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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 JULY 2016 FINANCIAL STABILITY REPORT

28 September 2016

The following items were discussed at the meeting:

1. Assessment of risks to UK financial stability;

2. Assessment of the resilience of the UK financial system;

3. Actions by the Financial Policy Committee

Assessment of risks to UK financial stability

1. The Chancellor and Governor discussed the assessment of risks to financial stability as contained in the Financial Policy Committee's (FPC) July 2016 Financial Stability Report (FSR).

2. Opening the discussion, the Governor noted that the FPC had identified in March 2016 the risks around the referendum on the United Kingdom's membership of the European Union as the most significant near-term domestic risks to financial stability. The FPC judged in its July FSR that some of those risks had begun to crystallise. In particular:

- The financing of the United Kingdom's large **current account deficit**, which relies on continuing material inflows of portfolio and foreign direct investment. Portfolio flows into UK equities appeared to have slowed in the run up to the referendum, and sterling experienced its largest two-day fall against the dollar since floating exchange rates were re-introduced almost half a century ago following the result.

- It had become more likely that adjustments in the **UK commercial real estate market** could tighten credit conditions for UK businesses. Foreign flows of capital into commercial real estate fell 50% in the first quarter of 2016, transaction volumes fell further during the second quarter, and share prices of property REITs dropped sharply following the referendum.

- The number of vulnerable **UK households** could increase due to a tougher economic outlook and a potential tightening of credit conditions. In particular, there had been growing evidence at the time the FSR was published that uncertainty about the referendum had delayed major economic decisions, such as business investment, construction and housing market activity.

- Subdued growth in the **global economy**, including the euro area could be exacerbated by a prolonged period of heightened uncertainty. This came at a time when banks in some vulnerable euro-area countries were still working through legacy issues from the financial crisis and facing challenges from operating in a low nominal interest rate environment.

3. More positively, the Governor observed that **financial markets** managed the volatility around the referendum well and did not add to stress. The foreign exchange market experienced particularly high volumes of transactions relative to normal levels with no apparent impairment of price discovery. Activity in some fixed-income markets had been subdued but largely orderly.

4. The Governor noted that, at its subsequent Policy meeting on 20 September, the FPC judged that while financial stability had been maintained in the United Kingdom through a period of volatility, and a number of economic indicators had picked up from their post-referendum low points, the United Kingdom faces a challenging period of uncertainty and adjustment. Heightened uncertainty about the near-term macroeconomic outlook and the United Kingdom's future relationship with the EU is reinforcing domestic risks, and risks from the global economy remained elevated.

5. The Chancellor welcomed the FPC's assessment of the risks to UK financial stability. The July FSR was the FPC's first such report since the United Kingdom voted to leave the European Union.

6. The Chancellor noted that the vote to leave the EU has created a period of uncertainty. This will be followed by a period of adjustment as the shape of the UK's new relationship with the EU becomes clear and the economy responds. But while the United Kingdom remains a member of the EU it will continue to play an active role and abide by its obligations. And it will continue to work closely with EU partners to establish a mutually advantageous arrangement for the future.

7. There was some volatility in financial markets following the referendum, but those markets have continued to function effectively. The economic adjustment has so far been orderly and we now see greater stability.

8. The Chancellor noted that the government will continue to monitor the situation closely and that fiscal policy may have a role to play in supporting the economy. The FPC should remain vigilant to further crystallisation of the risks it highlights as the UK economy adapts to its new environment. And the FPC should continue to use its macroprudential tools decisively where necessary to protect UK financial stability.

<u>Assessment of the resilience of the UK financial system</u>

9. The Governor noted that (as highlighted in the July 2016 FSR) during this period of uncertainty and adjustment, the **resilience of the UK financial system** upon which financial stability depends is grounded on:

a) Substantial capital and liquidity buffers.

10. The Bank of England has consistently strengthened the resilience of the UK financial system over the past seven years. Major UK banks have raised more than £130 billion of capital since the

crisis and their aggregate Tier 1 capital in June 2016 amounted to 13.8% of risk-weighted assets. They hold more than £600 billion of high-quality liquid assets, which is around four times the level they held before the financial crisis. And UK banks have been shown in repeated stress tests to enable banks to absorb extremely severe economic and market shocks and still have the capacity to lend to the real economy.

11. The Governor observed that market moves since the referendum demonstrated this resilience. Although lower bank equity prices are consistent with investor concerns over an uncertain economic outlook and lower bank profitability, overall bank funding costs have not increased. This should reduce the pressure on banks to tighten credit conditions.

b) The regulatory framework of the United Kingdom

12. The Governor noted that the flexibility embedded in the UK's regulatory framework allows capital and liquidity buffers to be drawn on, as needed, to allow the system to cushion shocks and maintain the provision of financial services to the real economy. The FPC strongly expects that banks will continue to support markets and provide credit to the real economy, by drawing on buffers as necessary.

c) **An institutional framework that promotes co-ordinated, evidence-based responses to risks.**

13. This framework was used to develop and implement extensive **contingency plans** by UK authorities and firms in advance of the referendum. Eligible counterparties positioned collateral with the Bank that creates the capacity to access more than £250 billion of additional funds through the Bank's normal operations and facilities. In March, the Bank announced measures to provide additional sterling liquidity around the referendum date, through three additional indexed long-term repo operations. On 30 June, the Bank announced that it will continue to offer indexed long-term repo operations on a weekly basis until end-September 2016. The Bank is also able to provide substantial liquidity in foreign currency, if required.

14. In summary, the Governor noted that the FPC's past efforts have created resilient financial institutions which can draw on their substantial capital and liquidity reserves to support the real economy, even during challenging times. The contingency measures that were put in place addressed the immediate risks from the vote and ensured that the financial system dampens shocks rather than amplifies them. And the FPC is supporting the real economy, by ensuring that banks can use the substantial capital and liquidity buffers they have in place.

15. The Chancellor agreed that the UK economy is underpinned by the fundamental strength and resilience of the financial system. It is because of the reforms that the UK has put in place that it can be more confident in the stability of the system during times of stress. This is a result of action by the UK government, the Bank of England, and international regulators since the crisis to put in place the necessary tools to protect financial stability and greatly strengthen the resilience of the UK

and global financial systems. The work of the government, the FPC, the Bank of England more broadly, and the UK's international partners also ensured that financial authorities were ready to respond to the risks posed by the referendum. It is in part because of this vastly increased resilience since the financial crisis that banks and building societies can be expected to continue to support market functioning and maintain lending to the real economy, even during periods of elevated stress.

Actions by the Financial Policy Committee

16. The Governor noted that, having consistently built the resilience that is necessary for the system to face this challenging outlook, the FPC stands ready to take actions that will ensure that capital and liquidity buffers can be drawn on as necessary to support the supply of credit and market functioning, and thereby promote financial stability.

17. At policy meetings on 28 June and 1 July, the **FPC reduced the UK countercyclical capital buffer rate from 0.5% to 0% of banks' UK exposures with immediate effect**. The Governor noted that this was a major change. It meant that three quarters of UK banks, accounting for 90% of the stock of UK lending, immediately had greater flexibility to supply credit to UK households and firms. Specifically, it reduced regulatory capital buffers by £5.7 billion, raising banks' capacity for lending to UK households and businesses by up to £150 billion. For comparison, in 2015 with a fully functioning banking system and one of the fastest growing economies in the G7, total net lending in the UK was £60 billion.

18. At its subsequent Policy meeting on 20 September, **the FPC reaffirmed that it expects to maintain a UK CCyB rate at 0% until at least June 2017, absent any material change in the outlook.**

19. In July, the FPC also welcomed the Bank of England's announcement that it will continue to offer indexed long-term repo operations on a weekly basis until end-September 2016. And the FPC supported the position of the PRA to allow insurance companies to use the flexibility in Solvency II regulations to recalculate transitional measures.

20. The Governor noted that, as the outlook evolves, the FPC stands ready to take any further actions deemed appropriate to support financial stability.

21. On the monetary policy side, the MPC in August agreed an exceptional package of measures to support the economy comprising: a 25 basis point reduction in Bank Rate to 0.25%; a new Term Funding Scheme to reinforce the pass-through of the cut in Bank Rate to the borrowing rates actually faced by households and firms; a new programme of private sector asset purchases with up to £10 billion of UK corporate bonds; and a £60 billion expansion of gilt purchases.

22. The coherence of that stimulus package was further enhanced by **the FPC's decision in August to amend the leverage ratio framework for UK banks by excluding central bank reserves.** In doing so, the FPC's aim is to ensure that the leverage ratio does not act as a barrier to the effective implementation of policy measures that might lead to an increase in central bank reserves.

23. Finally, the Governor noted that, in advance of the referendum, the FPC had reviewed developments in market liquidity and its leverage ratio Direction. Over the past year, government and corporate bond markets have shown signs of reduced liquidity, and activity in repo markets has fallen materially. These reductions in market liquidity probably, in part, reflect post-crisis regulations as firms adjust their risk management and business models. But the FPC judges that these regulations remain materially beneficial because of their contribution to the resilience of these markets and to financial stability more broadly.

24. However, the FPC judged that some market developments motivated careful review and consideration of whether there are possible refinements that would promote market effectiveness without compromising the resilience of the core system. In particular, the FPC judged that there would be merit in the future internationally agreed leverage ratio amending the current definition of total exposures in two respects: netting of cash receivables and cash payables from unsettled sales of securities; and allowing initial margin posted by clients to reduce dealers' potential future exposures to a default of those clients in centrally cleared derivatives transactions. The Committee also encouraged the Basel Committee to review carefully the possible unintended effects of forthcoming international leverage ratio standards on the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities as necessary.

25. The FPC contributed these conclusions, through the Bank of England, to the Basel Committee on Banking Supervision, which is working on an international standard for leverage ratio requirements and buffers. The FPC will carry out an in-depth review of its leverage ratio framework in 2017.

26. The Chancellor welcomed the FPC policy action. He noted it is important that the FPC acts decisively when it deems there to be a risk to financial stability that can be reduced or removed. Reducing the countercyclical capital buffer will ensure that firms' capacity to make loans to the real economy is maintained and will reinforce the message that capital buffers are there to be used if necessary.

27. The Chancellor also welcomed the FPC's plan to review the leverage ratio in 2017 and associated FPC action to complement monetary policy decisions. He looked forward to reading the Committee's conclusions and would consider carefully any recommendations for HMT that resulted from the review. He noted an important element of the FPC's accountability is its dialogue with financial market participants and other external experts. As stated in its latest remit and recommendations letter, the FPC should seek the views of these stakeholders, as appropriate, to supplement the Committee's own expertise.

28. The Chancellor concluded the meeting by noting the FPC should continue to take whatever action is necessary to maintain UK financial stability. The government will continue to monitor the macroeconomic environment closely.