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RECORD OF THE MEETING BETWEEN THE GOVERNOR OF THE BANK OF ENGLAND AND THE CHANCELLOR OF THE EXCHEQUER TO DISCUSS THE JUNE 2013 FINANCIAL STABILITY REPORT

22 JULY 2013

The following items were discussed at the meeting:

1. Financial Stability Report assessment of financial stability
2. Financial Policy Committee (FPC) capital adequacy and stress testing recommendations
3. FPC liquidity recommendations
4. Bank disclosures
5. International regulatory reform

1. Financial Stability Report assessment of financial stability

The Governor and Chancellor discussed the assessment of financial stability contained in the FPC's June 2013 Financial Stability Report.

Introducing the discussion, the Governor said that stimulative monetary conditions and low long-term interest rates were crucial to supporting economic recovery, but noted the need to be alert to the risks posed by excessive leverage or insufficient liquidity. The recent sharp movements in long-term yields had been accompanied by a spike in volatility. Although both moves had since considerably unwound, they served to highlight the risks that could crystallise. In the Governor's view, such moves emphasised the important synergies between the MPC and FPC. The MPC could promote financial stability through transparency about how it would respond to emerging signs of economic recovery. The FPC could promote economic recovery by monitoring and addressing the risks stemming from exceptionally stimulative monetary policy, thereby allowing that policy to remain in place for a period sufficiently long to secure recovery.

The Governor noted that sharp upward movements in interest rates and credit spreads could affect financial institutions directly through exposures to moves in asset prices or indirectly through counterparty credit risk. Risks could also extend beyond the banking system.

From the FPC's perspective, it was important that the authorities and institutions across the financial system were alert to the scale of risks stemming from shifts in interest rates or mispriced risk. To inform its consideration of these risks, the FPC had asked the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), with other Bank staff, to provide the FPC with an

assessment of the vulnerability of borrowers and financial institutions to sharp upward movements in long-term interest rates and credit spreads in the current low interest rate environment. They would report back to the FPC in September 2013.

Internationally, there were ongoing risks from a weak and uneven global recovery, including in the euro area, where UK banks had material exposures. While progress had been made, imbalances persisted. These concerns had been behind the previous FPC recommendation to manage and mitigate specific risks to UK banks from potential stress in the euro area, and were relevant to its broader recommendations on strengthening UK bank capital resilience.

Market participants had increasingly highlighted concerns about operational risk, including threats of cyber attack. This was the most frequently highlighted operational risk in the Bank of England's 2013 H1 Systemic Risk Survey. The FPC had therefore recommended that HMT and other authorities should work with the core UK financial system and its infrastructure providers to put in place a programme of work to improve and test resilience to cyber attack.

The Chancellor noted the analysis in the FSR, and in particular the focus on interest rate risks. He noted that current market conditions, with financial markets particularly sensitive to communications by central banks about the path of future interest rates, demonstrated the importance of strong coordination between the FPC and MPC. This was one of the recommendations contained in the Chancellor's remit and recommendations for the FPC of 30 April 2013.

The Chancellor welcomed the recommendation to the Treasury and other authorities concerning risks from cyber attack. He emphasised that the cyber threat was real and was growing and evolving. The financial authorities and Government had been working with the sector for some time to strengthen cyber security. The recommendation should reinforce the importance of continuing to work together to coordinate and strengthen this work. Treasury officials were working closely with Bank officials and with other key stakeholders to agree a plan in response to this recommendation for the FPC to consider, building on the work that is already taking place.

2. FPC capital adequacy and stress testing recommendations

The Governor noted that much of the FPC's work to date had centred on capital adequacy of the UK banking system. He explained that, following the crisis, there had been a pressing need to repair the capital strength of the UK banking system in order to avoid the risk of further serious economic

disruption. That minimum standard of resilience needed to be reached to secure a sustainable economic recovery.

In March the FPC had judged that, in light of the risks facing the UK banking system, the largest banks should have a Basel III common equity Tier 1 ratio of at least 7%, determined on end-point definitions, after taking into account adjustments for a realistic assessment of asset valuations, future conduct costs and a prudent assessment of risk weights. The Governor said that the work done by the PRA since the FPC's recommendation meant that the largest UK firms had either met or had plans to meet that standard of resilience.

The Governor noted that once this recommendation had been satisfied, there would no longer be as urgent a need to repair banks' balance sheets. There would, in the future, be other regulatory changes affecting the UK banking system, some of which would require the sector to further boost its capital adequacy. These included: the full implementation of Basel III, the surcharge for systemically important banks, the trading book review, potential requirements imposed by overseas regulators and implementation of the Independent Commission on Banking (ICB) proposals. However, these additional requirements could be introduced on a more gradual path.

The Chancellor said that the Government had been clear that Britain's banking system needed to be stronger and safer and he welcomed what had been achieved. The strengthening of banks' capital positions was a core part of that. UK banks would need to continue to strengthen their positions over time, in particular in the context of the implementation of Basel III, and the Government's implementation of the ICB proposals.

The Chancellor noted that the FPC had made clear that the PRA should implement the FPC capital recommendations in a way that did not hinder lending to the economy and asked the Governor for his assessment of the likely impact on lending. The Governor said that the PRA had focussed on the implications of firms' plans for lending to the real economy and was satisfied that those plans did not involve any scaling back in their lending to the real economy.

The Governor explained that the need to assess the system's capital adequacy was not a one-off exercise. The FPC had therefore asked Bank staff, including at the PRA, to develop a framework for stress testing the UK banking system's capital adequacy in future years. The June FSR had set out some design principles that would inform the development of this framework. The Chancellor noted that the US experience had demonstrated that well designed stress tests could play a crucial role in reducing uncertainty by providing credible information to markets.

3. Liquidity regulation

The Governor noted the new rules on the Liquidity Coverage Ratio (LCR), as defined in the EU's implementation of the Basel standard. In aggregate, the LCR of UK banks was above 100%, the level required by 2018. The FPC had recommended to the PRA that the minimum requirement should be set at an LCR of 80% until 1 January 2015, rising thereafter to reach an LCR of 100% on 1 January 2018.

The Chancellor asked the Governor about the likely impact of the FPC recommendation on financial stability and on bank lending. The Governor explained that the UK banking system was currently holding a larger buffer of liquid assets than required by regulation. Furthermore, there was scope to relax the requirements to support the economic recovery without compromising resilience. Based on end-2012 estimates, an initial LCR requirement of 80% rather than 100% would give the big four UK banks, in aggregate, additional scope to reduce their holdings of liquid assets by around £70 billion. The Governor noted, however, that the PRA would need to consider the position of individual firms, including their progress in strengthening capital resilience, when assessing the extent to which liquid asset buffers could be reduced.

4. Bank disclosures

The Governor said that it was important to have clear and transparent bank disclosure to strengthen market discipline and enhance financial stability. A recent Basel Committee on Banking Supervision report had found that capital requirements against hypothetical portfolios of exposures to sovereigns, banks and large corporates varied widely across a sample of big internationally active banks. The FPC had therefore made a series of recommendations to the PRA to enhance disclosures by UK banks and building societies. The Chancellor agreed on the importance of clear and transparent bank disclosures for strengthening market discipline and enhancing financial stability.

5. International regulatory reform

The Governor noted the coverage in the June 2013 FSR of the risk arising from gaps and inconsistencies in the international regulatory reform programme. An internationally consistent approach, avoiding local solutions, would reduce the risks of regulatory arbitrage and would preserve the benefits of an open, integrated global financial system. This would include reaching agreement on an international Basel III leverage ratio standard that would be implemented across

jurisdictions. The Governor noted the importance of reaching credible international agreements on the resolution of large, complex cross-border firms. Until such agreements were in place, national authorities would face incentives to ring-fence capital in their own jurisdictions and progress on tackling the 'too big to fail' problem would be slowed.

The Chancellor agreed on the crucial role of high, internationally consistent, regulatory standards in supporting global financial markets, and that a key part of this framework was an internationally agreed leverage ratio as a backstop to risk-weighted capital requirements. On tackling the too big to fail problem, solid progress had been made on the EU Bank Recovery and Resolution Directive negotiations but there would be more work to do in the coming months as the European Parliament and Member State Council negotiated final text. To reduce the risks of regulatory inconsistency and duplication, it was very important to put in place a formal framework for regulatory co-operation between EU and US regulators. Within the free trade agreement, the EU was proposing to agree a framework for stronger regulatory cooperation. The UK should continue to support the EU's efforts in this area.