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Role of the Bank of England in ensuring financial stability and economic growth in the UK: Implementation of Basel III in the UK

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- The views expressed here are those of the presenter and not necessarily those of the Bank of England or any Committees of the Bank



Regulatory landscape – pre-crisis



- Monetary policy (MPC)
 - Financial stability
 - Market operations



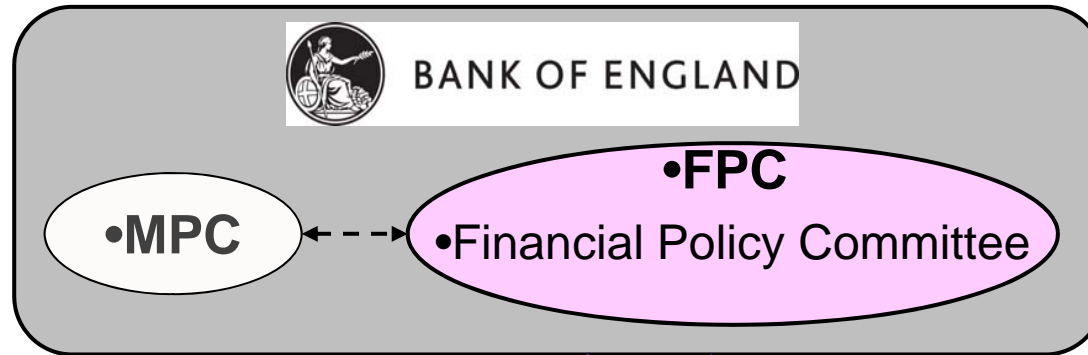
- Microprudential regulation and supervision
 - Conduct supervision
 - Markets oversight

- MoU (2006) between HM Treasury, Bank of England and FSA establishes a framework for co-operation between the authorities in the field of financial stability.
 - Tripartite Standing Committee on FS is the principal forum
 - Does not over-ride each authority's powers/duties
 - Meets monthly at Deputies (official) level (in crisis time, at Principals level)
 - No minutes published

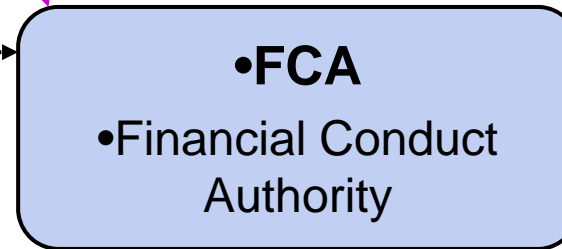
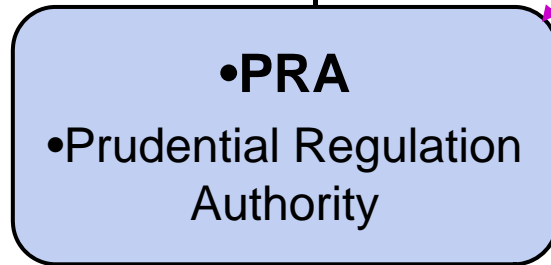


Reform of the regulatory framework

•From 2013



•subsidiary of the Bank



•powers of direction & recommendation to PRA & FCA in relation to FS

•cooperation & coordination

•microprudential regulation & supervision

•conduct regulation

•microprudential & conduct regulation



UK-Russian Interbanking Roundtable

The role of the Financial Policy Committee (FPC)

- The FPC's statutory responsibility will be 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's task will not be to achieve resilience at any cost, however. Its actions must not, have
 - 'a significant adverse affect on the capacity of the financial sector to contribute to the growth of the economy in the medium or long-term.'
- Subject to achieving its primary objective, the FPC must also support
 - 'the economic policy of the Government, including its objectives for growth and employment.'



Evolution of capital requirements

- 1988 Basel Accord (known as Basel 1) focuses principally on credit risk;
 - Tier 1 risk-based capital ratio (Tier 1 Capital/RWA): 4% minimum
 - Total risk-based capital ratio (Total capital/RWA): 8%
- Capital requirement for market risk, added in 1996 (Market Risk Amendment)
 - Applies to firms with significant trading activity
- The Basel II framework amends the risk-based capital standards for large, internationally active banking organisations
 - Includes an explicit minimum capital requirement for operational risk in addition to credit and market risks.



Observed weaknesses during crisis

- During the financial crisis, shortcomings in both the regulatory framework and banks' own processes became pronounced. More specifically:
 - Supervisory expectation that common equity serve as a 'predominant' form of tier 1 capital was neither explicitly defined nor viewed as a binding constraint;
 - Capital requirements were not commensurate with the risks posed by banks, and the risks they posed to the financial system, particularly those realised in a stressed environment; and
 - Inaccurate and ineffective bank management of liquidity risk became apparent, prompting the need for introduction of prudential liquidity standards.



Introduction of Basel III

- In December 2010, the Basel Committee on Banking Supervision (BCBS) finalised the Basel III accord aimed at:
 - Increasing the capacity of banks to absorb losses relative to risk;
 - Constraining leverage through a non-risked based backstop;
 - Increasing the capacity of banks to absorb shocks to funding and constraining structural funding mismatches;
 - Incorporating systemic and macroprudential perspectives into capital framework; and
 - Providing greater transparency so market participants can make informed assessments of banks' potential vulnerabilities to shocks

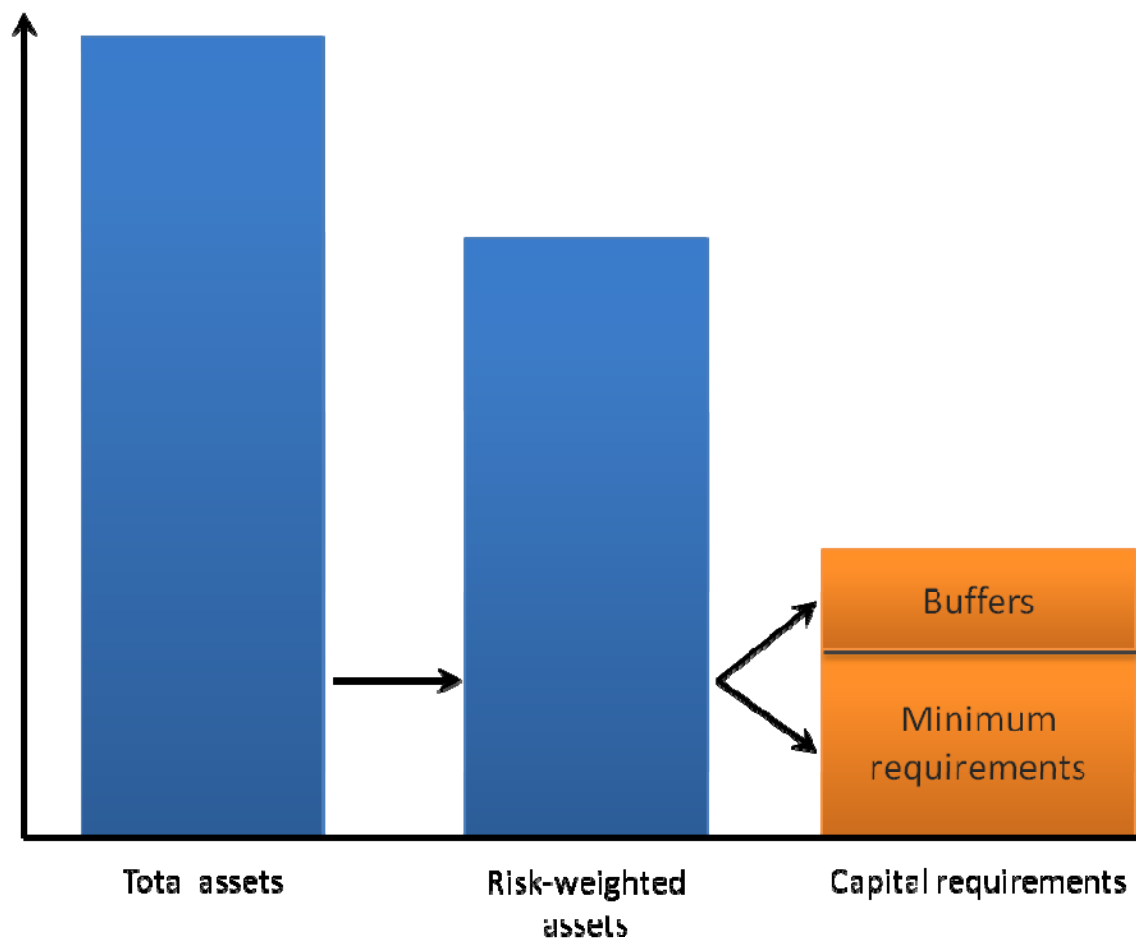


How much of banks' funding must be sourced from capital

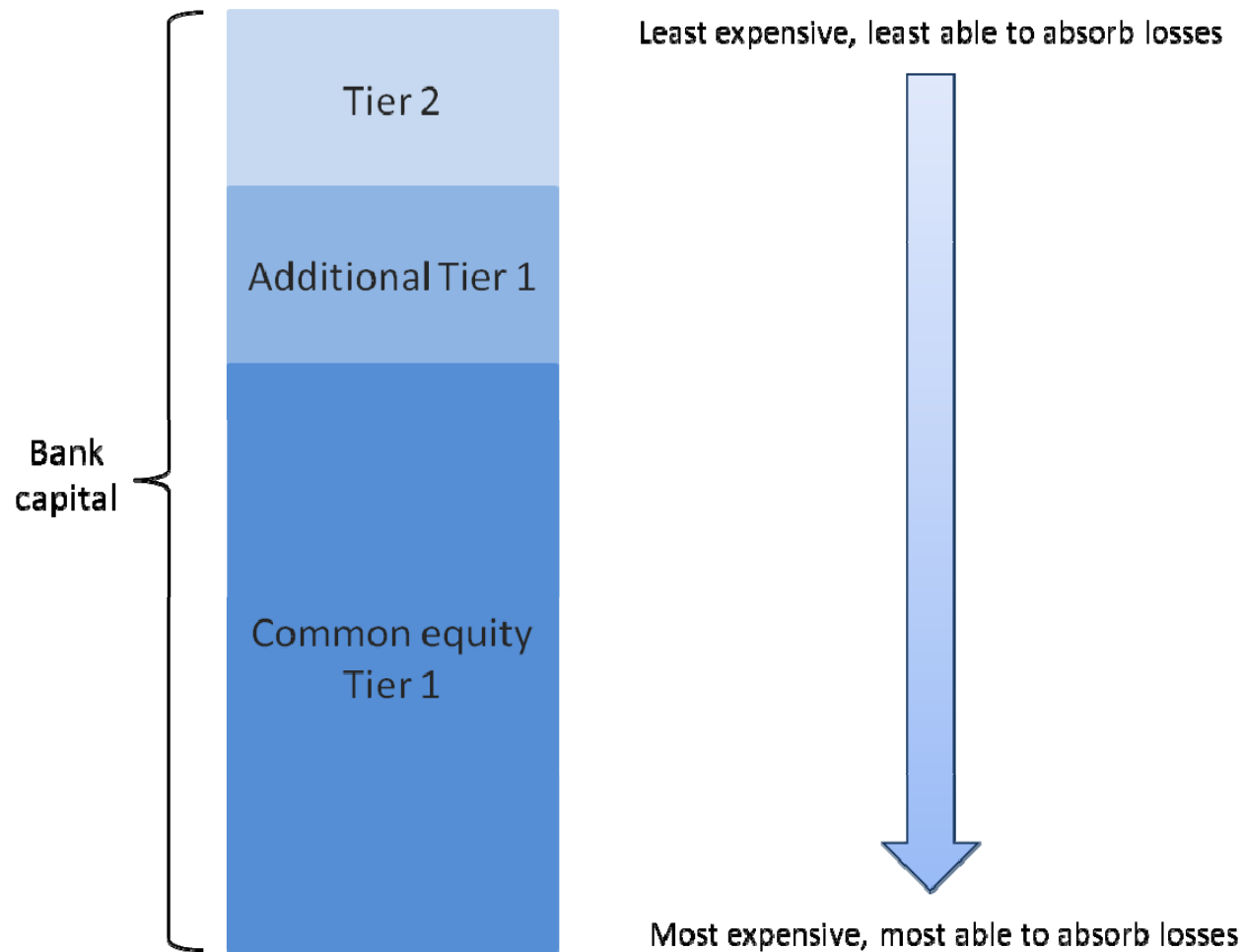
- According to Basel III standards, banks must fund risk-weighted assets with at least a certain amount of capital, known as '**minimum requirements**' of capital.
- In addition to the minimum requirements, banks will be required to have a number of **capital buffers**.
- These are meant to ensure that banks can absorb losses in times of stress without necessarily being deemed in breach of their minimum capital requirements.



Total assets, risk-weighted assets and capital requirements



Forms of regulatory capital



What counts as 'capital' (1)

- The main component of bank's capital resources is equity – referred to as **common equity Tier 1**. Key aspects of CET1 are:
 - it absorbs losses before any other tier of capital;
 - its capital instruments are perpetual; and
 - dividend payments are fully discretionary
- Banks can count, to a limited extent, further instruments in their regulatory capital. Additional Tier 1 (AT1) capital includes:
 - Perpetual subordinated debt instruments
- Basel III standards require that AT1 instruments must have a mechanism to absorb losses in a going concern
 - for example convertibility into ordinary shares



What counts as 'capital' (2)

- A banks' regulatory capital resource also comprises 'gone concern' capital.
- Gone concern capital supports the resolution of banks and the position of other creditors such as the bank's deposit customers in bankruptcy proceedings.
- This includes Tier 2 capital, which is dated subordinated debt, with a minimum maturity of five years.
- In addition, under Basel III, all additional Tier 1 and Tier 2 capital instruments must have a trigger so that they convert into ordinary shares or are written down when a bank is no longer viable.

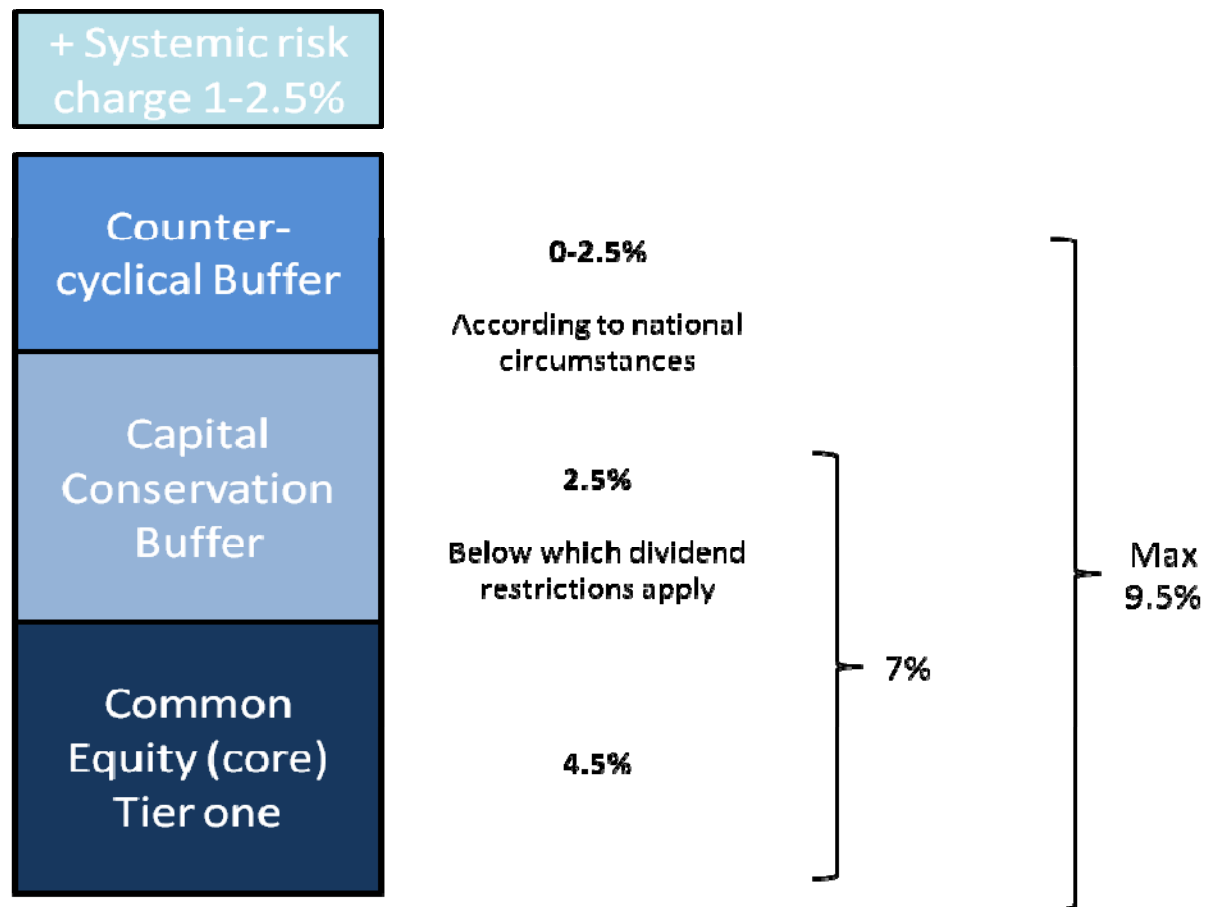


Basel III - Additional Requirements

- Capital conservation buffer 4.5% - 7.0%
 - Regulatory controls over dividends and remuneration
- Countercyclical buffer – proposal: 0% - 2.5%
 - Applies in periods of excess aggregate credit growth
- Systemically important financial institutions
 - Further capital surcharge 1% - 2.5%



Basel III – New Core Tier One ratios



UK approach (1)

- The Financial Policy Committee (FPC) is responsible for decisions on the countercyclical capital buffer (CCB) applied to certain financial institutions in the UK.
- The FPC also determines sectoral capital requirements (SCRs).
- The CCB tool would allow the FPC to change capital requirements above normal microprudential standards in relation to all loans and exposures of banks.
- The SCR tool is more targeted and would allow the FPC to change capital requirements above microprudential standards on exposures to specific sectors judged to pose a risk to the system as whole.

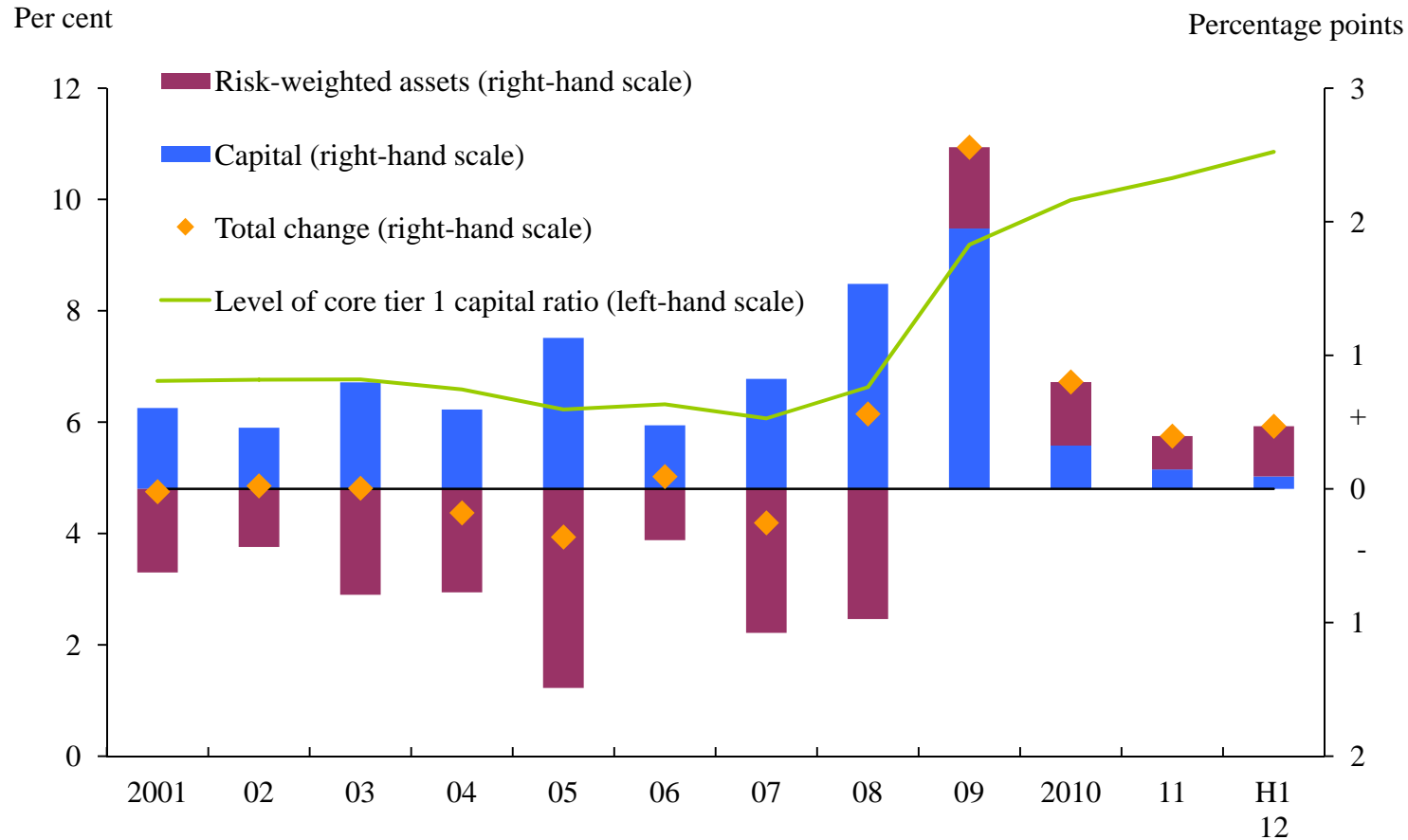


UK approach (2)

- The Interim Financial Policy Committee (FPC) recommended at its meeting held in November 2011 that, if earnings are insufficient to build capital further, banks should limit distributions and give serious consideration to raising external capital in the coming months.



Contributions to the change in major UK banks' core Tier 1 capital ratios^(a)

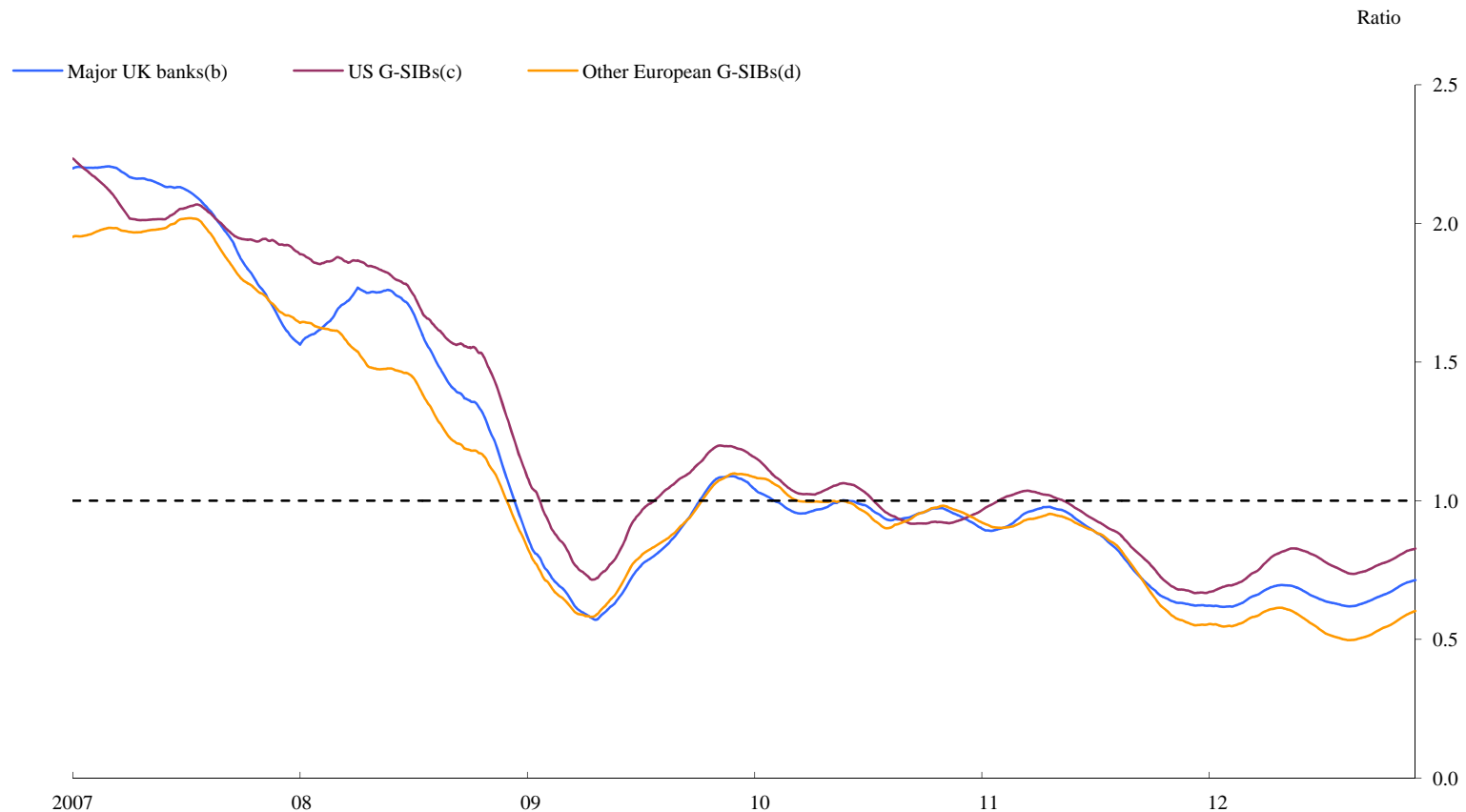


•Sources: Bank of England, published accounts and Bank calculations.

•(a) As Co-operative Banking Group, Nationwide and Virgin Money have not yet reported H1 2012 results, no change is assumed from their end-2011 results.



Major UK banks' and G-SIBs' price to book ratios^(a)



•Sources: Thomson Reuters Datastream and Bank calculations.

•(a) Chart shows the ratio of share price to book value per share. Simple averages of the ratios in each peer group are used. The chart plots the three-month rolling average.

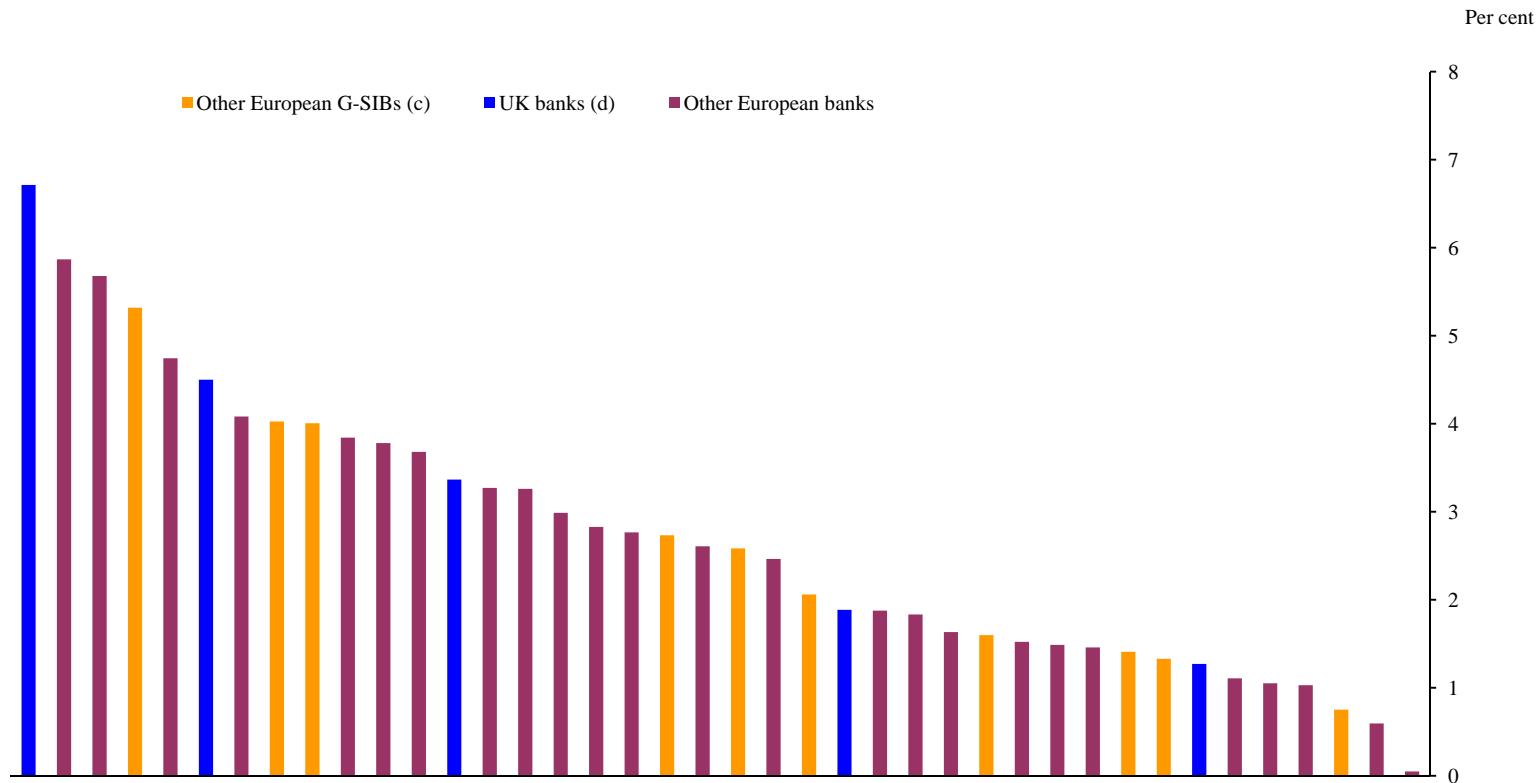
•(b) Excludes Co-operative Banking Group, Northern Rock (from end-2007), Nationwide and Britannia.

•(c) Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, State Street and Wells Fargo.

•(d) BBVA, BNP Paribas, Credit Suisse Group, Deutsche Bank, Nordea Bank, Societe Generale, UBS and Unicredit. For Group Credit Agricole and Groupe BPCE the traded entities Credit Agricole SA and Natixis are used respectively.



European banks' market-based capital ratios^{(a)(b)}



•Sources: Bank of England, Bloomberg, Thomson Reuters Datastream, SNL Financial and Bank calculations.

•(a) Calculated as market capitalisation divided by total book assets.

•(b) Sample comprises the top 40 listed banks in Europe by total assets, excluding Allied Irish and ING Group.

•(c) BBVA, BNP Paribas, Credit Suisse Group, Deutsche Bank, Nordea Bank, Societe Generale, UBS and UniCredit. For Group Credit Agricole and Groupe BPCE the traded entities Credit Agricole SA and Natixis are used respectively.

•(d) Banco Santander, Barclays, HSBC, LBG and RBS.



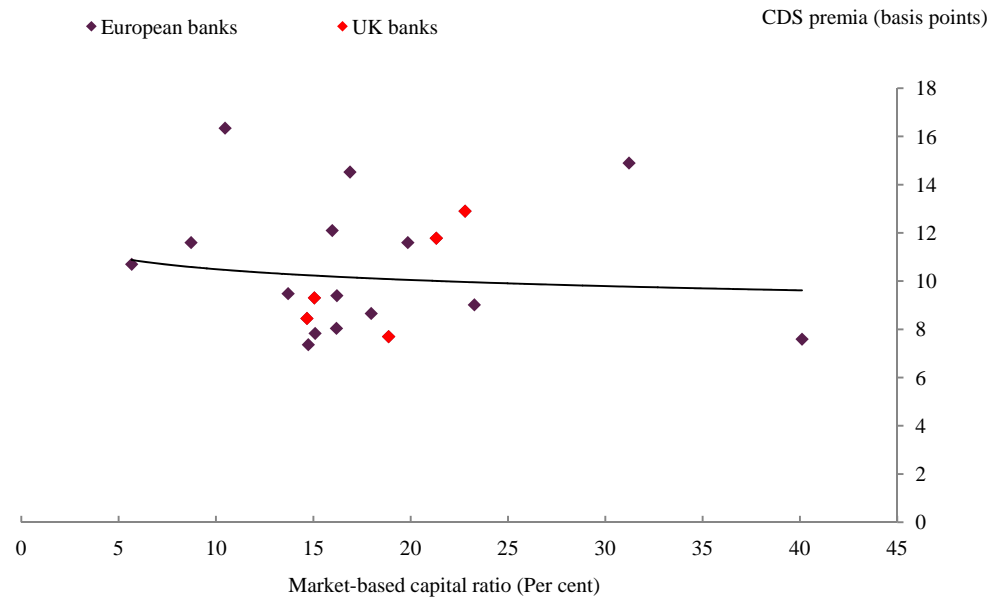
Capital ratios and funding costs in 2005

- Consider a situation where market participants perceive, potentially mistakenly, that banks are solvent and risks to the stability of the banking system are small.
- In this case, banks can borrow cheaply at a rate that may be relatively insensitive to the amount of capital they have.
- This was the situation preceding the financial crisis, while acknowledging the potential mispricing of both these indicators.



Capital and funding (1)

Chart 1: Pre-crisis relationship between market-based capital ratios and funding costs in December 2005^{(a)(b)(c)(d)}



Sources: Capital IQ, Markit Group Limited, Published accounts, Bank of England and Bank calculations.

(a) Market-based capital ratios are banks' market capitalisation as a percentage of published risk-weighted assets.

(b) The sample shown is the largest 20 European banks by assets.

(c) Funding costs are proxied by 5-year senior CDS premia. The 'line of best fit' shown above illustrates their relationship with market-based capital ratios.

(d) Where possible, Capital IQ data has been used to calculate the market-based capital ratio, but for some banks it was necessary to use published accounts data.



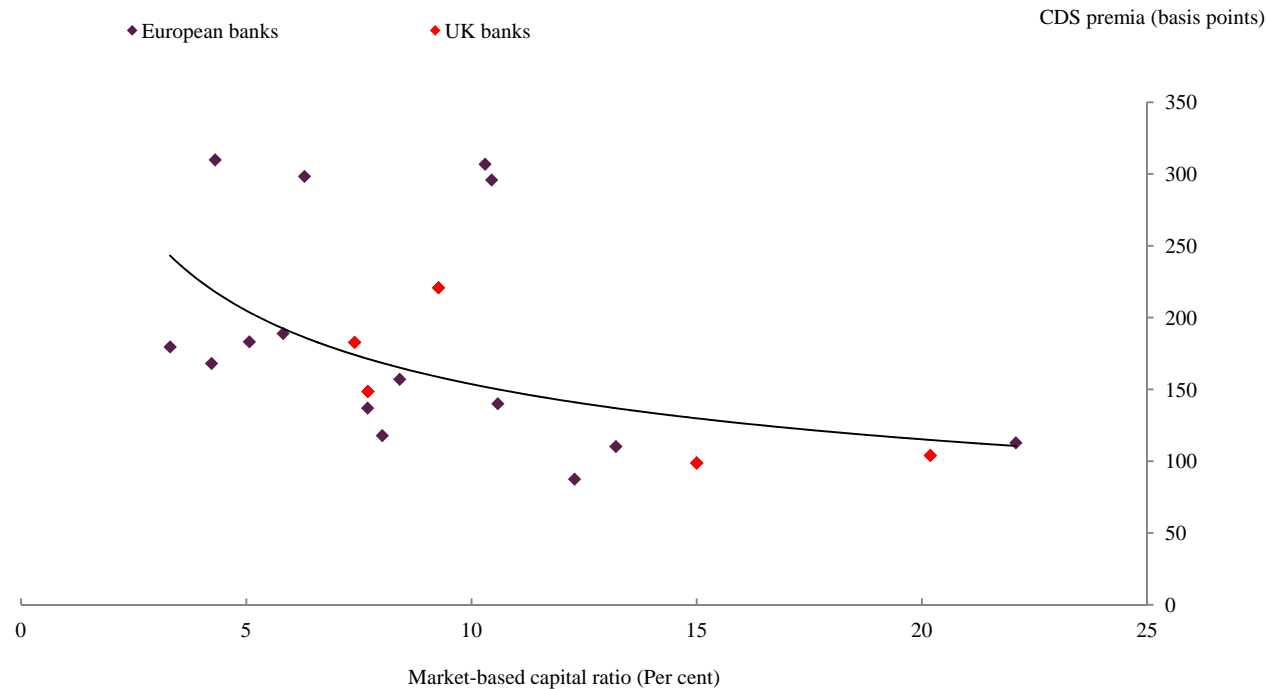
Capital ratios and funding costs in 2012

- In 2012, in a situation where market participants were highly concerned about banks' vulnerabilities to shocks, banks' borrowing costs were sensitive to their capital adequacy.
- The chart shows that European banks with higher market-based capital ratios have lower funding costs.
- The 5 European banks with the highest market-based capital ratios all have CDS premia below 190 basis points.
- This suggests that banks with lower market-based capital ratios may be able to reduce their CDS by raising capital levels.



Capital and funding (2)

Chart 2: Post-crisis relationship between market-based capital ratios and funding costs in November 2012^{(a)(b)(c)(d)}



Sources: Capital IQ, Markit Group Limited, published accounts, Bank of England and Bank calculations.

(a) Market-based capital ratios are banks' market capitalisation as a percentage of published risk-weighted assets.

(b) The sample shown is the largest 20 European banks by assets.



(c) Funding costs are proxied by 5-year senior CDS premia. The 'line of best fit' shown above illustrates their relationship with market-based capital ratios.

(d) Where possible, Capital IQ data has been used to calculate the market-based capital ratio, but for some banks it was necessary to use published accounts data.

Basel III leverage ratio

- Risk-based core Tier 1 capital ratios provided a relatively weaker signal during the financial crisis, not changing materially during the upswing as average risk weights fell.
- At the individual bank level, leverage ratios were a better predictor of banks that subsequently got into trouble during the crisis than risk-based capital ratios.
- The FPC recommended that the PRA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.



Liquidity risk

- It is useful to distinguish two types of liquidity risk faced by banks. These are:
- **Funding liquidity risk:** the risk that bank does not have sufficient cash or collateral to make payments to its counterparties and customers as they fall due.
- **Market liquidity risk:** this is the risk that an asset cannot be sold in the market quickly, or, if its sale is executed very rapidly, that this can only be achieved at a heavily discounted price.



Mitigating liquidity risk

- Banks can mitigate these liquidity risks in two ways.
- First, they can seek to attract stable sources of funding that are less likely to 'run' in the event of stressed market conditions.
- Second, banks can hold a buffer of highly liquid assets or cash that can be drawn down when their liabilities fall due.
 - this buffer is important if a bank is unable to roll over its existing sources of funding or
 - if other assets are not easy to liquidate.



Liquidity regulation in the UK

- The FPC has agreed that the PRA should employ the Liquidity Coverage Ratio (LCR) as defined in the EU's implementation of the Basel standard.
- It is designed to ensure that banks hold a buffer of liquid assets to survive a short-term liquidity stress.
- The minimum requirement should be set at an LCR of 80% until January 2015, rising thereafter to reach an LCR of 100% on January 2018.
- The Net Stable Funding Ratio, is designed to promote stable funding structures and is currently under review by BCBS.



Regulation is designed to correct market failures

- Regulators are rethinking their more fundamental role in affecting bank behaviours and market perceptions about bank risk.
- Market Failure Analysis is the key to understanding whether there is a genuine economic problem and therefore benefits.
- There will always be costs if we change the behaviour of firms in the market.
- We should only be satisfied with a policy if we can demonstrate that the benefits will outweigh the costs.

