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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 JUNE 2017 FINANCIAL STABILITY REPORT

5 July 2017

The following items were discussed at the meeting:

1. The FPC's latest assessment of financial stability risks and the countercyclical capital buffer decision;
2. Other FPC policy decisions at their June meeting; and
3. The FPC's medium term priorities.

<u>The FPC's latest assessment of financial stability risks and the countercyclical capital buffer decision</u>

1. The Chancellor and Governor discussed the assessment of risks to financial stability as contained in the Financial Policy Committee's (FPC) June 2017 Financial Stability Report (FSR).

2. Opening the discussion, the Governor noted that the FPC judged that the overall domestic risk environment was at a standard level - most financial stability indicators were neither particularly elevated nor subdued. Nevertheless, the FPC identified pockets of risk that warranted extra vigilance:

- Consumer credit had increased rapidly.
- Lending conditions in the mortgage market were becoming easier.
- And lenders might be placing undue weight on the recent performance of loans in benign conditions.
- Some possible global risks had not crystallised, though financial vulnerabilities in China remained pronounced.
- And measures of market volatility and the valuation of some assets - such as corporate bonds and UK commercial real estate - did not appear to reflect fully the downside risks that were implied by very low long-term interest rates.

3. The Governor noted that, with domestic risks now back at standard levels, the FPC increased the UK countercyclical capital buffer rate from 0% to 0.5%, in order to provide a buffer of capital that could be released quickly in the event of an adverse shock that threatened to tighten lending conditions. In addition, and consistent with its stated policies for a standard risk environment and of moving gradually, the FPC expected to increase the rate further to 1% at its November meeting.

4. The Governor and Chancellor then discussed the risks that merited increased vigilance.

Consumer credit

5. The Governor highlighted that consumer credit had grown by 10.3% in the year to April 2017 — markedly faster than nominal household income growth. In an environment of intense competition, banks' net interest margins on new lending had fallen and major lenders were using lower risk weights to calculate the capital they need to hold against these exposures. Other things equal, this meant lenders have less capacity to absorb losses. Moreover, the short maturity of consumer credit means that the credit quality of the stock of lending could deteriorate quickly.

6. The Governor observed that firms are the first line of defence to ensure that risks are priced and managed appropriately. The second line is supervisory oversight. In that context, a review by the PRA had found evidence of weaknesses in some aspects of underwriting and a reduction in resilience. The FPC therefore supported the intentions of the Prudential Regulation Authority and Financial Conduct Authority to publish their expectations of lenders in the consumer credit market, which were released on Tuesday 4 July.

7. The third line of defence was macro prudential policy. The Governor noted that the increase in the CCyB will bolster resilience. And the FPC was also bringing forward the assessment of stressed losses on consumer credit lending in the Bank's 2017 annual stress test. This would inform the FPC's assessment at its next meeting of any additional resilience required against this lending.

Mortgage market

8. The Governor turned to risks around housing. Historically, the build-up of mortgage debt has been a significant risk to financial and economic stability. The FPC therefore put policies in place in 2014 to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. Following an extensive review, the Governor explained that the FPC now expects these insurance measures to become structural features of the UK housing market. For consistency, the FPC also clarified that lenders should test affordability at their mortgage reversion rate – typically their Standard Variable Rate – plus three percentage points.

Global environment and asset valuations

9. The Governor observed that near-term growth prospects for the global economy had improved slightly since the November FSR, and some possible risks had not crystallised. But financial vulnerabilities in China remained pronounced as, although capital outflows have stabilised, economic growth continues to be accompanied by rapid credit expansion.

10. Long-term real rates were low across the G7, consistent with pessimistic growth expectations and high perceived tail risks. The Governor noted the risk that some asset valuations, particularly for some corporate bonds and UK commercial real estate assets, appeared to factor in a low level of long-term market interest rates but do not appear to be consistent with the pessimistic

and uncertain outlook embodied in those rates. In addition, measures of uncertainty implied by options prices were low at present - often in periods of low volatility, risks can build and later become apparent.

11. The Chancellor welcomed the publication of the FSR and the full assessment by the FPC of the risks to UK financial stability. He noted that the FPC considered the domestic risk environment to now be at a standard level. He said the government welcomed the actions that the Committee was taking to maintain and enhance the resilience of the financial system, and agreed that the FPC should remain vigilant to any crystallisation of the risks that it identifies.

EU withdrawal

12. The Governor noted that, consistent with its statutory duty, the FPC will continue to identify and monitor the UK financial stability risks associated with Brexit. In particular, the FPC will oversee contingency planning in order to help promote an orderly adjustment to the new relationship between the UK and the EU. The Governor explained that the FPC was focussed on scenarios that, however unlikely, could have the most impact on UK financial stability - including a scenario in which there is no agreement in place at the point at which the UK leaves the EU. Such scenarios are where contingency planning and preparation will be most valuable.

13. Without such plans, the Governor noted that financial stability could be affected directly by impacts on the provision of financial services, and indirectly, through macroeconomic shocks. The financial stability issues from the direct effects on financial service provision include:

- the need to make the legal and regulatory framework for financial services domestic at the point of withdrawal;
- possible disruptions to the flow of new banking and insurance services to UK customers if entities established in the EEA can no longer operate in the UK;
- "spillbacks" to the UK from the adverse consequences on European clients who lose access to the services of UK-located banks, insurers and financial market infrastructure; and
- higher costs and greater risks for both EU and UK companies and households if there were fragmentation of market-based finance.

14. The Bank's regular stress testing aimed to ensure that the banking system has the strength to withstand, and continue to lend in, a broad range of severe economic and market shocks. These included scenarios related to Brexit, which, as the Monetary Policy Committee (MPC) has stressed, have the potential to affect the UK economy through supply, demand, and exchange rate channels.

15. Irrespective of the particular form of the United Kingdom's future relationship with the EU, the Governor noted that the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This would require a level of resilience to be maintained that is

at least as great as that currently planned and which itself exceeds that required by international baseline standards.

16. The Chancellor welcomed the FPC's commitment to maintaining high prudential standards in the UK financial system, while emphasising the Government's continued commitment to ensuring that the UK has a globally competitive financial system.

17. The Chancellor also emphasised the importance of the FPC's role in monitoring potential risks to the UK financial system associated with the UK's exit from the EU and noted that, given the UK's role as a financial centre for the whole of the EU, there is a shared interest for the UK and the EU in managing and mitigating these risks. In this regard, the Chancellor noted the crucial importance of early agreement on a mutually beneficial interim period to avoid unnecessary disruption and dangerous cliff edges.

The leverage ratio

18. The Governor observed that, a year ago, the FPC took the decision to exclude central bank reserves from its simple measure of bank leverage - an action that was designed to ensure the Committee's leverage standards did not impede the transmission of monetary policy. Consistent with its commitment at the time to offset any loosening implied by this adjustment, the FPC was now recalibrating the minimum leverage requirement from 3% to 3.25% of non-reserve exposures, subject to consultation.

Cyber

19. The Governor noted that the FPC had catalysed measures to strengthen the resilience of the financial system to the risks from cyber-attacks, including vulnerability testing of all firms at the core of the financial system. 31 out of 34 firms at the core of the UK financial system, including banks representing more than 80% of the outstanding stock of PRA-regulated banks' lending to the UK real economy, so far had completed penetration testing and had action plans in place to remedy any issues identified. The FPC would now set out the essential elements of the regulatory framework for maintaining ongoing cyber resilience, and will monitor how relevant UK authorities fulfil their elements that affect the financial sector.

The FPC's medium-term priorities

20. The Governor concluded the meeting by noting that, alongside its ongoing assessment of the risk environment, the FPC is prioritising three initiatives over the next two to three years:

- Finalising, and refining if necessary, post-crisis bank capital and liquidity reforms.
- Completing post-crisis reforms to market-based finance in the United Kingdom, and improving the assessment of systemic risks across the financial system.
- Preparing for the United Kingdom's withdrawal from the European Union.

21. Across its priorities, the FPC remains committed to working with relevant authorities domestically and internationally, to protect and enhance the resilience of the UK financial system.

22. The Chancellor noted that the government supports the medium-term priorities of the FPC. The work undertaken by the FPC will further enhance the resilience of the financial system as a whole, and will continue to ensure that the financial system is well placed to support the wider economy.