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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 2016 FINANCIAL STABILITY REPORT

13 December 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 banking system;
3. Assessment of the resilience of markets and market-based finance.

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) November 2016 Financial Stability Report (FSR).

2. Opening the discussion, the Governor noted that UK financial stability had been maintained through a challenging period of uncertainty around the domestic and global economic outlook. But the outlook for UK financial stability remained challenging.

3. The Governor observed that the most significant risks to UK financial stability were **global**. Increases in sovereign bond yields since the US election, coupled with risks of reduced global trade, had reinforced vulnerabilities associated with those emerging market economies (EMEs) with high levels of debt. In particular, growth in China was increasingly reliant on rapid credit expansion – since the global financial crisis, Chinese non-financial sector debt had risen by around 100 percentage points relative to GDP, and currently stands at 260% of GDP. There were signs that capital outflows from China and other emerging economies had begun to pick up in recent months.

4. The Governor added that, in some euro-area economies, sovereign debt positions remain vulnerable to higher borrowing costs and weaker growth prospects that could be associated with trade or political risks. And challenges also remain to the resilience of parts of the euro-area banking system.

5. Additional risks from the euro area could also emerge as a consequence of the United Kingdom's withdrawal from the European Union. Firms incorporated in the United Kingdom are estimated to be involved in over half of debt and equity issuance by EU (excluding UK) borrowers. And within the European Union over three-quarters of foreign exchange and over-the-counter interest rate derivatives trading takes place in the United Kingdom. If these UK-based firms have to adjust their activities in a short time frame, there could be a greater risk of disruption to services

provided to the European real economy, some of which could spill back to the UK economy through trade and financial linkages.

6. The Governor noted that the likelihood that some UK-specific risks to financial stability could materialise also remains elevated. In particular:

- In the **UK commercial real estate market**, activity slowed further in 2016 Q3 and prices had fallen by 2.6% since the referendum. Despite signs of stabilisation more recently, there was a risk of further adjustment given the reliance of the market in recent years on inflows of foreign capital and, in some segments, stretched valuations.

- The United Kingdom's large **current account deficit** was vulnerable to a reduction in foreign investor appetite for UK assets. A sharp adjustment in the current account could test financial stability through higher funding costs for real economy borrowers and a further depreciation of sterling, worsening the trade-off between growth and inflation.

- The level of **UK household indebtedness** remains high. The ability of some households to service their debts could be challenged by a period of higher unemployment. These households could affect broader economic activity by cutting back sharply on expenditure in order to service their debts. **To guard against such risks, the Governor noted that the FPC had agreed to maintain the Recommendations it made in June 2014** to insure against the risk of a marked loosening in underwriting standards in the owner-occupier mortgage market and a significant increase in the number of highly indebted households.

7. Finally, the FPC had noted in the FSR that it will take time to clarify the United Kingdom's new relationships with the European Union and the rest of the world as well as for the UK economy to adjust to these changes. The orderliness of the adjustment will influence the risk to financial stability.

8. The Chancellor welcomed the FPC's assessment of the risks to UK financial stability and noted that the outlook for financial stability remains challenging. The Chancellor said that the government will continue to monitor the situation closely. The FPC should remain vigilant to further crystallisation of the risks it highlights and should take any action it deems necessary to protect and enhance financial stability.

Assessment of the resilience of the UK banking sector

9. The Governor noted that the resilience of the system during the past year in part reflects the consistent build-up of capital resources by banks since the global financial crisis. The aggregate common equity Tier 1 capital of major UK banks was 13.5% of risk-weighted assets in September 2016 - higher than the level of capital the FPC requires in normal circumstances.

2016 stress test

10. That conclusion was corroborated by the Bank's 2016 stress test, which comprised a severe, synchronised UK and global recession with associated shocks to financial market prices, and stressed projections, generated by Bank staff, for potential misconduct costs. This combination of stresses led to system-wide losses of £44 billion over the first two years of the stress - around five times those incurred by the same banks over the two years at the height of the financial crisis. Despite the fact that the test was more severe than its two predecessors, the aggregate CET1 low point of the 2016 stress test is higher.

11. The stress test also judged banks against the Bank's new hurdle rate framework, which included so-called Pillar 2A requirements that address risks not fully captured by Pillar 1 requirements. And it held systemic firms to an even higher standard, reflecting the phasing-in of additional capital buffers for them.

12. The Governor explained that while the Prudential Regulation Authority Board judged that some capital inadequacies were revealed for three banks (RBS, Barclays and Standard Chartered), these banks now had plans in place to build further resilience. **The FPC judged that, as a consequence of the test, the banking system was in aggregate capitalised to support the real economy in a severe, broad and synchronised stress.** As a result, the FPC did not require any system-wide macroprudential actions on bank capital.

Countercyclical Capital Buffer (CCyB)

13. In July, the FPC reduced the countercyclical buffer rate on banks' UK exposures from 0.5% to 0%. This was a response to greater uncertainty around the UK economic outlook and the increased possibility that material domestic risks could crystallise in the near term. The FPC was concerned that banks could respond to these developments by hoarding capital and restricting lending. The reduction of the CCyB rate was intended to reinforce the FPC's expectation that all elements of capital and liquidity buffers are able to be drawn on to support the real economy.

14. The Governor explained that this position has not changed, and the FPC therefore agreed at its November Policy meeting to maintain the CCyB rate at 0% and that it expects, absent any material change in the outlook, to maintain this rate until at least June 2017.

Future challenges to resilience

15. The Governor explained that the FPC remains focused on the ability of the UK banking system to maintain this resilience in future.

16. Some major UK banks continue to face the challenge of weak profitability, which is reflected in market valuations of their equity. These reflect several headwinds, including costs related to past misconduct and the weak profitability of the investment banking businesses of UK banks. Weak profitability diminishes banks' future ability to rebuild capital following a shock while also maintaining credit supply. The Bank will run an 'exploratory' scenario alongside the 2017 annual

cyclical scenario to assess the impact on the UK banking sector of weak global supply growth, persistently low interest rates, and a continuation of declines in both world trade relative to GDP and cross-border banking activity.

17. The Governor noted that changes to financial firms' business models and structures as the United Kingdom withdraws from the European Union could have implications for the resilience of the financial system in the United Kingdom and more broadly. Possible implications include disruption of services, particularly if any adjustment cannot be made smoothly, a further weakening of investment banking profitability and the potential for greater complexity in firms' legal structures — which could place greater demands on firms' risk management and on supervisory oversight, and pose challenges for effective resolution. The FPC is working with supervisors to assess these implications as firms begin to plan for the United Kingdom's new relationship with the EU.

18. Finally, the Governor noted that cyber and technology-enabled attacks continue to be a serious threat to the resilience of the UK financial system. High-profile incidents in 2016 had raised awareness of the importance for institutions of ensuring that they have appropriate controls and measures in place to counter fraud.

19. The Chancellor was reassured that the resilience of the financial system continues to improve. Firms have built up significant capital and liquidity resources, which increases their resilience to periods of stress.

20. The Chancellor also welcomed the results of the 2016 stress test. He noted the results show that the banking system continues to grow more resilient. The results were further proof that, thanks to the work of government and regulators, the banking system is strong, safer and well placed to support the wider economy.

<u>Assessment of the resilience of markets and market-based finance</u>

21. The Governor explained that recent market developments further highlighted the importance of the resilience of markets, and of market-based finance, to sharp market moves.

22. Overall, the Governor observed that core financial markets had functioned effectively in the period since the July FSR, despite testing conditions. These conditions included spikes in uncertainty and risk aversion, with trading volumes at many multiples of normal levels at times. But the resilience of market liquidity continued to be uneven. For example, on 7 October, sterling depreciated by around 9% against the US dollar in less than 40 seconds, before quickly retracing much of the move. As with other recent episodes, this 'flash event' proved to be short-lived and without immediate consequences for financial stability. Nevertheless, such disruptions underscore the concern that liquidity in some markets may have become more fragile in recent years. The FPC, drawing on the work of the Bank for International Settlements Markets Committee, will seek to examine the potential implications of these developments for financial stability.

23. The Governor observed that market liquidity could also be challenged during a period of adjustment related to the United Kingdom's new relationship with the European Union. Any change in arrangements could have implications for levels of activity in exchanges and other trading venues. It could also affect the level of market-making activity by intermediaries as they adjust business structures. The Governor said that the FPC would continue to assess these risks.

24. The Governor concluded by setting out a range of work that the FPC and Bank had undertaken, or is going to undertake in 2017, to enhance the resilience of market-based finance:

- The Bank is developing a **system-wide stress simulation** to assess the dynamics of markets under stress. It will include an analysis of the behaviour of various sectors — such as open-ended investment funds, insurance companies and dealers. That exercise will identify any material gaps in the data needed to assess risks.
- Relatedly, the FPC has assessed **procyclicality in insurers' investment activities**. The current design of the 'risk margin' element of Solvency II rules could, in future, encourage procyclical investment behaviour. It should be addressed, including through the forthcoming review of Solvency II by the European Commission.
- The FPC has further concluded that **unit-linked insurance products share some economic similarities with open-ended investment funds**, with investors able to switch between funds at short notice. There is tentative evidence that this flexibility could lead to procyclical investment behaviour, particularly during times of stress. The Bank will include unit-linked funds in its system-wide stress simulation.
- The FPC has asked the Bank to complete an in-depth assessment of the **financial stability risks associated with derivative transactions.** This will examine progress towards implementation of the post-crisis reforms in derivatives markets and consider the implications for the resilience of the financial system. This will also contribute to a broader review by the Financial Stability Board.

25. The Chancellor noted that the government supports the FPC's work to enhance the resilience of market-based finance. Although the banking system is an important facet of the financial system, we should not ignore the important roles that other sectors play in the system.