Publication date: 21 August 2014

RECORD OF THE MEETING BETWEEN THE GOVERNOR OF THE BANK OF ENGLAND AND THE CHANCELLOR OF THE EXCHEQUER TO DISCUSS THE JUNE 2014 FINANCIAL STABILITY REPORT

16 JULY 2014

The following items were discussed at the meeting:

1. Financial Stability Report assessment of risks to financial stability;
2. The Financial Policy Committee's consideration of UK housing market developments;
3. The Financial Policy Committee's setting of the countercyclical capital buffer; and
4. The Financial Policy Committee's medium-term priorities.

1. Financial Stability Report assessment of risks to financial stability

The Chancellor and Governor discussed the assessment of financial stability as contained in the Financial Policy Committee's (FPC) June 2014 Financial Stability Report (FSR).

Introducing the discussion, the Governor noted that the recovery in advanced economies had continued. Strengthening economic growth had bolstered the resilience of global and UK banks, and market concerns about tail risk had reduced.

The Governor observed that economic developments, and actions taken by regulators, had fed through into higher bank capital in the UK. CET1 ratios for major UK banks averaged 10% in Q1 2014, or 8.4% after the adjustments recommended by the FPC in March 2013 as part of the capital shortfall exercise. The Governor emphasised that while these developments were pleasing, banks continued to face headwinds, especially arising from the impact of litigation and past misconduct.

The Chancellor welcomed the continued recovery in advanced economies, particularly in the United Kingdom, and the increasing resilience of UK banks, but noted that many risks remained. He asked for the Governor's assessment of whether the rise in UK banks' capital and leverage ratios had impacted on lending to the real economy, and whether banks could sustain lending as efforts continued to strengthen resilience. The Governor said that the FPC had considered this question and found that, in line with guidance received from the PRA, banks had improved capital ratios in ways that did not impact negatively on lending to the real economy. With this in mind the FPC had closed its recommendations in this area.

Turning to threats to stability the Governor said that housing – which would be discussed separately – was the biggest risk to UK financial stability in the medium term. But the FPC had also identified other important risks elsewhere, notably those associated with the 'low-for-long' environment. Volatility in financial markets was at unusually low levels despite an increase in geopolitical risks, and the Governor felt there were increasing signs of 'search for yield' across global markets, as evidenced by compressed spreads on risky debt, increased leveraged lending and growing appetite for complex assets. It was concerning that liquidity risk premia were still low, despite signs of a structural decline in secondary market liquidity in response to regulatory changes.

The Governor explained that the FPC had taken comfort from work done in 2013 that suggested that UK banks were likely to be resilient to direct risks from an anticipated gradual increase in long-term interest rates. But the future path of monetary policy could affect market conditions, and even an anticipated monetary tightening could expose weakening in underwriting standards in some markets. Adjustments in markets could be amplified if narrowed liquidity risk premia unwound.

The Chancellor asked the Governor what measures he believed might become necessary to mitigate the risk from a sharp adjustment in asset prices and volatility. The Governor said that it was important to recognise that sterling monetary policy was not necessarily an effective answer to *global* risks arising from search for yield. But the FPC would remain vigilant in this area and various workstreams were ongoing - including work to examine liquidity conditions and underwriting standards in leveraged lending markets in more detail. The Governor noted that bank stress tests currently underway included a 'snap-back risk' element to give the authorities further information on banks' resilience. But, given the global nature of the problem, cross-border responses were also necessary. The Governor pointed to international work on margining requirements for securities financing transactions which was ongoing; and to efforts to ensure global regulators were coordinating and sharing information in this area.

2. Developments in the UK housing market

The Chancellor and the Governor discussed the substantial strengthening in the housing market over the past year, which had been supported by an improved economic outlook and easier credit conditions. House prices had risen strongly by 9% nationally in the year to 2014 Q1. And while price growth in London had been most pronounced (a quarterly rise of 4.5% in Q1), house prices had risen in all regions in Q1. Nonetheless, despite this recent strengthening, house prices were still lower in real terms than they were in 2007.

The Governor said that when discussing housing market trends, the FPC had been conscious of the ongoing gap between house building and growth in demand, reflected in a net supply of private housing of 110,000 in 2013 versus an average of 180,000 in the years between 2000 and 2007. The Chancellor agreed that housing supply was one of the most important structural issues facing the economy and said that the Government had taken important steps to improve housing supply, in particular through reforms to the planning system, and permissions for new homes had risen by 20% in a year.

Turning to the outlook for the housing market the Governor emphasised that the FPC's role was not to control house prices, and said that the Committee could not address underlying structural issues. The FPC's role was to manage risks to financial stability. With this in mind, the FPC had concluded that prospects for household indebtedness were the greatest concern. UK households started from a vulnerable position, with household debt at 140% of disposable income. And there was evidence of sustained increases in the share of mortgages at higher loan to income (LTI) multiples, with the proportion of new borrowers with an LTI multiple greater than four rising to 22% in 2014 Q1.

The Governor explained that the FPC considered that risks to financial stability from the UK housing market arose via two main channels:

- directly, since an excessive build-up of debt, and more borrowers vulnerable to shocks, posed direct risks to the resilience of the banking system. This was mitigated by the measures taken to ensure that lenders have sufficient capital to cover losses, and would be tested again this year by the FPC's stress tests, which incorporated a severe housing market shock; and
- indirectly since an unexpected fall in income or rise in interest rates could force households to cut back other spending in order to continue servicing their mortgage. British people traditionally did everything they could to meet their loan payments, meaning that a greater proportion of more highly-stretched borrowers increased risks of a knock-on effect for the rest of the economy; and helped explain why recessions that follow periods of rapid credit growth tended to be deeper and longer lasting.

While the FPC felt that housing posed the biggest single risk to UK financial stability the Governor said that the Committee had judged that household indebtedness did not pose an *imminent* threat, not least because underwriting standards were currently more responsible than in the past. But past experience in the United Kingdom had shown how that could change rapidly – and the increase in the share of mortgages extended at high LTI multiples, and the possibility of further increases in the future, meant that the indirect channel could pose a serious risk to financial stability.

The Bank's central view was that house prices and activity would moderate in coming years. In that case, the FPC expected only a moderate increase in household indebtedness. But if price growth and activity persisted or quickened and lending at higher LTIs picked up further, then the risk to household resilience and financial stability could be greater.

The FPC had therefore chosen to act against a further significant increase in the proportion of lending at very high LTI multiples, electing to:

- issue guidance on the calibration of interest rate affordability tests, so that lenders should assess whether borrowers could afford their mortgages if Bank Rate were to be 3 percentage points higher than the prevailing rate at origination; and
- recommending a limit so that no more than 15% of a lender's new mortgages could be at or greater than 4.5 times the borrower's income.

The Governor said that the Committee had been careful to calibrate its measures as insurance: to help to reinforce prudent standards and prevent a slide into riskier lending rather than dampen current activity or stop borrowers who could afford mortgages from getting them.

The guidance on affordability tests was in line with the tests already applied by many prudent lenders, and the current share of new mortgage lending with LTI in excess of 4.5 was only 10%. At present, 12% of first time buyers took mortgages at 4.5 LTI or higher. That lending could continue: and the decision to extend such loans was for the lenders themselves.

On a central view, the share of mortgages at high LTI ratios was expected to rise to 15%, but the limit could be relevant sooner if prices accelerated, incomes grew more slowly, or underwriting standards slipped.

The Chancellor said that it was right for the FPC to continue to monitor housing market developments closely and urged the Committee to remain vigilant. He welcomed the FPC's decision to intervene early and in a graduated and proportionate way so as to avoid the need for more severe action later.

The Chancellor said that the FPC's recommendations on housing would be applied to all future mortgages under the Help to Buy: mortgage guarantee scheme. The Governor welcomed this decision.

The Chancellor reiterated his commitment to giving the Bank new powers over mortgages including over the size of mortgage loans as a share of family incomes or the value of the house. He explained that these would be legislated for and in place before the end of this Parliament.

3. <u>Countercyclical capital buffer</u>

Having been made responsible for setting the countercyclical capital buffer (CCB) for UK exposures in May 2014, the Committee had set the buffer rate for the first time in June 2014. The Governor explained the process by which the FPC had elected to set the CCB at zero per cent.

When making its decision, the Committee had considered the 'buffer guide' – a simple metric identified in EU legislation, which provides a guide to the CCB rate based on the gap between the ratio of credit to GDP and its long-term trend. At over 160% of GDP, the level of aggregate credit in the UK economy remained very high, and at a sectoral level, household and corporate debt levels were high relative to income. But weak credit growth since the peak of the crisis meant that the credit gap had been strongly negative recently and so the buffer guide had suggested a buffer rate of zero per cent.

Nevertheless, the Committee had stated in its Policy Statement on the CCB that it would not limit itself to looking at the buffer guide, and instead would use its judgement, considering a wider set of core indicators, other relevant economic and financial data, supervisory and market intelligence and, where available, information from stress tests, when making its decision.

The Chancellor noted the FPC's decision and welcomed the holistic approach taken, which was preferable to focusing solely on the credit-to-GDP gap.

4. Structural developments

Turning to structural developments, the Chancellor welcomed the progress made by the FPC since the November 2013 FSR on its three medium-term priorities: establishing the medium-term capital framework; ending too big to fail; and ensuring diverse and resilient sources of market-based finance.

The Governor noted that the Committee had published a Consultation Paper on the leverage ratio on 11 July. It dealt with the design of a UK leverage ratio framework – including quality of capital, whether to introduce supplementary requirements for certain firms, and the merits of a time-varying leverage ratio.

Following responses to the Consultation Paper, the FPC planned to send final recommendations – along with an assessment of impacts on banks and the economy - to HM Treasury in time for it to consult on legislation to be made during this Parliament.

The Chancellor reiterated the Government's support for a simple leverage ratio as a key element of the internationally agreed prudential regulatory framework. The FPC's decision to publish a consultation paper was welcome as it was important that all interested parties had the opportunity to feed in their views. The Chancellor reiterated his view that the FPC needed to consider the impact of the introduction of the leverage ratio on the ability of banks to continue to support lending to UK consumers and businesses. It would be particularly important to assess the impact on firms with high concentrations of low-risk-weight assets, and the Chancellor expected to be presented with a detailed and evidence-based recommendation. Subject to this, the Chancellor said that he expected to be in a position to submit the FPC's proposals in this Parliament for approval.

Finally, the Governor said that the FPC had held its annual discussion of the regulatory perimeter - covering the boundaries between and within regulated and non-regulated sectors of the financial system. The Committee had considered channels through which stress in the non-bank system, including institutions and markets, could impact financial stability, and discussed international initiatives to enhance understanding of the non-bank sector.

Based on its assessment of risks and the work under way to improve understanding and manage some risks within these sectors, the Governor said that the FPC did not at that point see a case for recommending changes to the regulatory framework, but would return to the issue on an annual basis, or sooner if necessary.

The Chancellor welcomed the FPC's vigilance to potential risks within the non-bank financial sector. The Chancellor noted that gaps in the data on entities and activities outside the banking system were a key impediment to assessing the financial stability implications of the non-bank financial system. Therefore, the FSB's work on mapping the shadow banking system was welcome. In particular, the Chancellor welcomed the FSB's publication of its Global Shadow Banking Monitoring Report in November 2013. The Chancellor asked the Governor what work the Bank currently had in train to address the data gaps identified by the FSB. The Governor said that work to address such data gaps included sector-level analysis of activities beyond the core of the system; assessing the role of investment funds in supporting market liquidity; and developing better measures of banks' exposures to hedge funds.