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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 DECEMBER 2014 FINANCIAL STABILITY REPORT

3 FEBRUARY 2015

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 bank resilience and stress tests;

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) December 2014 Financial Stability Report (FSR).

Introducing the discussion, the Governor noted that concern about geopolitical risks had increased since June and there had been a deterioration in the global economic environment. Projections for global growth in 2015 had weakened slightly with larger downward revisions for the euro area and parts of Asia, such as Japan, but with improvements in the United States. Nominal and real yields on government bonds had fallen significantly across many advanced economies suggesting that market participants expected weak growth and low inflation to persist. Since the publication of the FSR, the ECB had announced a new programme of quantitative easing in the light of continued weak euro area growth and weaker than expected inflation dynamics.

Financial stability in the UK could be affected by global developments if concerns about persistently low nominal growth caused a sudden reappraisal of vulnerabilities in highly indebted countries; or if a shift in global risk appetite triggered sharp adjustments in financial markets. Most recently, the Greek election results in January had led to the prospect of increased market volatility during potentially protracted negotiations. The Chancellor and Governor agreed that the most extreme outcome – a Greek exit from the euro – could potentially have widespread impacts on market conditions and confidence. The Bank and the Treasury were, as a consequence, working closely to refresh and extend contingency plans.

The Governor noted the FPC's view that a sharp adjustment to financial markets could be more disruptive if investors' pricing of liquidity risk did not fully reflect structural changes in market liquidity. There had been recent episodes in which liquidity had declined sharply intra-day before returning just as quickly a short time later. In the event, losses in the banking system had been relatively small, suggesting that the core of the system was safer. But tail events, or more sustained declines in liquidity, could trigger a larger and more prolonged reaction in asset prices and volatility.

The Governor and the Chancellor discussed the recent sharp fall in the oil price. Both agreed that, on balance, it should support global and UK growth, but that it could pose some risks to financial stability. For instance, geopolitical risks could intensify due to the impact of weaker prices on some oil-producing countries. Inflation expectations could be further depressed in economies where core inflation was already weak, slowing nominal income growth and increasing the burden of debt. And a sustained fall in oil prices could also affect the ability of some shale oil and gas exploration firms, who had issued significant amounts of high-yield bonds in recent years, to service their debts. This could affect market sentiment more broadly.

Taking these factors into account, the Governor observed that, overall, the potential for the global economic and financial environment to expose vulnerabilities in UK financial stability had grown since the June 2014 FSR was published. In the light of this, the Chancellor welcomed the FPC's intention to take developments in the global economic and financial environment into account when building the 2015 stress testing scenario.

Turning to domestic developments, the Governor noted that the Committee had already taken action to guard against the biggest domestic risks to financial stability, which it believed arose from the housing market. In June, the Committee took steps to insure against a loosening of underwriting standards and further significant increases in the number of highly indebted households.

Since then, activity in the UK housing market had slowed and near-term indicators of house price inflation had weakened markedly, particularly in London. A number of factors might have caused this moderation: Momentum in the market had eased, particularly in London, perhaps reflecting concerns about the near-term sustainability of house price inflation. The introduction of the Mortgage Market Review might also have had an impact on housing market activity. The Bank's market intelligence suggested that some lenders had tightened their lending criteria in Q3 2014. And while the FPC's Recommendation on lending at high LTI ratios was not expected to have had a material impact on mortgage lending in the near term, the authorities voicing concerns might in itself have encouraged some lenders and borrowers to step back.

Notwithstanding the recent moderation, UK household sector debt levels remained elevated relative to incomes and, while further increases in risks from the housing market had not occurred since June, momentum might return to the housing market — for example, if the recent changes to stamp duty provided support. The Committee's insurance therefore remained relevant.

The Chancellor agreed that the FPC should remain vigilant in identifying potential risks to financial stability that might arise from the housing market. With this in mind the Government had acted to give the FPC new powers of Direction to tackle risks in the housing market through caps on debt-to-income (DTI) and loan-to-value (LTV), and legislation had been laid in Parliament to put these powers into law. The Government had also taken important steps to improve housing supply, such as by reforming the planning system.

2. The Committee's consideration of resilience and stress tests

The Governor and Chancellor noted the important milestones in the reform of the prudential regulatory framework for banks since the June 2014 FSR, including an international agreement on proposals for total loss-absorbing capacity requirements for Globally Systemically Important Banks, and publication of *the*

FPC's Review of the Leverage Ratio. The overall design of the regulatory framework had now been largely set out, and would be progressed further by a consultation on the framework for the systemic risk buffer expected later in 2015.

The Governor said that it was clear that changes to the regulatory framework made since the crisis had put the UK banking sector on a transition path to greater resilience. In the last year, UK banks had greatly improved their financial strength and were set to meet global capital standards ("fully loaded" Basel III) ahead of schedule. The average common equity tier 1 (CET1) ratio for major UK banks was now over 10%.

In addition to this, the Governor highlighted the results of the recent stress-testing exercise, published in December, which provided further evidence that the resilience of the system had improved. In the stress test, the Committee had looked, among other things, at: the number of institutions that suffered sharp declines or low capital ratios in a severe stress scenario; indications that system-wide bank behaviour in the stress could adversely affect the macroeconomy or the stability of other parts of the financial system; and sectoral concentrations in losses.

In considering the final results from a system-wide perspective, the FPC had noted that the stress test did not reveal capital inadequacies for five of the eight participating banks, and only one bank had fallen below the 4.5% CET1 threshold at the trough of the stress scenario. Overall, the FPC judged that the resilience of the system had improved significantly since the capital shortfall exercise in 2013. Moreover, the stress-test results and banks' capital plans, taken together, had suggested the banking system would have the capacity to maintain its core functions in a stress scenario. On this basis the FPC had judged that no system-wide, macroprudential actions on bank capital were needed in response to the stress test.

The Governor explained that the exercise had, however, provided empirical evidence of procyclicality in some banks' capital models, and highlighted differences in risk weights calculated by firms through the cycle. While the FPC recognised that there could be macroprudential benefits from diversity in banks' models, Bank staff had been asked to look at the drivers of risk-weight procyclicality and how models could produce very different capital requirements based on similar portfolios.

The Chancellor congratulated the Governor on the successful completion of the first concurrent stress tests. The process had been complex and demanding but the results – in the context of the severity of the tests - had emphasised the resilience of the UK banking system and the credibility of the UK regulatory system. Looking forward, the Chancellor suggested that the 2015 stress tests should aim to complement the 2014 version by adjusting the stress applied to different geographies or sectors, such as a 'global slowdown' scenario featuring an emerging markets stress and a financial market shock.

While the improvement in financial resilience was welcome, the Governor noted that recent events had demonstrated that rebuilding confidence in the UK banking system required more than just stronger capital and liquidity. Ongoing misconduct cases continued to present a risk of financial losses and highlighted the challenges for those responsible for governing banks. Furthermore, changes to banks' business models, owing both to commercial and regulatory drivers and operational challenges including cyber risks, were also expected to challenge management capacity over the next few years.

In this environment, the Committee judged that strong, effective and well-informed governance and management in banks would be essential to rebuild confidence in the banking system and to manage the

transition. Further, the FPC judged that there was a need for core firms and financial market infrastructures to conduct vulnerability testing as soon as practicable in order to enhance the resilience of the financial system to cyber threats.

The Chancellor welcomed the FPC's continuing focus on cyber risks and other operational risks, and said that he was grateful to the Bank for its work to drive through the work programme in response to the FPC's June 2013 recommendation on cyber risk. Cyber risk posed particular challenges and boards should consider this as a strategic priority. It was vital that cyber was not just seen as a 'technical' issue.

3. The Committee's setting of the countercyclical capital buffer

The Governor informed the Chancellor that the FPC had set the countercyclical capital buffer rate in December 2014 at zero percent, unchanged from September 2014. In taking this decision, the Committee had considered a range of factors including: the 'buffer guide', which provides a guide for the CCB based on the size of the credit-to-GDP gap – the guide currently suggested that the CCB should be set at 0%; the FPC's assessment of bank resilience, supported by the stress-testing exercise; and its overall assessment of the risk outlook, informed by its Core Indicators.

The Chancellor welcomed the FPC's decision noting it was consistent with the FPC's policy statement that "when the FPC does not judge there to be material threats to resilience in the United Kingdom, it expects the CCB rate applied to UK exposures … to be set to zero." The Chancellor also welcomed the FPC's holistic approach to making judgements on the CCB, looking at relevant metrics, supervisory and market intelligence and information from stress tests, rather than solely focusing on one measure such as the buffer guide.

4. Structural developments

Turning to structural developments, the Chancellor welcomed the significant domestic and international progress on the Committee's 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 Chancellor also welcomed the Committee's two Recommendations made since June on new macroprudential instruments – concerning additional powers of Direction to guard against financial stability risks from the housing market; and giving the FPC power to implement a leverage ratio requirement ahead of the international timetable. The legislation granting the FPC powers over the owner-occupied housing market and over a leverage ratio framework for UK banks had been laid in Parliament, and there would be a consultation on buy-to-let powers in the next Parliament. The Committee's recently published draft Policy Statements would be helpful for informing the Parliamentary debate of the proposed legislation to provide these powers.