

12. The FPC was clear that its intention was not to alter capital standards as a result of adjusting the definition of the exposure measure. Over recent years, the UK financial system had consistently built the resilience necessary to face the currently challenging outlook. Having built that resilience, at its meeting on 1 July, the FPC had reduced the countercyclical capital buffer (CCyB) rate from 0.5% to 0% of banks' UK exposures – and, given the design of the leverage ratio framework, the countercyclical leverage buffer.

13. It followed that, to uphold this resilience, the FPC would need to recalibrate – 'gross up' – the current leverage ratio standard to offset the impact on capital requirements of excluding central bank reserves from the leverage exposure measure. But before deciding whether to do so, the FPC considered the arguments against grossing up.

14. First, when setting the leverage standard in 2014 and 2015, the FPC had reviewed data that showed that on average peak losses of UK banks during the crisis would have been absorbed by capital if a leverage ratio requirement of 3% had been in place. Given the relatively low level of central bank reserves before the crisis, in 2006, this calculation would be virtually unaffected if central bank reserves were excluded from the exposure measure.

15. That said, the leverage ratio was, by design, a blunt tool that provided an overall capitalisation level on all assets independent of their measurable risk, recognising that there can be inaccuracies in models used to provide measures of risk-weighted assets. In this way, a leverage ratio requirement over capitalised some assets and under capitalised others. Some members noted that they had put weight on this effect when arriving at the 3% minimum calibration, at a time when the level of reserves was relatively high.

16. Second, there was concern that grossing up the leverage ratio standard would be perceived as a tightening of capital requirements, and therefore would appear to be inconsistent with the reduction in the UK CCyB rate announced in the July *Financial Stability Report*. But, as the Committee had discussed, grossing up the leverage ratio standard would not represent a tightening in requirements. Instead, it would be a means of keeping the current required nominal level of capital under the leverage regime unchanged following the exclusion of central bank reserves. A number of members put weight on this – while it was important to avoid the misperception that grossing up was a tightening in requirements, it was also important to avoid the misperception that the FPC was implicitly loosening capital requirements by excluding central bank reserves.

17. Finally, the FPC considered whether grossing up would exacerbate the impact of leverage ratio requirements on market liquidity. The FPC recognised that grossing up would increase the rate of capital required to fund any increase in non-reserve assets. To the extent that leverage ratio requirements were being applied by firms to specific business lines, this could mean a tightening in financial conditions at the margin, particularly for low-risk assets like prime mortgage lending and repo activity. This could reduce market liquidity in core financial markets and was a concern in particular to those members who put weight on this consequence of the leverage ratio framework more broadly. The FPC had, however, reiterated its intention for the leverage ratio framework to apply only at a consolidated level, not at the level of individual activities, as part of its review that had been published in the July *Financial Stability Report*. And the FPC would continue to monitor market functioning.

18. The Committee also discussed when any grossing up would occur. The international leverage ratio standard was due to be finalised by the end of the year. To take account of this, the FPC was due to review the UK leverage ratio framework in 2017. The FPC judged that it would be appropriate to put into effect any recalibration as part of that review, so that the option for how to recalibrate could be considered in the light of the international leverage ratio standard.

19. Options for recalibration were linked to the structure of the current leverage ratio framework. The framework had two parts: a minimum requirement (of 3%) and buffers linked to a firm's systemic importance and to the countercyclical capital buffer. The scalar used to calculate these buffers was currently set at 35% of the relevant risk-weighted requirements. At a headline level, it followed that recalibration options included: an increase in the minimum requirement and the scalar used to calculate the buffers; an increase in the minimum requirement only; an increase in the scalar only; or the introduction of a new buffer.

20. The FPC's initial view was that it was important to maintain the proportionate relationship between the leverage and risk-weighted regimes. When the FPC had first set out its leverage ratio framework, complementarity with the risk-weighted regime had been seen as important in order to avoid creating unintended incentives for firms to change their business models simply because of the introduction of the leverage constraint. But it would consider in detail the pros and cons of different options as part of its review in 2017.

21. Taking all of these considerations together, alongside the statutory considerations to which it must have regard, the FPC formed a consensus view that:

- There was a strong case for improving the design of the leverage ratio standard under the UK framework by excluding central bank reserves from the exposure measure, as it had set out at its meeting on 1 July. The current design meant that leverage ratio requirements could act as an unnecessary constraint on banks making use of central bank liquidity facilities and on the implementation of any monetary policy action that led to an increase in reserves. This adjustment supported the FPC's financial stability objective by increasing the ability of the financial sector to cushion shocks.

- The monetary and financial stability policy measures currently being put in place in the United Kingdom put this case into sharper relief.

- Absent offsetting action, exclusion of central bank reserves would mechanically lead to a reduction in the nominal amount of capital currently needed to meet the UK leverage ratio standard. This was not the FPC's intention.

- With that in mind, the FPC intended to recalibrate the UK leverage ratio standard to adjust for the exclusion of current central bank reserves from the exposure measure. It would consult and decide on the appropriate form of this recalibration as part of its planned review of the leverage ratio framework in 2017, in the light of the internationally agreed leverage standard. The PRA would be able to monitor behaviour of firms in the interim.

22. The FPC then took the necessary steps to enable the PRA to implement the exclusion of central bank reserves from the exposure measure with immediate effect.

23. It confirmed that this exclusion applied to all central bank claims – including reserves held by a firm at the central bank, banknotes and coins constituting legal currency in the jurisdiction of the central bank, and assets representing debt claims on the central bank with a maturity of no longer than three months. It covered claims in sterling and in other currencies provided they were matched by deposits accepted by the firm denominated in the same currency and of identical or longer maturity. The FPC was content that this: would not affect any requirements placed on subsidiaries of UK banks overseas by foreign authorities; would not affect the relative level of consolidated and solo or sub-consolidated requirements, once its intention to gross up the leverage ratio standard had been implemented; and that, in practice, building up central bank claims would be unlikely to be sufficiently profitable to induce a firm to alter the currency mix of its deposit funding and its asset allocation for reasons other than those in the normal course of business. The PRA could monitor for this.

24. The FPC agreed to revoke its Direction of 24 June 2015 to the PRA regarding the leverage ratio with immediate effect. Until the definition of the exposure measure used in the relevant statutory instrument was amended, this was necessary in order to allow the PRA to implement the exclusion of central bank reserves with immediate effect. Following the meeting, the FPC would provide the relevant formal notice to the PRA in the following terms: Pursuant to section 9J(1) of the Bank of England Act 1998 (as amended by the Financial Services Act 2012), the FPC hereby

revokes its Direction of 24 June 2015 to the PRA regarding the leverage ratio with immediate effect. Subject to its 2017 review, the FPC intended to take steps to ensure that the change could be put in place on a permanent basis using its powers of Direction, which would require asking HM Treasury for a change in the relevant statutory instrument.

25. The FPC then agreed a Recommendation to the PRA: **The FPC recommends to the PRA that, when applying its rules on the leverage ratio, it considers allowing firms to exclude from the calculation of the total exposure measure those assets constituting claims on central banks where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity.**

26. The FPC made the Recommendation 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). The FPC was informed after its meeting that the PRA would comply with this Recommendation, and would issue a statement to firms on how it would be put into effect.

27. The FPC was clear that this Recommendation did not change the leverage ratio reporting and disclosure requirements that were applicable to UK banks and building societies as set out in the Capital Requirements Regulation (575/2013). This would mean that firms would continue to disclose leverage ratios on the basis set out in those requirements, including central bank reserves in the exposure measure.

28. Following the meeting, the FPC agreed that it was no longer in the public interest to redact text from the Record of its meetings on 28 June and 1 July referring to its decision in principle. It would publish this text when it released the Record of its current meeting, alongside publication of the MPC's August *Inflation Report.* The text is also in the annex of this Record.

Treatment of netting and initial margin in the exposure measure

29. The FPC had set out in the July *Financial Stability Report* the reasons for why there would be merit in any internationally agreed leverage ratio standard amending the total exposure measure as follows:

- Netting of cash receivables and cash payables from unsettled sales of securities, which would avoid unnecessarily discouraging activities that support market liquidity in core financial markets;

- Allowing initial margin posted by clients to reduce banks' potential future exposures to a default of those clients in centrally cleared derivatives transactions, which would avoid discouraging central clearing of derivatives – a core element of the post-crisis reform agenda.

30. The Committee judged that there was no pressing need to make these changes to the UK framework at this stage. The Basel Committee on Banking Supervision had recently consulted on amendments as part of finalising the international leverage ratio standard and, given that market functioning had been largely maintained since the referendum, the FPC was content to await the outcome of that consultation and its own review of the UK leverage ratio framework in 2017. The FPC would continue to monitor market functioning in the interim.

Financial stability considerations of possible monetary policy options

31. The MPC was due to meet shortly to agree its economic projections that would be published in the August *Inflation Report*, alongside its monetary policy decision. Since the referendum, the yield curve had fallen, reflecting in part expectations of stimulative monetary policy in the short term. At their joint meeting on 6 July, the FPC and MPC had discussed the impact of this fall on the balance sheets of banks, insurers and pension fund providers. A summary of that meeting was due to be published in the August *Inflation Report*. Ahead of the MPC's deliberations, the FPC received at its meeting a further briefing on the impact of stimulative monetary policy measures, including further falls in the yield curve, on financial stability.

32. At a headline level, stimulative monetary policy should support financial stability through an improvement in the outlook for economic activity and employment. There could be circumstances in which implications occur for financial stability, including where benchmark interest rates are very low or negative. For banks, such implications include the impact of low benchmark rates on banks' net interest margins. The Governor, as chair of the MPC as well as the FPC, emphasised to the FPC that the MPC would consider this in their deliberations.

33. Downside risks to insurance companies and pension funds from falls in the yield curve arose from the impact on valuation of their liabilities – and from the potential for this to affect their investment behaviour, and, therefore, market functioning. However, a number of mitigants were in place. For example, as the FPC had noted in the July *Financial Stability Report*, the PRA was allowing insurance companies to use flexibility in Solvency II regulations to recalculate transitional measures. And trustees of pension schemes were encouraged by the pensions regulator to take a long-term view in the face of market volatility.

The following members of the Committee were present:

Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Ben Broadbent, Deputy Governor responsible for monetary policy
Nemat Shafik, Deputy Governor responsible for markets and banking
Sam Woods, Deputy Governor responsible for prudential regulation
Clara Furse
Richard Sharp
Martin Taylor
Andrew Bailey, Chief Executive of the Financial Conduct Authority
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Alex Brazier had been present at the FPC's 28 June and 1 July meetings, but was unable to attend the meeting on 25 July because of paternity leave; Donald Kohn had been present at the FPC's 28 June and 1 July meetings, but was unavoidably unable to attend the meeting on 25 July.

ANNEX: DEFERRED PUBLICATION TEXT

Under Section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of its Records if it decides that publication at that point would be against the public interest. As set out in paragraph 28 of this Record, the FPC has decided to publish now the following text from the Record of its meetings on 28 June and 1 July. That Record has been updated on the Bank's website.

Text previously deferred from publication in the Record of FPC meetings on 28 June and 1 July 2016
(p2) Agreed in principle that central bank reserves should be excluded from the measure of exposures used to calculate banks' leverage ratios. It agreed to schedule an additional meeting in the summer in order to take the necessary action to implement this change in practice and announce it alongside the publication of the Monetary Policy Committee's August *Inflation Report,* in order to avoid giving an unintended signal about the future path of monetary policy.
70. The FPC then discussed whether it would be appropriate to exclude central bank reserves from the exposures measure in the current UK leverage ratio framework. A motivation for this was to ensure that the leverage ratio would not act as a barrier to the effective implementation of any policy measure that may increase central bank reserves. This had become more relevant since the referendum. Central bank reserves could increase as a result of the Bank of England's indexed long-term repo operations, for example, or if banks chose to use their pre-positioned collateral to take advantage of these additional liquidity facilities. Future decisions by the Monetary Policy Committee could also lead to an increase in reserves. Therefore, in the light of its view that there was no direct resilience benefit to funding reserves with capital, and given these near-term practical considerations, the FPC agreed in principle to exclude central bank reserves from the exposures measure in the current UK leverage ratio framework.
71. However, the FPC was concerned that announcing such a change might be taken as a signal about the future path of monetary policy. This was outside the FPC's remit and the Monetary Policy Committee had not yet met following the referendum. To avoid this, the Committee agreed to schedule an additional meeting ahead of publication of the Monetary Policy Committee's August *Inflation Report*. This would be in order to consider the action necessary to implement this change in practice and announce it alongside the publication of that Report. The next regular joint discussion meeting with the Monetary Policy Committee was due to take place on 6 July. The FPC was briefed that implementing the change might require revoking its current leverage Direction and replacing it with a Recommendation, given that amendments to the Direction were not possible.
72. The Committee noted excluding central bank reserves from the exposures measure would mean, other things equal, that a lower amount of capital would be needed to meet the current minimum 3% leverage ratio requirement. On the one hand, there were arguments for maintaining the existing calibration of the regime. If the existing calibration was appropriate, then amending the definition to exclude central bank reserves in the exposures measure should not affect capital required to fund genuinely risky assets. On the other hand, there was a case for grossing up the calibration in order to maintain the same overall level of capital required and avoid changing the leverage constraint at the aggregate level. The Committee agreed it would consider the implications of excluding central bank reserves for the calibration of the leverage ratio framework at its additional meeting. It would also consider whether to make the changes to the UK framework that it had discussed in the context of development of the international standard – ie on the treatment of outright sales and purchases of securities and the treatment of client derivatives cleared through central counterparties.
73. The Committee judged that it would be contrary to the public interest to publish details of such a decision at this stage because it could give an inadvertent signal on the future path of monetary policy. At this stage the Committee expected to be able to publish the text in August alongside the Monetary Policy Committee's *Inflation Report*.