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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 2015 FINANCIAL STABILITY REPORT

7 September 2015

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
3. 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) July 2015 Financial Stability Report (FSR).

Opening the discussion, the Governor noted that risks associated with Greece had increased rapidly in the run up to publication of the FSR, and had become particularly acute immediately prior to the FPC's Policy Meeting. This resulted in the Greek authorities imposing a bank holiday and capital controls just before the FSR was published.

Subsequent to publication, the Greek government had agreed a new financing deal with creditors which meant that the risk of an immediate default had receded. But the situation remained fluid. The Governor noted that the United Kingdom was relatively well insulated from the direct consequences of events in Greece. For example, UK banks' exposures to Greece were very small and the footprint of Greek banks in the United Kingdom was tiny. But it was possible that a renewed deepening of the Greek crisis could prompt a broader reassessment of risk in financial markets.

The Chancellor said that the Government welcomed the progress made on resolving the Greek issue and encouraged all parties involved in negotiations to seek a lasting solution. While the Bank and HMT had worked closely with the FCA and European counterparts to put contingency plans in place the UK authorities would need to remain vigilant and, if necessary, act to protect UK financial stability.

The Governor said that the global outlook beyond Greece was mixed. Risks stemming from the macroeconomic environment in advanced economies had diminished, but risks from emerging market economies (EMEs) had increased. The economic outlook had weakened in a number of EMEs, including in China where – following a rapid build-up of indebtedness – policymakers faced challenges in sustaining growth, managing financial stability and increasing openness. The recent volatility in Chinese equity prices had underlined the challenges faced by the Chinese authorities.

More broadly, vulnerabilities had increased in a number of EMEs following a long period of capital inflows and rising private indebtedness, much of which had been financed through the capital markets and in US dollars. The combination of weaker domestic economies, a stronger US dollar and an eventual rise in US interest rates could threaten the ability of those businesses to meet their obligations.

Banks and other financial institutions operating in the United Kingdom had material exposures to EMEs via direct lending to households and firms as well as via holdings of securities. UK banks' direct exposures to emerging markets and China stood at around 3½ times their Core Equity Tier 1 capital, making them directly exposed to a deterioration in economic conditions in those countries.

The Chancellor noted the particular importance of global developments for the UK financial sector and the wider economy. The UK was one of the most open economies in the world, with significant trade and financial links with other countries. The international focus of the scenario for the Bank's 2015 stress test of major UK banks was therefore welcome and particularly apt, given the recent volatility in Asian markets and increasing concerns regarding growth prospects for some EMEs.

The Governor agreed, and observed that while the resilience of institutions at the core of the financial system had continued to strengthen risks could shift into other parts of the system, including into markets and the infrastructures that underpin them. For example, some fixed income markets had become less liquid since the crisis with smaller average trade sizes, thinner market depth and more volatile prices. The Governor said that greater volatility did not necessarily threaten stability. Indeed, to the extent that changes in market dynamics reflected stronger prudential requirements, increased volatility might be a product of a much-needed increase in the resilience of the core of the financial system. Markets would adjust over time to this new reality.

Of greater concern was that an adjustment in risk appetite could lead to a persistent dislocation in markets. This could be the product of the interaction between regulation, changes to market structure, and market participants' assumptions about the continuous availability of short-term market liquidity. The FPC was taking steps to deepen its understanding of the macroprudential risks associated with changes in market liquidity and the activities of various market participants. The Bank was also working through the Financial Stability Board to assess these risks globally, and would convene an Open Forum on 11 November 2015 to discuss developments in market functioning and potential measures to improve market resilience.

The Chancellor welcomed the open and collaborative approach being taken by the Committee and emphasised the importance of coordination with other jurisdictions given the international nature of financial markets.

Turning to the UK, the Governor noted that recent UK economic growth had been solid. At around 6 per cent of GDP, however, the UK's current account deficit was very large by historical and international standards. The risks associated with this deficit were mitigated by currency composition and the long-term nature of the capital flows that were financing it, as well as by the fact that the deficit was not combined with a rapid growth of domestic credit. However, continued, smooth financing of the UK current account deficit depended on the credibility of the UK's macroeconomic policy framework, including the UK's openness to trade and investment. The scenario employed in the Bank's 2014 stress test had sought to assess what could happen to the economy and financial system if, in an extreme case, these assumptions were called into question.

The burden of household debt had continued to fall modestly, and its distribution had improved. Despite this progress, UK household debt-to-income remained high, and , after having slowed previously, momentum in the housing market was showing signs of returning. Meanwhile, lending in the buy-to-let mortgage market had continued to grow and accounted for 15% of the stock of outstanding mortgages and nearly 20% of the flow in 2015 Q1.

On this basis the Committee had judged that its policies, introduced in June 2014, to insure against a marked loosening in underwriting standards for owner-occupied mortgages, remained warranted.

The Chancellor noted that the Government had legislated to grant the FPC powers of direction over the PRA and the FCA with respect to owner-occupied mortgages. And HM Treasury would consult on the financial stability impacts of buy to let mortgage lending.

The Summer Budget was accompanied by a new remit for the FPC, which specified the government's economic policy and made a number of recommendations to the Committee. In particular, the remit made clear that subject to achieving its primary objective the FPC should support the government's economic objectives by acting in a way that facilitates the supply of finance for productive investment provided by the UK's financial system, and by acting in a way that supports competition, innovation and competitiveness in financial services. The Chancellor welcomed the FPC's response to the remit and its commitment to continue to take account of the effect of its actions on the sustainable supply of finance to the real economy, including by pursuing the Committee's medium-term priority to ensure more diverse and resilient sources of market-based finance.

The Governor said that the UK banking sector continued to face a range of non-financial risks. Misconduct had undercut public trust in the financial system, exposing fault lines in markets' 'soft' infrastructure and posing risks to systemic stability. Fines and redress costs paid by UK banks now totalled £30 billion, roughly equivalent to all of the capital these banks had raised privately since 2009. The Committee intended to review the adequacy of sector-wide projections of future misconduct costs in the 2015 stress test.

However, fines alone would not rebuild trust in markets. That would require a better balance between firm and individual accountability. The Fair and Effective Markets Review showed the way forward with a series of concrete initiatives at domestic and global levels.

The Chancellor said that HMT was committed to working with the Bank and the FCA to implement the recommendations of the Fair and Effective Markets Review which would help to restore public trust in the financial system. The Chancellor looked forward to receiving the Chairs' update on the implementation of the Review's recommendations by June 2016.

The Governor noted that the FPC was also alert to operational threats to firms and to the 'hard' infrastructure of the financial system. Of particular concern were breaches of IT security, with financial firms among those most frequently targeted by cyber attackers. The adaptive nature of the cyber threat meant that banks' resilience, and their ability to recover from attacks, needed to continually evolve. That required advanced technological capabilities but also strong governance. With this in mind, the Committee had replaced its existing Recommendation with a new Recommendation to regulators that focused on establishing a regular assessment of the resilience of firms, and the infrastructure at the core of the system, to cyber attacks.

The Chancellor recognised the prolific, growing and evolving nature of the cyber threat to the finance sector. The new remit for the FPC clarified its responsibility for addressing non-financial risks to the sector, including cyber threats. HMT had completed some work reviewing official governance of cyber resilience to ensure that there were appropriate arrangements to improve and build resilience in the sector against the risk of a threat crystallising.

The Chancellor recognised the Committee's recommendation for building cyber resilience in the sector, including the centrality of the CBEST testing programme. The Chancellor regarded this type of sophisticated integrity and penetration testing as critical for building resilience, and felt that it should be applied to as much of the sector as possible; and certainly to the firms and infrastructures that were key to the stability and security of the sector.

The Chancellor also recognised the need for the UK financial authorities, government cyber experts and the industry to continue their work, often in collaboration, to strengthen the defences and resilience of the sector as a whole to cyber attack. The key focus of this work should be: i) improving response capabilities among the authorities and the sector; ii) ensuring stronger governance in individual firms; and iii) incorporating intelligence–led penetration testing of the sector's critical systems into the regular supervisory assessment of resilience.

There also needed to be stronger international cooperation given the global nature of the threat and the interconnectedness of the global financial sector. HMT was supporting international engagement through active participation in the UK/US cyber exercise ('Resilient Shield'), which was focused on the financial sector.

2. Resilience of the financial system

The Governor said that the risks to the system should be weighed against the increasing resilience of the banking system where capital positions had continued to improve in the past six months.

Most of the prudential regulatory reform requirements for banks had been set out, including through the FPC's formal implementation of the leverage ratio requirements it announced last year. The Committee would consider the methodology to determine capital buffers for ring-fenced banks and large building societies, and the overall capital framework, more broadly in 2015 H2 as part of its medium-term priority around establishing the medium-term capital framework for UK banks.

The Chancellor noted the significant progress made in the last Parliament in increasing the resilience of the banking system and thanked the FPC for its work in this area. The FPC and the Bank should take an open and consultative approach, where appropriate, when finalising its proposals for the medium-term capital framework. When considering the methodology to determine capital buffers for ring-fenced banks and large building societies, it was particularly important that the FPC should consider how its proposals interacted with other recent changes to the capital framework and ensure that the impacts on a range of business models were considered.

With the programme of reform in the banking sector close to finalisation and implementation well underway, the FPC could broaden its focus to consider resilience across the entire financial system. The Committee was already considering risks to stability that might arise from outside the core banking system and should continue to expand its programme of assessments.

3. Countercyclical capital buffer

The FPC had set the countercyclical capital buffer rate at its June 2015 meeting at zero percent, unchanged from March 2015. In taking this decision, the Committee had considered the risks facing the UK financial system set against the still modest recovery in credit extended to UK households and companies. The decision was informed by its Core Indicators; the increased resilience of the financial system and the action taken in response to the 2014 stress test of major UK banks; and the 'buffer guide', which provided 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 Chancellor welcomed the FPC's decision and its holistic approach to making a judgement on the CCB, looking at relevant metrics, supervisory and market intelligence and information from stress tests.