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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 2013 FINANCIAL STABILITY REPORT

30 JANUARY 2014

The following items were discussed at the meeting:

1. Financial Stability Report assessment of financial stability;
2. Financial Policy Committee consideration of UK housing market developments; and
3. Financial Policy Committee medium-term priorities.

1. The Financial Stability Report assessment of financial stability

The Chancellor and Governor discussed the assessment of financial stability as contained in the Financial Policy Committee (FPC) November 2013 Financial Stability Report (FSR).

Introducing the discussion, the Governor noted that the strengthening economic recovery in the UK and other advanced economies, and a reduction in concerns about tail risks from the euro area, had reduced threats to financial stability. Market interest rates in advanced economies had begun to rise gradually, although they remained at historically low levels.

The Governor highlighted that while risks closer to home had abated, some emerging market economies, particularly those with large external and domestic imbalances, had experienced capital outflows during the summer of 2013. Risks were also evident in China, particularly its shadow banking sector. These fragilities had become more evident again recently, including since publication of the November FSR.

The FPC had also observed that the improved economic outlook had helped banks to strengthen resilience to risks. Most large global banks had reported capital ratios above 9% on a "fully loaded" Basel III basis, although downside risks remained including the impact of conduct-related costs on profitability. The Governor noted that UK banks had made substantial progress in implementing plans agreed with the Prudential Regulation Authority (PRA) to reduce capital shortfalls identified in work following an FPC recommendation in March 2013. At the time of the November FSR banks had filled around three quarters of the shortfall identified in the exercise and work was continuing to address remaining requirements.

The Chancellor welcomed the improvement in the UK economic outlook and the greater resilience of the banking system, and observed that market indicators suggested that investors were now perceiving UK banks to be safer. Price to book ratios for major UK banks had returned, on average, to around parity for the first time since the crisis.

Although UK banks were making good progress on strengthening capital positions, the Governor emphasised that the broader process of bank reform was far from complete. Ongoing efforts to enhance bank and market resilience remained important, in particular because that could help to further improve credit availability. Against this backdrop the Governor said that the ECB's comprehensive assessment of euro-area banks would be an important step in bolstering confidence.

The Governor noted that the FSR had also drawn attention to high indebtedness among some groups of borrowers. In advanced economies, debt to GDP ratios (outside of the financial sector) had risen by an average of 40 percentage points in the decade leading up to the financial crisis. While there had been some deleveraging recently, overall non-financial sector debt to GDP ratios in these economies were on

average a further 55 percentage points higher than in 2007. Vulnerabilities from over-indebtedness had been kept in check by low interest rates and other policy interventions. But a rapid rise in interest rates could test financial system resilience.

The Chancellor asked the Governor for his assessment of possible signs of a deepening search for yield in some markets, which could increase some market participants' exposure to a reversal of global interest rates. In reply, the Governor noted that there had continued to be signs of a search for yield. For example, in the period since the June 2013 FSR, US high-yield loan issuance had reached record levels, and issuance of collateralised loan obligations was close to levels seen just ahead of the crisis. It was this type of activity that had led the FPC in June 2013 to recommend that the Financial Conduct Authority (FCA) and PRA, with other Bank staff, should assess the vulnerability of borrowers and financial institutions to a sharp upward movement in long-term rates and credit spreads. Preliminary work had suggested that the UK banking sector would be resilient to direct losses caused by the impact of a moderate increase in long-term rates on loan books and fixed-income portfolios. But the work had also found that market participants had not always considered potential amplification mechanisms working through the financial system. The FPC had therefore asked for further work to ensure that these considerations were factored into firms' risk management.

2. Housing market developments

The Chancellor and Governor discussed the recovery that had been seen in the housing market in recent months. The Chancellor noted that, like many other parts of the economy, the housing market had suffered a downturn due to the recession which may have been exacerbated by banks' subsequent pull-back in lending. As confidence across the economy improved, we would expect to see increased activity in a number of sectors, including the housing market.

The Chancellor updated the Governor on the Government's key policies to increase supply of housing. There had been signs of recovery in the house building sector, new planning approvals rose by around 25% in 2012, and new housing output had grown by 8.6% in the year to the second quarter of 2013.

The Governor noted that, although the FPC at its meeting in November had seen little evidence of an immediate threat to stability, it had noted that a sustained material rise in house prices and borrowing, coupled with a subsequent housing downturn, could prospectively pose risks to financial stability. In particular, the FPC had noted that despite some deleveraging since the crisis, household debt levels in the UK were still high at around 140% of income. The Governor highlighted that some cohorts of UK households were particularly indebted: for instance, households with debts exceeding four times their income accounted for nearly 30% of mortgage debt. It was also striking that nearly a third of households with a mortgage reported that they had less than £300 of income remaining per month after housing and other essential spending, despite the exceptionally low level of interest rates. A substantial rise in interest rates, especially if it were not associated with a strengthening in incomes, could challenge more vulnerable borrowers.

In that context, the FPC had assessed the various actions that had been taken to guard against a build-up in vulnerabilities, including steps to strengthen banks' underwriting standards which had fallen prior to the financial crisis. The Chancellor asked for the Governor's latest assessment of underwriting standards. The Governor assured the Chancellor that present mortgage underwriting standards were significantly better than pre-crisis. There were, though, signs of a pick-up in lending at higher loan-to-income ratios

and over longer terms. As the FPC had noted in the FSR, these trends were not necessarily signs of imprudent lending; but did suggest that risk levels could be gradually increasing again.

The Governor referred to the introduction by the FCA of the Mortgage Market Review (MMR) reforms, which included an obligation for lenders to assess borrower loan affordability under an interest rate stress. The Governor thought this would be important in helping to maintain strong mortgage underwriting standards. The FPC had also agreed that it would be prudent for the Committee to be able to give guidance on the appropriate interest rate to be used in MMR stress tests, and had made a recommendation to the FCA that measures be put in place to that effect. The Chancellor supported this, noting that the Government had already taken account of MMR standards in the design of the Help to Buy: mortgage guarantee scheme, under which participating lenders were required to lend in line with the MMR rules on affordability, including an interest rate stress test, for all qualifying loan applications even prior to the formal introduction of FCA rules in April 2014.

More broadly, the Governor noted that the FPC recommendation should be viewed as part of the wider package of measures in train to mitigate risks from the housing market, including those initiated by other bodies. This package included the increased capital held by banks as a result of global regulatory reforms and the recent capital raising exercise; and the planned stress test of banks in 2014 that would examine specifically risks to housing-related portfolios.

The Chancellor and the Governor discussed the decision by the Bank and HMT in November that they would modify the terms of the Funding for Lending Scheme (FLS) and both welcomed the refocusing of the FLS to support further lending to small and medium sized businesses.

The Governor explained the FPC had also used the FSR to set out a package of further measures that could be used, if needed, to tackle emerging threats. These measures included: recommendations or directions over sectoral capital requirements or the countercyclical capital buffer; recommendations on loan-to-value, loan-to-income, debt-to-income ratios, mortgage term, or underwriting standards; and recommendations to HMT on the Help-to Buy scheme. The Chancellor felt it was important that the FPC had reaffirmed that it would take a proportionate and graduated approach to potential risks arising from the housing market.

The Chancellor welcomed the FPC's ongoing vigilance and noted that the new FPC framework provided a far more effective system of monitoring and policy options than had existed in the run up to the crisis. The Chancellor also welcomed the FPC's decision to set out in the FSR the indicators the Committee would focus on in monitoring developments from the housing market.

3. The FPC's medium-term priorities

The Governor explained that the FPC had identified three main priorities for its work over the next 18 months: the medium-term capital framework for banks; ending too big to fail; and shadow banking and resilient market-based finance.

In each area substantive progress had been made internationally on regulatory reforms. The FSR had laid out that the FPC planned to review, and where necessary take steps to influence, the design and implementation of reforms in these areas, subject to where policies had been settled internationally. The Chancellor welcomed the decision by the FPC to focus its medium term agenda on a few critical priorities.

With regard to the medium-term capital framework for banks, the Governor said that the Committee's aim was to ensure that prospective changes to regulatory capital requirements for UK banks are, in

aggregate, appropriately calibrated and phased in from a macroprudential perspective. Reforms needed to fit together to deliver a stable, prudent and coherent package, which took account of the broader impact on the financial system.

The Governor outlined the agreement that had recently been reached on an internationally comparable leverage ratio. This was an important step, and would provide the basis for the FPC's review of the role of the leverage ratio that the Chancellor had requested in October 2013. But there were also a number of important international agreements yet to be finalised, including capital requirements on the trading book, and the capital framework for securitisation. The Chancellor emphasised the Government's support of high prudential standards, in line with the Basel agreements, and welcomed the FPC's focus on this key aspect of the regulatory reform agenda.

With regard to ending too big to fail, the FPC aimed to review and, where necessary, influence the design and implementation of reforms including the gone-concern loss absorbing capital (GLAC) framework, resolution planning and the high-level objectives of structural reforms. The Chancellor hoped that this work would build on the steps that the Government had taken to tackle 'too big to fail', including the successful passage of the Banking Reform Act which implemented the recommendation by the Independent Commission on Banking that 'core' banking services should be ring-fenced. On GLAC, the Governor and Chancellor agreed it would be important that the Bank and HMT work closely on this issue to secure a robust international agreement.

The Chancellor observed that the ability to carry out bail-in within resolution was an important component in the Government's reforms to help ensure that UK taxpayers are not in future required to shoulder the burden of failing banks. The introduction of bail-in powers in the Banking Reform Act was a significant step forward in the UK's compliance with the FSB's Key Attributes of Effective Resolution Regimes, which had been endorsed by the G20 in November 2011.

The Chancellor also noted that the Bank Recovery and Resolution Directive (and the Deposit Guarantee Schemes Directive) had led to rules that would enable the UK to implement its bail-in legislation while protecting the level playing field.

Finally, the Governor outlined the Committee's aim on its priority work to support diverse and resilient sources of market-based finance. As part of this work, the FPC would seek to identify and manage potential systemic risks from outside the existing regulatory perimeter, with a focus on the shadow banking sector. It would also work to improve the diversity and robustness of market-based financing, for example by acting to remove impediments to the provision and development of such sources of finance. This might include initiatives in support of developing better functioning securitisation markets, and the development of a credit register.

The Chancellor welcomed the FPC's focus on addressing the risks from shadow banking. This was a G20 priority which the Government strongly supported. The Chancellor also noted that, in the Autumn Statement, the Government had set out its intention to consult on proposals to require banks to share information on their SME customers with other lenders, through Credit Reference Agencies.