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# RECORD OF THE FINANCIAL POLICY COMMITTEE MEETING

# 13 MAY 2016

This is the record of the Financial Policy Committee meeting held on 13 May 2016.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1605.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's next policy meeting will be on 28 June 2016 and the record of that meeting will be published on 12 July.

# RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 13 MAY 2016

- At its meeting on 13 May, the Financial Policy Committee (FPC) reviewed the responses to its January 2016 consultation paper on the systemic risk buffer (SRB) framework.

- Having reflected on those responses, the Committee decided to adopt as final a framework that was broadly the same as that on which it had consulted.

- The only addition was the FPC agreed to supplement the SRB framework with the following Recommendation to the Prudential Regulation Authority (PRA):

  **The FPC recommends to the PRA that it should seek to ensure that, where systemic buffers apply at different levels of consolidation, there is sufficient capital within the consolidated group, and distributed appropriately across it, to address both global systemic risks and domestic systemic risks.**

  The aim of the Recommendation was to ensure that sufficient capital was held within, and distributed appropriately across, consolidated groups to address both global and domestic systemic risks, which was an issue that had been highlighted in a number of the consultation responses.

- The Committee considered other issues raised in consultation responses. It discussed the relative merits of a set of alternative proposals to address them. When taken with the Recommendation above, the FPC was content to adopt the elements of the framework set out in the consultation paper.

- The final SRB framework agreed by the Committee on 13 May would be laid out in detail in a separate published document, *The Financial Policy Committee's framework for the systemic risk buffer*.

**FPC's framework for the systemic risk buffer**

1. The systemic risk buffer (SRB) augments the capital buffer of a ring-fenced bank or large building society, enabling them to absorb greater losses before breaching their minimum capital requirements.

2. Under the UK legislation implementing the SRB,[1] the Financial Policy Committee (FPC) is required to specify a framework to guide the setting of the SRB. On 29 January 2016, the FPC published a consultation paper setting out its proposed framework for the SRB.

3. The aspects of the SRB Regulations relating to the FPC come into force on 31 May 2016 and the FPC has aimed to publish its framework for the SRB by this date in order to provide clarity to institutions that will be subject to the SRB. Once agreed by the FPC, the framework will be applied by the Prudential Regulation Authority (PRA) from 1 January 2019 to all ring-fenced banks and to large building societies that hold more than £25 billion in deposits and shares (excluding deferred shares).

4. The overarching purpose of the SRB is to raise the capacity of ring-fenced banks and large building societies to withstand stress, thereby increasing their resilience. This aim reflects the additional damage that these firms could cause to the economy in the event that they incur losses that deplete, or come close to depleting, their capital buffers, and in distress these institutions restrict the supply of critical economic functions, such as deposit taking, lending and payment services. In its consultation paper published on 29 January, the FPC had judged that the SRB should reflect the likely extent of those wider economic costs.

5. Under the SRB Regulations, the FPC's framework must set out criteria for assessing the domestic systemic importance of banks and building societies; a methodology for measuring and scoring the criteria; and for each score specify a corresponding 'SRB rate'. This rate is expressed as a percentage of each institutions' risk-weighted assets and determines the size of the additional capital buffer. The only rates which the FPC may specify under the SRB Regulations are 0%, 1%, 1.5%, 2%, 2.5% and 3% of risk-weighted assets.

6. The main proposals for the SRB framework set out in the FPC's consultation paper were:

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[1] See The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

- to use total assets as a proxy to measure the domestic systemic importance of SRB firms; and
- to set the threshold for systemic importance above which a non-zero SRB rate would apply at £175 billion of total assets (equivalent to around 10% of UK GDP) and above this threshold adopt a graduated approach, with higher SRB rates applied to SRB firms as their total assets increased through defined buckets.

7. The Committee received four responses to its consultation. Five aspects of the framework were raised in the responses: the calibration of SRB rates; the potential competitive implications of the framework; the interaction of the SRB with the buffer for global systemically important banks; the interaction of the SRB with Pillar 2A capital requirements; and the scope of firms subject to the SRB.

8. The FPC therefore met on 13 May 2016 to discuss the consultation responses and agree the final framework for the SRB.

*Overall capital framework for major UK banks*

9. Before considering the detail of the framework for the SRB, the FPC discussed the judgements it had reached in December 2015 when it had set out its view on the appropriate overall level of capital for major UK banks.[2] The SRB constituted one element of the overall requirements and therefore needed to be viewed in the wider context, a point that had been raised in one consultation response.

10. In its December judgement the Committee had concluded, based on analysis of the economic costs and benefits of going concern bank equity, that the appropriate Tier 1 capital requirement for the UK banking system in aggregate was 13.5% of risk-weighted assets (on current measures of risk-weighted assets). This referred to requirements that did not vary through time. In addition, the FPC stated its intention to make active use of the time-varying countercyclical capital buffer.

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[2] See 'Supplement to the December 2015 Financial Stability Report: The framework of capital requirements for UK banks', December 2015; http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf

11. The FPC's view at its meeting on 13 May was that no new evidence had been presented since December to affect the Committee's judgement on the overall level of capital. However, the FPC agreed that three important detailed judgements underpinning its assessment would need to be reviewed in due course as further evidence emerged. These were: international work to address definitional shortcomings in measures of risk-weighted assets; the effectiveness of arrangements for resolving banks that failed; and the economic costs of higher capital requirements.

12. In its December judgement, the FPC had judged that the appropriate Tier 1 capital requirement for the UK banking system should reflect definitional shortcomings in measures of risk-weighted assets. It had compensated for these in additional equity requirements including for trading book risk and defined-benefit pension fund risk. If all of these definitional shortcomings were addressed, and risk-weighted assets were properly measured, the Committee had judged that the appropriate Tier 1 capital requirement for the UK banking system would fall to around 11% of risk-weighted assets, although the nominal amount of capital required would be unchanged relative to the 13.5% of risk-weighted assets that the FPC had judged would be required if risk-weighted assets were not appropriately measured.

13. The Committee had also judged that the development of effective bank resolution regimes, and forthcoming requirements for banks to have the capacity to absorb losses and be recapitalised in resolution, would materially reduce both the probability and costs of financial crises. The Bank was working to ensure that feasible and credible resolution strategies were in place for individual firms and had consulted in December on its proposed approach to setting minimum requirements for own funds and eligible liabilities (MREL).[3]

14. The FPC's view remained that these developments in effective bank resolution made a material difference to the appropriate overall level of capital for these institutions by reducing both the probability and costs of bank failure and therefore the costs of disruption to the wider economy. The SRB framework could then focus on the costs to the wider economy of a ring-fenced bank or large building society becoming distressed and restricting credit provision, rather

[3] See 'The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)', December 2015;
http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf

than on the costs of contagion and disruption to the wider financial system that might otherwise materialise given failure.

15. Finally, the Committee had judged there to be wider economic costs to mandating higher capital requirements for the UK banking system overall. Although the costs of shifting banks' funding from debt to equity capital were likely to be much smaller for the wider economy than they were for existing shareholders or would be implied by a simple comparison of the current costs of equity and debt funding, these costs nevertheless needed to be taken into account when assessing the appropriate level of capital for the banking system.

16. The FPC planned to review its leverage ratio framework in 2017, in light of progress towards an international standard for a minimum leverage ratio requirement. This would be the first opportunity to test some of the judgements underlying the capital framework, against the evidence of how the framework for risk-weighted assets was evolving and resolution planning was being implemented, and taking into account the wider economic costs of raising capital. The Committee noted that the natural point for a full review of its judgements on the capital framework would be in 2019, as the final elements of the Basel III capital framework were fully phased in. Were new evidence to emerge, the FPC could make changes to the SRB framework as part of the two-yearly reviews of the framework mandated under SRB Regulations, which would begin in 2018.

17. The Treasury Committee had also indicated its intention to initiate further work on capital standards for UK banks. The FPC would consider any new evidence from the Treasury Committee's inquiry and could make amendments to its framework as appropriate.

*Calibration of SRB rates and potential implications of the framework for competition*

18. On the calibration of the SRB, one consultation response had proposed that the FPC should use the maximum SRB rate of 3% permitted under the SRB Regulations for all firms and that this SRB rate should be applied to all ring-fenced banks and buildings societies with total assets equivalent to £160 billion or more.

19. The FPC considered the merits of this proposal. It had sought to calibrate its proposed SRB framework to ensure that ring-fenced banks and large building societies held sufficient capital to offset the greater potential harm that these firms could cause to the economy if they were close to failure, but at the same time ensure that restricting the risks posed by systemic

institutions did not result in the SRB acting as a barrier to entry or expansion for challenger banks. As a result, the FPC had chosen a graduated approach to calibrating the SRB, placing firms into risk 'buckets' with those with higher levels of total assets – and therefore posing greater potential damage to the UK economy if they were to become distressed and restrict lending – being subject to higher SRB rates than less systemic firms. This meant that firms with higher potential impact on the domestic economy would have greater levels of resilience. Under the FPC's proposed approach and given firms' current plans, no ring-fenced bank or building society was large enough to fall into the top category that would require the highest SRB rate of 3%. The Committee had noted when discussing the proposed SRB framework in November 2015, that this created a helpful disincentive for firms falling into the next highest size category subject to an SRB rate of 2.5% to expand their balance sheets and so further increase the risk they posed to the domestic economy.

20. A non-graduated approach that applied a flat 3% rate to all firms above the threshold for systemic importance would imply that the SRB rate would increase sharply from 0% to 3% as firms' balance sheets expanded and total assets crossed the systemic threshold. This could create a barrier to growth by challenger banks, while the corresponding increase in the overall aggregate capital in the UK banking system and its resilience would be relatively small. The FPC therefore judged it appropriate to retain a graduated approach. However, it considered again an alternative calibration of the SRB framework in which the graduated approach was retained but the SRB rate for all buckets above the FPC's £175 billion threshold for systemic importance were raised by 50 basis points. This would increase the SRB rate applied to banks with total assets between £610 billion and less than £755 billion to the top rate of 3%. The SRB rate applied to banks in the lowest bucket with total assets of between £175 billion and less than £320 billion would, likewise, increase from 1% to 1.5%.

21. The FPC judged that such a calibration would have two drawbacks relative to the proposal on which it had consulted. First, the alternative calibration meant that the top SRB rate of 3% permitted by the SRB Regulations would be used and there would no longer be an empty top bucket that would then be applied to the largest firms should their assets expand in future, to reflect the greater risk that they would pose to the domestic economy in distress. This could remove the disincentive for these firms to expand further.

22. Second, the alternative calibration would mean that smaller banks would face a larger step-up in capital requirements were they to expand. The FPC could reduce this 'cliff edge' effect by introducing a lower bucket corresponding to a 1% SRB rate, but this would bring challenger

banks closer to being in scope of the SRB and potentially remove some of the incentives for them to grow.

23. Members placed different weights on these considerations and how they balanced against the small increase in resilience of systemic institutions. One member argued in favour of the alternative calibration, when looked at in isolation. But when looked at within the context of the overall capital framework, and given that it would make only a small difference to resilience, that member was content to join the consensus that the proposal on which the Committee had consulted in January 2016 should be retained. This also acknowledged the desire to give firms clarity as early as possible on this part of the capital framework. The FPC noted that it was mandated under the SRB Regulations to review the SRB framework at least every two years, beginning in 2018.

*Interaction of the SRB and the GSIB buffer*

24. Two of the consultation responses had highlighted a concern that, for those ring-fenced banks that were part of banking groups that had also been designated as global systemically important banks (GSIBs), the implementation of the SRB could 'trap' an excessive amount of the capital buffer applied to GSIBs in the ring-fenced bank and leave the non-ring fenced banking activities more exposed to risks.

25. Under the SRB Regulations, the resilience of non-ring fenced banking activities was not a responsibility of the FPC when setting the SRB. Nonetheless, the FPC noted the potential risk of the SRB reducing the resilience of non-ring fenced activities. Banking groups that had been designated as GSIBs and that incorporated a ring-fenced bank would be subject to a GSIB buffer at the consolidated group level and an SRB at the level of the ring-fenced bank sub-group. As the equity requirement to meet the SRB was likely to be downstreamed from the group holding company rather than issued directly to external investors by the ring-fenced bank, when the SRB rate exceeded the GSIB buffer rate a proportionally higher amount of group resources would be allocated to the ring-fenced bank sub-group than the rest of the group. This created a risk that the non-ring fenced parts of the group, which often provided important services such as market making and underwriting services, would not be protected by the group's GSIB buffer in proportion to their size relative to the group as a whole (ie they would not be able to access their 'fair share' of the GSIB buffer). This could reduce the resilience of banking sub-groups that were globally systemically important.

26. The FPC agreed with the principle set out in the Basel Committee on Banking Supervision's principles for domestic systemically important banks that the double counting of global and domestic systemic risk should be avoided. In consequence, it did not plan to require firms to hold sufficient capital to meet the sum of both the SRB and GSIB buffer. But at the same time, the Committee judged that it was necessary to ensure that adequate capital was allocated appropriately across banking groups, so that firms could continue to provide important services both domestically and globally in the event of distress, and so to meet the aims of both the SRB and the GSIB buffer frameworks.

27. In accordance with its objectives, the Committee therefore made the following Recommendation to the PRA: **The FPC recommends to the PRA that it should seek to ensure that, where systemic buffers apply at different levels of consolidation, there is sufficient capital within the consolidated group, and distributed appropriately across it, to address both global systemic risks and domestic systemic risks.**

28. In making this Recommendation to the PRA, the FPC's intention was neither to alter the design or application of the SRB nor of the GSIB buffers. Rather it was to ensure that the banking group as a whole had sufficient capital overall to meet 'fair shares' of both buffers.

29. Given the current distribution of SRB and GSIB buffers, the FPC estimated the impact of the Recommendation on firms to be very small at present. Staff estimates suggested that implementing the Recommendation would raise average group systemic buffers by around 3 basis points. It would not therefore affect materially the estimated macroeconomic benefits of the SRB relative to the proposal on which the FPC consulted. The Committee noted, however, that in future it was possible that a greater number of firms could have SRB rates in excess of their GSIB rates, as their business models evolved. By seeking to ensure that there was sufficient overall capital within the banking sector to address both global and domestic systemic risks, the Recommendation supported the financial stability of the United Kingdom and increased the resilience of material providers of lending to the UK economy.

30. The FPC recalled that it was required to have regard to the impact of its policies on the PRA's objectives. The Committee considered that the implementation of the Recommendation would be within the PRA's objectives. In particular, the implementation of the Recommendation would have a positive impact on the resilience of firms to both global and domestic systemic risks, and thus the resilience of the UK financial system as a whole. It should therefore also have a

positive impact on the PRA's general objective to promote the safety and soundness of the firms that it regulated, which included consideration of financial stability.

*Other issues raised in the consultation*

31. A number of the consultation responses had raised questions about the interaction of the SRB with Pillar 2A capital requirements. They had questioned whether risks associated with concentrated exposures were reflected in both and were therefore being double counted. The FPC concluded that this was not the case. The SRB and Pillar 2A requirements addressed different and separate risks. Pillar 2A addressed, amongst other risks, risks associated with concentrated geographical, sectoral, or specific name risk in a firm's credit exposures that could lead to a bank incurring higher credit losses in a downturn. The SRB addressed the greater potential impact a systemically important institution could have on the economy by restricting lending to UK households and non-financial companies if it became distressed. The two elements of the capital framework were therefore different: Pillar 2A addressed risks facing the firm; the SRB aimed to increase resilience against risks that the distress of a domestic systemically important firm could pose to the UK economy. A ring-fenced bank or large building society with concentrated exposures would therefore need to be subject to both additional capital requirements.

32. One response to the consultation requested clarification on the scope of application of the SRB and whether firms other than ring-fenced banks and large building societies should be covered by the SRB as such firms also provided lending to the UK economy and might be considered systemic.

33. The FPC noted that ring-fenced banks and large building societies were expected to account for a substantial proportion of UK household and private non-financial corporate lending, reflecting the large aggregate market share of existing UK banking groups and building societies that would be subject to the SRB (around 80% of total lending to UK households and private non-financial corporates). The majority of domestic systemic risk was therefore being addressed by the SRB. Ring-fencing itself was also intended to ensure that ring-fenced banks were protected from shocks that originated in the rest of the banking group or the broader financial system in order to minimise disruption to the provision of core services. The Committee agreed that firms other than ring-fenced banks and large building societies could pose systemic risks, but that this would happen through channels other than domestic lending, including their support for capital markets through market making activity and clearing, custody and settlement activities. Such

firms were not themselves within the scope of the SRB, which was conceived to address risks associated with the distress of domestic systemically important banks. And the FPC did not have the discretion to revise the scope of firms subject to the SRB framework under the SRB Regulations. The SRB Regulations required the FPC to produce a framework for applying an SRB to ring-fenced banks and to large building societies with deposits and shares (excluding deferred shares) over £25 billion. However, the FPC agreed to keep these potential systemic risks, including the distribution of credit provision across ring-fenced banks and other non-ring fenced entities, under review, including through its annual assessment of risks outside the core banking system and its two-yearly reviews of the SRB framework.

34. More detail on the final framework, including a summary of consultation responses and the FPC's response to them and the competition considerations and costs and benefits of the SRB framework, was set out in a separate document, the *Financial Policy Committee's framework for the systemic risk buffer*, which the FPC agreed to publish on 26 May 2016 alongside the Record of the 13 May meeting.

The following members of the Committee were present at the meeting; Donald Kohn joined the meeting by telephone:
Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Andrew Bailey, Deputy Governor responsible for prudential regulation
Ben Broadbent, Deputy Governor responsible for monetary policy
Alex Brazier
Clara Furse
Donald Kohn
Richard Sharp
Martin Taylor
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Tracey McDermott, Acting Chief Executive of the Financial Conduct Authority, was unable to attend the meeting as she was overseas at a meeting of the International Organization of Securities Commissions (IOSCO).

Nemat Shafik, Deputy Governor responsible for markets and banking, also attended the meeting.