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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 2015 FINANCIAL STABILITY REPORT

27 January 2016

The following items were discussed at the meeting:

1. Assessment of risks to financial stability;
2. Assessment of the resilience of the financial system and stress test results;
3. The Financial Policy Committee's view on the overall calibration of the capital framework for UK banks; and
4. The Financial Policy Committee's setting of the countercyclical capital buffer.

1. Financial Stability Report assessment of risks to financial stability

The Chancellor and Governor discussed the assessment of risks to financial stability as contained in the Financial Policy Committee's (FPC) December 2015 Financial Stability Report (FSR).

Opening the discussion, the Governor noted that the UK financial system had moved out of the period of heightened risk aversion that followed the global financial crisis, but the global macroeconomic environment had remained challenging. For example, while risks in relation to Greece had fallen from their acute level at the time of the publication of the July 2015 FSR, they had increased in relation to emerging market economies (EME). Since July 2015, there had been further downward revisions to EME growth forecasts. In China, growth was expected to decelerate further. The Governor noted the event risk from a sharp Chinese currency depreciation and noted the value of greater dialogue amongst SDR currency economies.

The Chancellor noted the FPC's assessment that UK financial conditions were moving out of their post-crisis repair phase and agreed that the global economic environment remained challenging. 2016 would be a critical year for the UK economy and it would be important to continue with the plan to secure the economic recovery, protect the country from financial instability and build on the progress the country had made since the financial crisis. There were a number of risks in various countries across the globe and this had been reflected in several downward revisions to forecasts for growth in emerging markets. The Chancellor stressed the importance of remaining alert to any implications of weaker global growth for UK financial stability.

Turning to the UK, the Governor noted that UK growth was projected to be broadly stable in the near term amid the continued subdued global growth, ongoing domestic fiscal consolidation, and uncertainty about the implications of the referendum on EU membership.

Some domestic risks had remained elevated. The buy-to-let (BTL) sector continued to drive growth in the UK mortgage market. In the year to 2015 Q3, the stock of BTL lending had risen by 10%. Greater competition in this sector had not to date led to a widespread deterioration in underwriting standards of UK banks, but new loans to BTL investors were often subject to less stringent affordability tests than loans to owner-occupiers. Assessed against relevant affordability metrics, BTL borrowers might be more vulnerable to an unexpected

rise in interest rates or a fall in income, which could exacerbate the scale of a fall in house prices. During an upswing in house prices, investors seeking capital gain could increase leverage including through the purchase of multiple properties, which could add further pressure to house prices. The Committee remained alert to financial stability risks arising from rapid growth in BTL lending, and welcomed the PRA's intention to review underwriting standards amongst BTL lenders. The FPC would continue to monitor developments in BTL activity following the recently announced tax changes. The FPC was also monitoring developments in the UK Commercial Real Estate (CRE) market, where prices had risen significantly and the funding of investments was becoming riskier.

Turning to the United Kingdom's current account deficit, the Governor observed that the current account had narrowed in 2015 Q2, but remained high by historical and international standards. The FPC monitored capital inflows to assess the extent to which vulnerabilities, such as refinancing risk, might be building, and remained vigilant to the possibility that capital inflows may amplify risks in specific sectors such as CRE

The Chancellor noted the FPC's judgement that some domestic risks had remained elevated, including in the BTL market and the current account deficit. In the Summer Budget, the Treasury took action to level the playing field between landlords and owner-occupiers by restricting the rate of tax relief available to landlords to the basic rate of income tax. Furthermore, in the Autumn Statement, the Treasury set out its intention to place a surcharge on stamp duty tax rates applicable to additional residential properties. The Chancellor said that the recent tax measures were partly based on macroprudential considerations.

In December 2015, the Treasury had also launched a consultation on the FPC's recommendation relating to new macroprudential tools in the BTL market, with the consultation period ending in March 2016. The responses from the consultation would help to shape the final statutory instrument that placed the new powers of direction in legislation. The Chancellor commented that the addition of these new tools to the Bank's existing macroprudential housing tools should give the Committee the confidence that it had all the tools it needed to tackle potential financial stability risks in domestic property markets.

Turning to financial markets, the Governor noted that global asset prices remained vulnerable to a crystallisation of risks in EMEs, to a sharp increase in market interest rates, or to the compensation demanded by investors for holding risky assets. In particular, shocks to asset prices might be amplified if market liquidity proved to be fragile. The Committee had completed its review of the potential risks arising from open-ended investment funds offering short-term redemptions in 2015 Q4 and had welcomed the FCA's recently announced study of investor awareness of liquidity risks in these products. Following the survey of 143 investment funds' liquidity management plans, the Bank would seek to test the resilience of markets to widespread redemptions. This would involve considering plausible redemption scenarios for European investment funds; estimating the scale of resulting asset sales; and assessing whether markets could absorb such sales without disruptive price impact. The Bank would also bring the activity of investment funds into the system-wide stress testing; and continue to work at the FSB to internationalise such efforts.

The Chancellor noted the FPC's view on risks from market fragility, asset prices and market liquidity. The Chancellor welcomed the Committee's work programme which would help to better understand these risks and how they interacted. The Chancellor encouraged continued collaboration with the FCA, other regulatory bodies and industry where it was deemed appropriate.

The Governor also observed that as set out in the response to the latest remit letter, the FPC would assess the costs and benefits of the cumulative impact of regulatory reforms, including any unintended

consequences for market liquidity in core financial markets, also drawing on inputs from the Bank's recent Open Forum. The Chancellor said that the FPC's assessment of the costs and benefits of the cumulative impact of regulatory reform was important as the economy moved out of the post-crisis phase and as the final elements of the post-crisis regulatory framework were put in place.

Turning to non-financial risks, the Governor noted the FPC's judgement that cyber risk continued to pose a threat to the financial system. UK and international authorities had already taken action with regard to cyber risk, including through a joint exercise in November 2015. In the UK, progress on 'CBEST' vulnerability testing had continued with ten out of 35 core firms - those judged most critical to financial stability in the event of a major cyber attack - having completed CBEST tests at the time of the December 2015 Report, up from five at the time of the July 2015 Report. The FPC would receive a report on a work programme implemented by UK authorities by Summer 2016.

The Chancellor agreed with the FPC's assessment that cyber risk continued to pose a threat to the financial system, and that market participants must have robust contingency plans in place. The Government recognises the need to play a role in protecting the United Kingdom from cyber attack, which was why a provision in the spending review committed to almost double the investment in cyber, and why the Government is considering options for regulation of cyber resilience for critical infrastructure. This investment would include a new National Cyber Centre to act as a single point of contact in government and to better support industry. The Chancellor noted that while the National Cyber Centre would help to improve response capabilities, strengthening the defences and resilience of the finance sector to attack requires stronger governance in firms, and incorporation of intelligence-led penetration testing, like CBEST, into the regular supervisory assessment of resilience. The Chancellor recognised the CBEST testing programme as critical for building resilience, and, while progress with CBEST was continuing, faster and further progress needed to be made on understanding and improving the resilience of the financial operators to cyber threat. This should include the timely development of a form of the CBEST testing framework that could be applied more regularly. The Chancellor recognised that this was in line with the FPC recommendation of July 2015.

2. Assessment of the resilience of the financial system and stress test results

The Governor observed that the UK banking system had continued to become more resilient: the aggregate Tier 1 capital position of major UK banks was 13% of risk-weighted assets in September 2015. The results of the Bank of England's 2015 stress test underscored this improvement. The 2015 test had focused on an emerging market stress that prompted reassessments of global prospects and asset prices; considered the implication of deflation not inflation; and placed greater emphasis on exposures to corporates rather than households. It also included an unrelated but important stress of costs for known misconduct risks. The stress test results, taken together with the bank's capital plans, indicated that the UK banking system would have the capacity to continue to lend to the real economy even under such a severe scenario.

The Chancellor noted the FPC's judgement that the resilience of the UK banking system had continued to improve and the results of the stress tests published at the end of 2015 had underlined that assessment. The Chancellor commented that the scenario for the 2015 stress tests – focused on weaker growth in emerging markets – had been particularly well-chosen. It was reassuring that the UK largest banks would be resilient to a shock of such magnitude and be able to maintain the provision of their core services to the UK economy.

3. The Financial Policy Committee's view on the overall calibration of the capital framework for UK banks

The Governor noted that since the crisis, authorities had worked to establish standards for bank equity and other capacity to absorb losses in order to fix some of the major fault lines that caused the financial crisis. The work to design those standards was reaching completion and was now moving into the phase of full implementation. The FPC had assessed the capital needs of the system and had provided clarity on the amount of capital the UK banking system needs given the risks it faced; and how that capital should be allocated across different types of firms and risks. A capital framework supplement was published alongside the December 2015 FSR.

The FPC had concluded that the appropriate Tier 1 equity requirement for the banking system, in aggregate, was 11% of risk-weighted assets, adjusting for definitional shortcomings. Of this 9.5 percentage points should be in the highest quality common equity capital and roughly half should be buffers, for use in stress. The Governor commented that this was a little above the basic international standards set out for major global banks, but was lower than some might have expected. Indeed, analysis by the Basel Committee in the aftermath of the crisis had concluded that the optimal equity ratio was around 18%.

The FPC had also assessed the amount of capital in the light of the cost of the crisis and the benefits of reforms made since, as well as two years of severe-but-plausible stress tests. Three factors had been decisive:

First, progress on resolution, where the Committee judged that effective arrangements for resolving banks materially reduced both the probability of financial crises and the economic costs of bank failure. By allowing a more efficient and cost-effective overall capital structure, the baseline amount of equity that banks needed to hold could be lower. The Bank began a consultation process on its approach to setting a minimum requirement for own funds and eligible liabilities (MREL) on 11 December 2015.

Second, effective supervision and structural reform, where the PRA's forward-looking, judgement-led supervision helped ensure that individual banks did not take excessive risks but carried additional capital for idiosyncratic exposures. Structural reform would further increase the resilience of ring-fenced banks.

Third, active use of countercyclical tools, where the Committed intended to use the countercyclical capital buffer (CCyB) to ensure capital in the system was commensurate with risks that would inevitably vary over time. Active use of CCyB meant a more efficient capital structure as the system would not be capitalised to withstand high-risk conditions at all times. This was something the FPC already explicitly recognised when setting the basic leverage ratio requirement at 3% - a lower requirement than would have been the case without active use of the CCyB.

The Governor observed that the framework differentiated between minimum capital standards that must be met at all times and buffers that were there to be used in stress. And for the first time the capital required to insure against macro-prudential risks would be separate from that needed for idiosyncratic firm risks.

The Chancellor noted the publication of the capital supplement to the FSR and the FPC's assessment of the costs and benefits of the appropriate level of capital for UK banks and building societies. The Chancellor agreed that it was important to provide clarity on the medium-term capital framework for UK banks and building societies as the economy moved out of the post-crisis repair phase and as the market fully implemented the new capital regulations.

4. The Financial Policy Committee's setting of the countercyclical capital buffer.

The Governor noted how the shift in financial conditions out of the post-crisis phase meant that the FPC was now actively considering the appropriate setting of the CCyB. While the FPC had maintained the UK CCyB rate in December 2015 at 0%, the Committee intended to set the CCyB above zero before the level of risk became elevated. More specifically, the Committee expected to set a CCyB in the region of 1% when risks were judged to be neither subdued nor elevated. This expectation would be kept under review and could change over time. The Governor observed that, as a first step in setting the buffer, the FPC intended to separate those risks currently captured by existing supervisory requirements that would in future be captured by the CCyB. To this end, the PRA Board had agreed to review individual firms' buffer requirements in 2016 Q1. The result of this one-off process would mean an increase in the countercyclical buffer from zero but would not, in itself, change the overall capital requirements for UK banks. Following the completion of this process, the FPC would carefully review the appropriate setting of the buffer rate in March 2016.

The Chancellor noted the setting of the CCyB at 0% for 2015 Q4, and the FPC's intention to make active use of the buffer as part of its medium-term capital framework. The CCyB was an important part of the time dimension of macroprudential policy. Active use of the CCyB would help to build banks' resilience across the financial cycle and ensure that banks prepare for the bad times during the good. Providing clarity on how the FPC intended to set the CCyB would allow the industry to better understand the FPC's reaction function, thereby contributing to maintaining financial stability as the financial cycle moved into its next phase.