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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 NOVEMBER 2018 FINANCIAL STABILITY REPORT

12 December 2018

The following items were discussed at the meeting:

- The 2018 stress test of the UK banking sector;
- The resilience of the UK financial system to Brexit;
- The UK countercyclical capital buffer rate decision;
- Leveraged lending;
- Global risks; and
- The FPC's assessment of the risks from leverage in the non-bank financial system.

1. The Chancellor opened the meeting by reflecting on the achievements of the Financial Policy Committee (FPC) over its first five years as a statutory committee and how, as a result, the financial system is far more resilient ten years on from the global financial crisis. The Chancellor welcomed the work that the FPC has undertaken to revise the capital framework for the UK banking system, including the introduction of the Countercyclical Capital Buffer (CCyB). He also welcomed the actions it has taken to build UK banking sector resilience to the mortgage market and household indebtedness, and to build financial sector resilience to cyber risk. He noted that the 2018 stress test was the fourth annual stress test undertaken by the FPC and PRC, and the importance of this exercise to ensure the resilience of the UK banking system.

2. He also noted the importance of the FPC setting out its assessment of risks to UK financial stability and the actions it has taken in a transparent and accountable manner, including through its biannual Financial Stability Reports.

The 2018 stress test of the UK banking sector

3. Turning to the November 2018 Financial Stability Report and stress test results, the Governor explained that the Bank's 2018 stress test showed that the UK banking system was resilient to deep simultaneous recessions in the UK and global economies that were more severe overall than the global financial crisis and that were combined with large falls in asset prices and a separate stress of misconduct costs.

4. The Governor noted that the major UK banks started the 2018 stress test with an aggregate common equity Tier 1 (CET1) capital ratio nearly three and a half times higher than before the global financial crisis. Despite facing loss rates consistent with the crisis, their aggregate CET1 capital ratio after the stress would still be twice its level before the crisis. This meant all participating banks would be able to continue to meet credit demand from the real economy, even in this very severe stress.

5. The Chancellor welcomed the results of the Bank's annual stress test, which highlight the resilience of Britain's banks. He noted the progress made to ensure the banking system is stronger, safer, and better able to support the wider economy.

The resilience of the UK financial system to Brexit

6. The Governor highlighted that since the EU referendum in 2016, the FPC and other authorities had identified risks of disruption to the financial system that could arise from Brexit and worked to ensure they are addressed. The Bank, other UK authorities and financial companies had also engaged in extensive contingency planning.

7. The Governor explained that stress tests and supervisory actions have ensured major UK banks have levels of capital and liquidity to withstand even a severe economic shock that could be associated with a disorderly Brexit. In particular, the FPC had reviewed a disorderly Brexit scenario, with no deal and no transition period, based on 'worst case' assumptions about the challenges the UK economy could face in the event of a cliff edge Brexit. These worst case assumptions included: the sudden imposition of trade barriers with the EU; loss of existing trade agreements with other countries; severe customs disruption; a sharp increase in the risk premium on UK assets; and negative spillovers to wider UK financial markets.

8. The FPC judged that the UK economic scenario in the 2018 stress test of major UK banks was sufficiently severe to encompass the economic shock in the disorderly Brexit scenario. Based on this, the FPC judged that the UK banking system is strong enough to continue to serve UK households and businesses even in the event of a disorderly Brexit.

9. Furthermore, the Governor noted that major UK banks have sufficient liquidity to withstand a major market disruption. Since the financial crisis, major UK banks have substantially reduced their reliance on wholesale funding. They hold more than £1 trillion of high-quality liquid assets and can access an additional £300 billion of liquidity through the Bank of England's regular facilities. Major UK banks now can withstand many months without access to wholesale or foreign exchange markets.

10. The FPC had also worked with other authorities to ensure most risks of disruption to cross-border financial services have been addressed. In particular, legislative preparations in the UK had progressed to avoid disruption to financial services provided by EU firms to UK households and businesses.

11. The Governor noted that two main actions remained. First, further UK legislation, currently in train, will need to be passed for a fully functioning legal and regulatory framework for financial services to be in place ahead of Brexit. And second, the European Commission needed to provide greater clarity to reduce disruption risks in derivative markets, following their recent, welcome statements.

12. Finally, the Governor noted that the FPC had reiterated its commitment that, irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory

responsibilities, the FPC will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining more generally the UK authorities' ability to manage UK financial stability risks.

13. The Chancellor appreciated the hard work the Bank, other UK authorities and financial companies have undertaken to prepare the financial system for Brexit in any form. He noted the analysis undertaken on 'worst-case' Brexit scenario, reiterating the need for the FPC to assess financial stability risks in all scenarios. The Chancellor welcomed the FPC's assessment that the UK banking system is strong enough to continue to serve UK households and businesses even in the event of a disorderly Brexit. He recognised the importance of having robust prudential standards and welcomed the Bank's commitment to the implementation of these in the UK, and to a level of resilience that already exceeds that required by international standards, regardless of the UK's future relationship with the EU. The Chancellor noted that it is vital that government and regulators continue to work closely together in order to secure the continuity of provision of credit and finance to households and businesses, and maintain the UK's position as a world-leading financial centre operating to the highest international standards.

<u>The UK countercyclical capital buffer rate decision</u>

14. The Governor noted that the FPC had maintained the UK countercyclical capital buffer (CCyB) rate at 1% at its November Policy meeting, and had signalled that it stood ready to move the UK CCyB rate in either direction as the risk environment evolves:

- On the one hand, if an economic stress were to materialise, the Governor noted that the FPC is prepared to cut the UK CCyB rate, as it did in July 2016. This would enable banks to use the released buffer to absorb up to £11 billion of losses, which might otherwise lead them to restrict lending. Given losses of that scale, a cut in the UK CCyB rate to zero could preserve their capacity to lend to UK households and businesses by around £250 billion. This compares to £65 billion of net lending in the past year.
- On the other hand, in the absence of economic stress, the FPC would remain vigilant to developments in the domestic credit environment. Lender risk appetite is strong but, reflecting uncertainty, demand for credit has been muted. Were that uncertainty to fade, credit demand could rebound significantly and lead to an increase in the riskiness of banks' exposures. Given current accommodative lending conditions, that could require a timely policy response to ensure resilience.

15. The Chancellor noted that the FPC had decided to maintain the CCyB at 1%, but that it could move in either direction in response to changes in the risk environment.

<u>Leveraged lending</u>

16. The Governor highlighted that leveraged lending to businesses had grown rapidly, both globally and, more recently, in the UK. That growth reflected strong creditor risk appetite and a

marked loosening of underwriting standards. It had been driven by increased securitisation activity through collateralised loan obligations (CLOs) as well as demand from investment funds.

17. Given the loosening of underwriting standards, the Governor noted that investors in leveraged loans were at increasing risk of loss. CLOs are held mainly by non-bank investors, although international banks are estimated to hold around a third of the outstanding stock, mainly the less risky tranches. UK banks, in contrast, only have small holdings of CLOs and their domestic corporate lending has not shifted materially towards higher-risk borrowers. And UK banks' exposures to leveraged lending had been tested in the 2018 stress test.

18. The Chancellor noted the growing use of leveraged loans and the loosening in underwriting standards. He welcomed that the fact that UK banks' holdings of CLOs are very small and that their exposures to leveraged lending were covered in the Bank's 2018 stress test.

Global risks

19. The Governor noted that the FPC judged that risks to UK financial stability from global debt vulnerabilities are material. Global financial conditions had continued to tighten since June, with equity prices falling and credit spreads rising. Emerging market economies remained vulnerable to a more widespread reduction in risk appetite. A sharp slowdown in growth in China — possibly as a result of an escalation of trade tensions with the US — would make its elevated debt levels significantly less sustainable. And a further deterioration in Italy's financial outlook could result in material spillovers to the euro area and the UK. Reflecting these risks, the Governor explained that the FPC incorporated a very severe global stress in the 2018 stress-test scenario.

20. The Chancellor recognised the tightening global financial conditions. He noted the material risks global debt vulnerabilities pose and potential spillovers to the UK.

The FPC's assessment of the risks from leverage in the non-bank financial system.

21. The Governor concluded the meeting by noting the FPC had completed an in-depth assessment of the risks associated with leverage from the use of derivatives in the non-bank financial system. The FPC judged that risks of forced sales to meet derivative margin calls currently appear limited. However, more comprehensive and consistent monitoring by authorities is needed to keep this under review. The Bank will therefore work with other domestic supervisors to enhance the monitoring of these risks. Internationally, the International Organization of Securities Commissions (IOSCO) has issued a consultation paper on how to operationalise the Financial Stability Board's (FSB's) recommendation to develop consistent leverage measures for funds. For IOSCO to deliver the objective of the FSB recommendation, the FPC considers that a core set of measures will need to be consistent globally and enable effective monitoring of the potential losses and liquidity demands funds could face.

22. The Chancellor welcomed the assessment into non-bank leverage and noted the risk of forced sales needed to meet derivative margin calls currently appears limited.