Publication date: 17 January 2018

RECORD OF THE MEETING BETWEEN THE GOVERNOR OF THE BANK OF ENGLAND AND THE CHANCELLOR OF THE EXCHEQUER TO DISCUSS THE NOVEMBER 2017 FINANCIAL STABILITY REPORT

4 December 2017

The following items were discussed at the meeting:

1. The FPC's latest assessment of financial stability risks;
2. The countercyclical capital buffer rate decision;
3. The 2017 annual cyclical scenario and the Biennial Exploratory Scenario;
4. Brexit; and
5. The FPC's annual review of risk and regulation beyond the core banking sector.

The FPC's latest assessment of financial stability risks

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

2. Opening the discussion, the Governor noted that the FPC judged that, apart from those related to Brexit, domestic risks were at a standard level overall, and that risks from global debt levels, asset valuations and misconduct costs remained material.

3. In particular, the Governor noted that:

- Consumer credit had been growing rapidly. Although this was not a material risk to economic growth, it was an important determinant of banks' ability to withstand severe economic downturns.
- The United Kingdom has a large external balance sheet and current account deficit. It is therefore vulnerable to a reduction in foreign investor appetite for UK assets. If that occurred, credit conditions would be expected to tighten, domestic demand would weaken and the sterling exchange rate would depreciate.
- Although near-term prospects for the global economy had continued to strengthen, risks from debt in several major economies remain material. In China, economic growth continued to be supported by rapid credit expansion.
- There was a risk that investors in global markets may currently be placing excessive weight on the recent benign environment continuing. Growth had been moderate, inflation subdued, and market volatility low. In that context, investors expected long-term interest rates to remain low and were willing to accept lower compensation for the risks they were taking. Risky asset prices may be vulnerable to a repricing, either through an increase in long-term interest rates or a downward adjustment in growth expectations, or both.
- In the UK, long-term interest rates and equity prices of domestically focused companies appeared to be factoring in pessimistic growth expectations and downside risks. In contrast,

the compensation for risk demanded by investors in some sterling corporate bonds appeared low, and valuations of some segments of the London commercial property market remained stretched. They appeared to factor in the low level of long-term market interest rates but not necessarily the cash flows associated with the economic outlook embodied in such rates.

4. The Governor explained that the Bank's 2017 stress test captured these risks. It showed the UK banking system is resilient to deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs. The economic scenario in the 2017 stress test was more severe than global financial crisis. It featured a 2.4% fall in world GDP and a 4.7% fall in UK GDP. There was a sudden reduction in investor appetite for UK assets and sterling fell sharply. Bank Rate rose sharply to 4.0% and unemployment more than doubled to 9.5%. UK residential and commercial real estate prices fell by 33% and 40%, respectively. In line with the Bank’s concerns over consumer credit, the stress test incorporated a severe consumer credit impairment rate of 20% over the three years across the banking system as a whole.

5. The Governor noted that the stress led to total losses for banks of around £50 billion during the first two years – losses that would have wiped out the entire common equity capital base of the UK banking system ten years ago. Today, such losses can be fully absorbed within the capital buffers that banks carry on top of their minimum capital requirements. This resilience reflects the fact that major UK banks have tripled their capital strength since 2007. Their Tier 1 capital ratio was in aggregate 16.7% in September 2017.

6. The Chancellor welcomed the FPC’s latest assessment of the risks to UK financial stability, and noted it was the view of the FPC that, apart from those related to Brexit, domestic risks remained at a standard level overall. The Chancellor welcomed the results of the Bank’s annual stress test and noted the important progress made by the UK’s banking sector to make it stronger, more resilient, and fit for the future.

<u>The Countercyclical capital buffer rate decision</u>

7. The Governor explained that, informed by the stress test results for losses on UK exposures, the FPC’s judgement that the domestic risk environment—apart from Brexit—is standard; and consistent with the FPC’s guidance in June; the FPC increased the UK countercyclical buffer rate from 0.5% to 1% with binding effect from 28 November 2018.

8. In addition, capital buffers for individual banks will be reviewed by the PRC in January. These will reflect the firm-specific results of the stress test, consistent with the judgements made by the FPC and PRC in September. The Governor noted that the setting of the CCyB and PRA buffers will not require banks to strengthen their capital positions. It will require them to incorporate some of the capital they currently hold in excess of their regulatory requirements into their regulatory capital buffers.

9. The Chancellor welcomed the action that the Financial Policy Committee was taking to maintain and enhance the resilience of the financial system.

Brexit – macroeconomic risks

10. The Governor noted there are also potential risks arising from the macroeconomic consequences of some possible Brexit outcomes. There are many possible combinations of risks that could result from a sudden exit from the European Union without a trade agreement. Consistent with its remit, the FPC is focused on scenarios that, even if the least likely to occur, could have the greatest impact on UK financial stability.

11. The 2017 stress test scenario encompasses the many possible combinations of macroeconomic risks and associated losses to banks that could arise in this event. As a result, the FPC judged that, given their current level of resilience, the UK banking system could continue to support the real economy through a disorderly Brexit.

12. The Governor noted, however, that the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in the stress test. In such circumstances, capital buffers would be drawn down substantially more than in the stress test and, as a result, banks would be more likely to restrict lending to the real economy.

13. The FPC would therefore reconsider the adequacy of a 1% UK countercyclical capital buffer rate during the first half of 2018, in light of the evolution of the overall risk environment.

Brexit – risks to the provision of financial services

14. The Governor noted that the FPC continues to assess the risk of disruption to financial services from Brexit, so that preparations can be made an action taken to mitigate them. Consistent with the Bank's statutory responsibilities, the FPC had published a checklist of steps that would promote financial stability in the UK in a no deal outcome.

15. The Governor summarised its four elements:

- First, ensuring that a UK legal and regulatory framework for financial services is in place at the point of leaving the EU.
- Second, recognising that it will be difficult, ahead of March 2019, for all financial institutions to have completed all the necessary steps to avoid disruption in some financial services. Timely agreement on an implementation period would significantly reduce such risks, which could materially disrupt the provision of financial services in Europe and the UK.
- Third, preserving the continuity of existing cross-border insurance and derivatives contracts would require UK and EU legislation. Otherwise, six million UK insurance policy holders with £20 billion of insurance coverage, and thirty million EU policy holders with £40 billion in

insurance coverage, could be left without effective cover; and around £26 trillion of derivatives contracts could be affected.

- Fourth, deciding on the authorisations of EEA banks that currently operate in the UK as branches will be important. Conditions for authorisation, particularly for systemic firms, will depend on the degree of cooperation between regulatory authorities. The PRA plans to set out its approach before the end of the year.

16. The Governor noted that, irrespective of the particular form of the United Kingdom's future relationship with the EU, the FPC would remain committed to the implementation of robust prudential standards. This will require maintaining a level of resilience that is at least as great as that currently planned and which itself exceeds that required by international baseline standards.

17. The Chancellor noted the FPC's assessment of the risks of disruption to financial services arising from Brexit. The Chancellor confirmed that HM Treasury was considering all options for mitigating risks to the continuity of outstanding cross-border financial services contracts. The Chancellor also emphasised that an integral part of the government delivering EU withdrawal would be the negotiation of a time-limited implementation period, to provide certainty and avoid a cliff-edge for businesses and individuals during the adjustment from the current structures of membership to the new relationship.

<u>The Biennial Exploratory Scenario</u>

18. The Governor noted that the FPC and PRC had examined the strategic responses of major UK banks to an extended low growth, low interest rate environment combined with increasing competitive pressures in retail banking from increased use of new financial technologies. FinTech is creating opportunities for consumers and businesses, and has the potential to increase the resilience and competitiveness of the UK financial system as a whole. In the process, however, it could also have profound consequences for the business models of incumbent banks. The exploratory exercise was designed to encourage banks to consider such strategic challenges.

19. The Governor explained that major UK banks believe they could, by reducing costs, adapt to such an environment without major changes to strategy or by taking more risk – but there were clear risks to this:

- Competitive pressures enabled by FinTech may cause a greater and faster disruption to banks' business models than they currently expect.
- The cost of maintaining and acquiring customers in a more competitive environment could reduce the scope for cost reductions or result in greater loss of market share.

- The future costs of equity for banks could be higher than the 8% level that banks expected in this scenario either because of higher economic uncertainty or greater perceived downside risks.

20. The Governor noted that supervisors will discuss the results of the exercise with banks, including the potential implications of these risks.

21. The Chancellor welcomed the Bank of England conducting its first Exploratory Scenario, and noted that it is another step in ensuring that the banking system is stronger, safer, and better placed to support the wider economy.

Annual review of risk and regulation beyond the core banking sector

22. The Governor concluded the meeting by noting that the FPC had completed an annual review of risk and regulation beyond the core banking sector. It did not recommend any changes to the regulatory perimeter at this stage. It had also undertaken an in-depth assessment of post-crisis reforms to derivatives transactions and judged that these reforms have improved the resilience of the financial system. The FPC has asked for an in-depth assessment of the use of leverage in the non-bank financial sector, focusing on leverage created through use of derivatives. Finally, the FPC had considered, and will continue to monitor, risks to the provision of market-based finance from the growth of electronic and algorithmic trading.