Publication date: 14/08/18

RECORD OF THE MEETING BETWEEN THE GOVERNOR OF THE BANK OF ENGLAND AND THE CHANCELLOR OF THE EXCHEQUER TO DISCUSS THE JUNE 2018 FINANCIAL STABILITY REPORT

4 July 2018

The following items were discussed at the meeting:

1. The FPC's latest assessment of financial stability risks and the UK countercyclical capital buffer rate decision;
2. Brexit;
3. Cyber risk; and
4. Libor.

<u>The FPC's latest assessment of financial stability risks and the UK countercyclical capital buffer rate 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 2018 Financial Stability Report (FSR).

2. Opening the discussion, the Governor explained that the FPC had judged that risks from the global environment were material and had increased in recent months. In particular:

- Increases in Italian government bond yields underlined vulnerabilities created by high levels of public debt and the interlinkages between banks and sovereigns in a currency union.
- Tightening conditions in US dollar funding markets were creating headwinds to growth and increasing risks in some emerging markets.
- Trade tensions had intensified. Debt levels in China remained highly elevated. And corporate leverage in the US had continued to increase.

3. These conditions could crystallise the longstanding risks of a snap back in interest rates and a tightening in global financial conditions, with negative spillovers to the UK.

4. The Governor then noted that the FPC continued to judge that, apart from those related to Brexit, domestic risks remain standard overall. In recent months there had been some reduction in domestic risk appetite, although it remained strong:

- Levels of household and corporate debt in the UK relative to incomes remained materially below their 2008 levels. Overall, private sector credit growth remained broadly in line with the growth in nominal GDP. In addition, debt-servicing burdens were low, and it would take a sharp increase in UK interest rates, without any corresponding rise in incomes, to return them to historic averages.

- In recent months, corporate bond spreads had increased and mortgage loan spreads had widened a little.

- Non-bank lending to riskier companies had been expanding rapidly. But lending by banks had been muted, limiting the increase in overall corporate leverage and the effect on banks' resilience.
- Although banks' risk appetite in mortgage lending had increased over the past few years, weak demand had kept mortgage credit growth modest. And the FPC's previous mortgage market measures had insured against a marked deterioration in lending standards.
- Consumer credit continued to expand rapidly. But the FPC acted in 2017 to ensure lenders are able to absorb severe losses on consumer credit, and there were recent signs of reduced availability of credit.

5. In this standard risk environment, the Governor noted that the FPC had maintained the UK countercyclical capital buffer (CCyB) rate at 1%. But the FPC remained alert to any increase in risks faced by the UK banking system. For example, financing conditions in debt markets, which remain accommodative, could promote further risk-taking in the UK and elsewhere. The UK was more vulnerable to a reduction in foreign investor appetite for UK assets, as the share of capital inflows vulnerable to refinancing risk has risen. And material global risks could spill over to the UK. The FPC would conduct as normal a comprehensive assessment of the resilience of the UK banking system in the 2018 stress test and review the adequacy of the 1% CCyB rate.

6. The Chancellor welcomed the publication of the FSR and the full assessment by the FPC of the risks to financial stability. He noted the FPC's judgement that risks from the global environment remained material and had increased, and that domestic risks remain standard overall. The Chancellor noted that given the FPC's judgement of the risk environment, the FPC had decided to maintain the CCyB at 1%.

Brexit

7. The Governor explained that the FPC continued to assess the risks of disruption to UK financial services arising from Brexit. It was acting in three principal ways to reduce the impact of these risks on UK households and businesses.

8. First, the FPC was ensuring that the UK banking system could continue to lend to UK households and businesses even in the event of a disorderly, cliff-edge Brexit, however unlikely that may be. The 2017 stress test had encompassed a wide range of UK macroeconomic outcomes that could be associated with Brexit, meaning that Brexit risks did not warrant additional capital buffers for UK banks.

9. Second, the FPC was continuing to monitor preparations to mitigate disruption to financial services that could arise from Brexit. The FPC judged that progress had been made but material risks remained:

- An implementation period had been agreed, subject to finalisation and ratification of the Withdrawal Agreement between the EU and the UK, elements of which were still in negotiation.
- The European Union (Withdrawal) Act had received Royal Assent.
- The UK Government had committed to legislate, if necessary, to put in place a temporary permissions regime to enable EU-based financial companies to continue to provide financial services to UK end-users. Once enacted, this will mitigate a number of risks of disruption to UK customers including those relating to insurance contracts.
- The biggest remaining risks were areas where action was needed by both UK and EU authorities, such as ensuring the continuity of the £96 trillion of existing derivative contracts (in both cleared and uncleared markets). The Governor noted that, based on the Bank's experience and knowledge of these markets, it will not be possible, ahead of March 2019, for private financial institutions on their own to mitigate fully the risks of disruption to financial services. As yet the EU had not indicated a solution analogous to a temporary permissions regime. The FPC had welcomed the establishment in April of a technical working group, chaired by the European Central Bank and Bank of England, on risk management in the area of financial services in the period around 30 March 2019.

10. Third, the FPC had reiterated that, irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibility, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international baseline standards.

11. The Chancellor noted the FPC's assessment of the risks of disruption to financial services arising from Brexit, and the actions the FPC is taking to reduce the impact of those risks.

Cyber risk

12. The Governor noted that the FPC had agreed to set standards for how quickly critical financial companies must be able to restore vital services following a cyber attack. Firms have primary responsibility for their ability to resist and recover from cyber attacks. But to guide firms in their planning, the FPC will set impact tolerances – specifically, the time after which a disruption of vital financial services could cause material economic impact. Firms will be expected to demonstrate their ability to meet the FPC's impact tolerances in 'severe but plausible' scenarios. The FPC will assess this via cyber stress tests, developed in coordination with other authorities, including the National Cyber Security Centre. If firms cannot demonstrate they are able to withstand these tests, remedial action plans will have to developed and agreed with supervisors. The Bank plans to launch a pilot of the approach to operational resilience in 2019, and will publish further details in 2018 Q4.

13. The Governor added that these tests build on the FPC's broader cyber strategy which includes regular penetration testing of the 30 largest firms, consistent supervisory follow up on the key findings of those tests, improved cyber governance within firms, new communications protocols and robust international coordination arrangements including through our leadership of the G7 Cyber Expert group.

14. The Chancellor welcomed the work that the FPC is undertaking to set standards for impact tolerances in the event of a cyber attack in financial services, and agreed that firms must have robust plans in place. The Chancellor noted the growing and evolving nature of cyber threats to the financial sector and the wider work being carried out under the National Cyber Security Strategy to defend the UK's people, businesses and assets.

Libor

15. The Governor noted that the continued reliance of financial markets on Libor poses a risk to financial stability that can be reduced only through a transition to alternative rates. Good progress had been made to establish potential alternatives to Libor - in the UK, SONIA (the sterling overnight index average) was the preferred alternative. Two important market‑led consultation exercises were due to be carried out soon that should – respectively – facilitate transition away from Libor for an important subset of end-users in sterling markets, and help coalesce views on the appropriate fallbacks for Libor. And the FCA had secured agreement of Libor panel banks to submit to Libor until end‑2021. However, as long as the outstanding stock of contracts maturing after 2021 that reference Libor continued to increase, so will associated medium‑term financial stability risks. The Governor noted that the FPC will monitor progress and report regularly.

16. The Chancellor noted the financial stability risks associated with financial markets continued reliance on Libor, and the progress made in establishing alternative rates. The Chancellor welcomed the FPC's commitment to monitor progress in the transition from Libor to alternative rates, and to report on this area on a regular basis.