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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 Financial Stability Report.

26 July 2019

The following items were discussed at the meeting:

- The resilience of the UK financial system to Brexit;
- Global risks;
- Vulnerabilities in open-ended funds;
- The transition away from Libor;
- Developments in payments; and
- Climate change.

1. The Governor opened the meeting by congratulating the Chancellor on his appointment to one of the highest offices of state at a critical time and said that he very much looked forward to working together with him.

2. The Chancellor thanked the Governor for his warm words and said that he anticipated a productive relationship with the Governor.

Near-term vulnerabilities

The resilience of the UK financial system to Brexit

3. Turning to the July 2019 *Financial Stability Report*, the Governor noted that the single most important determinant of the UK's economic outlook remained the nature and timing of Brexit. The perceived likelihood of a no-deal Brexit had increased since the start of 2019, and although the degree of preparedness of the UK economy for such a scenario had improved, material risks of economic disruption remained.

4. The FPC continued to judge that its 2018 stress test of major UK banks was sufficiently severe to encompass the wide range of UK economic and financial shocks that could be associated with Brexit. Major UK banks demonstrated their resilience to that stress scenario. Since the stress test they had maintained Tier 1 capital levels of around 17% of risk-weighted assets - more than three times higher than before the global financial crisis. The FPC therefore concluded that the UK banking system remained strong enough to continue to lend through the wide range of UK economic and financial shocks that could be associated with Brexit.

5. Most risks to UK financial stability from disruption to cross-border financial services in a no-deal Brexit had been mitigated. However, in the absence of further action by EU authorities, some disruption was still possible. The Governor explained that although such disruption would primarily

affect EU households and businesses, it could amplify volatility and spill back to the UK in ways that cannot be fully anticipated or mitigated.

6. The Governor explained that financial stability was not the same as market stability. In a disorderly Brexit, a range of UK asset prices would be expected to adjust sharply, tightening financial conditions for UK households and businesses. But if a major economic stress were to materialise, the FPC was prepared to cut the UK CCyB rate, as it did in July 2016. This could preserve banks' capacity to lend to UK households and businesses by around £250 billion.

7. Finally, the Governor noted that, irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

8. The Chancellor welcomed the vital work that the government and regulators have undertaken so far to secure the continued provision of finance to households and businesses in all Brexit scenarios, including the passage of legislation to ensure a UK legal and regulatory framework is in place when the UK leaves the EU. He noted the FPC's judgement in the Financial Stability Report that the core of the UK's financial system, including banks, dealers and insurance companies, is resilient to, and prepared for, the wide range of risks it could face, including a worst-case disorderly Brexit.

Global risks

9. The Governor explained that Brexit developments had been taking place against a backdrop of increasing risks to the global outlook. Global business confidence had been hit by the possibility that trade tensions become more pervasive, persistent and damaging. Financial markets were pricing in lower growth, with risk-free interest rates falling markedly and corporate earnings expectations declining sharply.

10. Were trade tensions to crystallise, the FPC judged that their impact on the global economy would be amplified by continued material underlying vulnerabilities. In particular:

- Credit growth in China continued to outpace nominal income growth and non-financial private sector debt was more than 200% of GDP.
- Some emerging market economies with large current account deficits or high levels of debt denominated in foreign currencies remained vulnerable to renewed capital outflows.
- US corporate debt was above pre-crisis levels as a share of GDP and the share of debt owed by highly leveraged US companies had reached pre-crisis levels.

11. Overall, the FPC judged that the core of the UK banking system remained resilient to these risks. Major UK banks had been subjected to a severe scenario for the global economy in the 2018

stress test, in which world GDP contracted by 2.4% over the first year. This was worse than the fall in the global financial crisis and significantly more severe than the Bank's estimated worst-case impact of a global trade war. Major UK banks showed they were resilient to that scenario.

12. Even if a protectionist-driven global slowdown were to spill over to the UK at the same time as a worst-case disorderly Brexit, the FPC judged that the core UK banking system would be strong enough to absorb, rather than amplify, the resulting economic shocks.

13. The Chancellor noted his concerns regarding the material underlying vulnerabilities present in the global economy. He welcomed the FPC's judgement that the core of the UK banking system remained resilient to these risks, along with the risks posed by a trade war.

<u>Medium and longer-term risks</u>

14. The Governor then updated the Chancellor on the key remaining risks in the *Financial Stability Report*.

<u>Vulnerabilities in open-ended funds</u>

15. Since 2008, market-based finance had accounted for all of the net increase in the debt finance of UK non-financial businesses. There were benefits from this diversification of funding sources; however there were also new risks.

16. For example, open-ended investment funds globally played an increasing and important role in the provision of finance. Many funds offered daily redemptions while investing in assets that can take weeks or months to sell in an orderly way. Under stress, open-ended funds may need to sell assets quickly, creating an incentive for investors to redeem when they expect others to do so.

17. This self-reinforcing dynamic could trigger a jump to suspension by the fund. And, more broadly, the ability of the market to absorb asset sales could be tested. The FPC therefore continued to judge that the mismatch between redemption terms and the liquidity of some funds' assets had the potential to become a systemic issue.

18. For several years, the FPC had highlighted this vulnerability. And evidence was growing that it went beyond any single market or fund type. The more important open- ended funds become, and the more illiquid their underlying investments are, the greater the potential risks to financial stability.

19. Because this is a global issue, the FPC supported the FSB's 2017 recommendation that funds' assets and investment strategies should be consistent with their redemption terms. However, subsequent work by the International Organization of Securities Commissions did not prescribe how this should be achieved and it left implementation to national authorities and funds themselves.

20. The Bank and the FCA would work together to assess how funds' redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks without compromising the supply of productive finance. The review would also assess the effectiveness of

measures that are already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions.

The transition away from Libor

21. The continued reliance of global financial markets on Libor posed risks to financial stability that could be reduced only through a transition to alternative benchmark rates by end-2021. The FPC had stated that there was no justification for firms continuing to increase their exposures to Libor. The pace of market participants' transition efforts now needed to accelerate and the FPC would monitor progress closely.

22. The smoothest transition will be one in which market participants: cease new issuance of Libor-linked contracts; identify all existing contracts without appropriate fallback clauses and rectify this to the greatest extent possible; and actively reduce legacy exposures by negotiating their transition to new rates.

23. Well-managed firms were expected to lead the transition. And all firms that responded to the PRA's and FCA's Dear CEO letter had now appointed a Senior Manager accountable for overseeing the transition.

24. The Chancellor noted the risks presented by the slow pace of the transition away from Libor and therefore the need for firms to accelerate transition efforts.

Developments in payments

25. Payments were currently a focal point for innovation. Consistent with its mandate, the FPC would aim to ensure that systemically important payment systems support financial stability, while allowing competition and innovation in payments to thrive.

26. The Governor explained that to do this, the FPC would:

- Assess developments in the scope and nature of regulation for payments and other innovative financial services to ensure the approach reflects their systemic importance.
- Assess risks to the UK financial system associated with the use of tokens and other assets used to facilitate new payment options and appropriate safeguards for their use to maintain financial stability and the supply of finance to the economy.
- Review the Bank's proposals on the appropriate level of access to its payments infrastructure and balance sheet in order to ensure that access supports fully the stability and resilience of the system while also allowing innovation in payments.

27. The Chancellor noted the Treasury-led review of the payments landscape – announced at Mansion House – which will bring together policymakers and regulators to make sure that our regulation and infrastructure keeps pace with new payment methods. The Chancellor looked forward to the FPC's input into this review.

Climate change

28. The move to a carbon-neutral economy, with the associated changes in policies, technologies and physical risks, would prompt a reassessment of the value of a large range of assets. It was therefore important that the financial system can do its part to support a smooth transition to a carbon-neutral economy.

29. To that end, in the 2021 biennial exploratory scenario, the Bank will stress test the UK financial system's resilience to the physical and transition risks of climate change. This exercise will be the first of its kind to integrate climate scenarios with macroeconomic and financial system models. It will motivate firms to address data gaps and to develop cutting-edge risk management consistent with a range of possible climate pathways: ranging from early and orderly to late and disruptive.

30. The Bank would publish a discussion paper this autumn, well in advance of the exercise, to gather views on its design from risk specialists from across the financial sector, industry experts and other informed stakeholders.

31. The Chancellor welcomed the Bank's announcement of a climate change scenario for the 2021 biennial exploratory scenario. The Chancellor also highlighted the recent publication of the Government's Green Finance Strategy, which outlines how the Government will drive the greening of the global financial system, as well as help to mobilise private sector finance to meet our environmental objectives, and support industry in capturing the risks and opportunities arising from climate change. The initiatives covered in the Green Finance Strategy, along with those undertaken by the Bank, are important for helping the Government achieve it climate emissions target.