Record of the meeting between the Governor of the Bank of England and the Chancellor of the Exchequer to discuss the December Financial Stability Report.
19 December 2019

The following items were discussed at the meeting:

- The resilience of banks to domestic and global shocks
- The resilience of the UK financial system to Brexit
- Bank capital requirements
- Review of FPC mortgage market Recommendations
- The transition away from Libor
- Vulnerabilities in open-ended funds
- Developments in payments

Near-Term Risks

The resilience of banks to domestic and global shocks

1. The 2019 stress test showed the UK banking system was resilient to an unprecedented combination of simultaneous recessions in the UK and global economies, more severe than those during the global financial crisis, large falls in asset prices, and a separate stress of misconduct costs. All seven major banks and building societies that were subjected to the test could not only withstand these extreme shocks but also continue to meet the demands for credit from UK households and businesses. In part, that was because their capital ratios were over three times higher than they were at the start of the global financial crisis. Even after stress, their capital ratios would still be more than twice their pre-crisis levels.

2. Banks' resilience in the test relies in part on their ability to cut dividend payments, reduce employee variable remuneration, and cease coupon payments on additional Tier 1 instruments. If banks had not cut such distributions during the stress they would not, in aggregate, have met the 2019 ACS hurdle rate. This demonstrated the flexibility of the system but it also underscored that investors should be aware that banks would make such cuts as necessary if a stress were to materialise.

3. Acknowledging the results of the 2019 stress test, the Chancellor welcomed the judgement of the FPC that the UK banking system was resilient to simultaneous recessions in the UK and global economies, more severe than those during the global financial crisis, large falls in asset prices, and a separate stress of misconduct costs. The Chancellor noted the need for investors to appreciate the actions that banks would need to undertake in a severe stress.

The resilience of the UK financial system to Brexit

4. The FPC's job is to focus on, and prepare for, worst-case downside risks, including those that could be associated with disorderly forms of Brexit, however unlikely. The FPC continued to judge that the financial system was ready for Brexit, whatever form it takes. Reflecting extensive preparations made by authorities and the private sector, most risks to UK financial stability that could arise from disruption to cross-border financial services in a no-deal Brexit had been mitigated. In particular, the FPC welcomed the European

Commission's decision to extend the temporary equivalence arrangements relating to UK central counterparties (CCPs).

5. The Chancellor noted the FPC's judgement that the financial system is ready for Brexit, and highlighted the importance of the work undertaken by the UK authorities and financial services firms to prepare for a no deal exit. He also welcomed the European Commission's decision to extend temporary equivalence arrangements for UK CCPs.

Structural actions to improve resilience and increase productive finance

Bank capital requirements

6. Stepping back from current risks, the FPC, together with the PRC and the Bank, had reviewed the structural level and balance of capital requirements for the UK banking system to increase its **resilience**, **responsiveness** to economic conditions and **resolvability**. As a result:

- The FPC raised the level of the UK countercyclical capital buffer (CCyB) rate that it expected to set in a standard risk environment from the region of 1% to the region of 2%.
- The FPC judged the 2% UK CCyB rate to be appropriate for the standard risk environment prevailing at the time. The new 2% rate would take effect on 16 December 2020.
- Reflecting the additional resilience associated with higher macroprudential buffers, the Prudential Regulation Authority (PRA) would consult in 2020 on proposals to reduce minimum capital requirements in a way that would leave overall loss absorbing capacity in the banking system broadly unchanged.
- The Bank also clarified that, in the event of a bank resolution, it expected all debt that is bailed in to be written down or converted to the highest quality of capital, Common Equity Tier 1 (CET1).

7. These changes increase **resilience** by shifting the balance of loss absorbing capacity towards higher quality Tier 1 capital while leaving the overall loss absorbing capacity for the banking system broadly unaffected. Tier 1 capital requirements for major UK banks would remain in line with the benchmark level first set by the FPC in 2015 of 14% of risk-weighted assets. That benchmark balanced the need for banks to be able to keep lending through downturns with the need for them to provide the finance to support growth over the medium term.

8. These changes would also improve the **responsiveness** of capital requirements to economic conditions by shifting the balance of capital requirements from minimum requirements that must be met at all times towards buffers that can be drawn down as needed. For example, if the UK CCyB rate were cut from 2% to 0%, this would enable banks to absorb up to £23bn of losses, preserving up to £500 billion of banks' capacity to lend to UK households and businesses. A higher setting of the UK countercyclical buffer in standard conditions would also allow the FPC to pursue a gradual approach to raising the buffer as risks increase.

9. These changes enhance the **resolvability** of failing banks via the Bank of England's intention to write down or convert debt to CET1 capital. This would make banks more

resilient to future losses, supporting their resolution and minimising the wider economic costs of their failure.

10. The Chancellor acknowledged the FPC's decision to increase the UK CCyB rate that it expects to set in a standard risk environment from the region of 1% to the region of 2%. He noted the FPC's expectation that this would increase resilience, improve the responsiveness of capital requirements to economic conditions, and enhance the resolvability of failing banks.

Review of FPC mortgage market Recommendations

11. The FPC has reviewed its mortgage market Recommendations: a 15% limit on the amount of new mortgage lending at or above 4.5 times the borrower's income; and its recommendation that lenders assess whether borrowers could meet their mortgage payments if interest rates rose by 3 percentage points.

12. Mortgages were the largest financial liability of households and the largest loan exposure of lenders. In the past, as an economic expansion had progressed, lenders' underwriting standards had often shifted from responsible to reckless, leading to a significant increase in highly indebted households. As a consequence, these households were likely to face greater difficulties and could cut back more sharply on spending to make their mortgage payments. This deepened the recession and worsened the impact on the wider economy.

13. The FPC's tools maintained financial stability and supported economic growth through the cycle, providing benefits that substantially outweighed the macroeconomic costs. Alternatives to achieve similar benefits would be much more costly to the wider economy. For example, without the FPC's insurance policies, monetary policy would have to be tightened significantly to address the financial stability risks of deteriorating underwriting standards and rapid credit growth. This would reduce jobs and growth across the economy. Alternatively, in the face of looser underwriting standards, banks would be required to have materially higher levels of capital. This would raise the cost of credit for everyone. The FPC had therefore judged it appropriate to maintain both Recommendations. The FPC expected these structural measures should remain in place through the housing cycle.

14. The Chancellor welcomed the FPC's review of its mortgage market Recommendations and noted the conclusion that the structural tools will support economic growth through the cycle.

The transition away from Libor

15. Continued reliance of financial markets on Libor posed risks to financial stability that could only be reduced through a transition to alternative risk-free rates. Accordingly, the intention was that sterling Libor would cease to exist after the end of 2021. No firm should plan otherwise.

16. There were encouraging signs in sterling markets. The FPC endorsed the UK industry working group's target to cease new issuance of cash products linked to sterling Libor by Q3 2020. And the FPC agreed with the PRA and FCA that the largest regulated firms with material Libor exposure should have a senior manager responsible for transition.

17. But gaps remained and efforts would need to accelerate in the first half of 2020. To that end:

- The Bank of England was reviewing its risk management approach to Libor-linked collateral delivered in its Sterling Monetary Framework.
- The FPC was considering further potential supervisory tools that could be deployed by authorities to encourage the reduction in the stock of legacy Libor contracts to an irreducible minimum ahead of end-2021, and would keep them under review in light of progress made by firms in the transition.

18. The Chancellor welcomed the progress in sterling markets to transition away from LIBOR and noted the need for firms to accelerate LIBOR transition in 2020.

Innovation and productive finance

Vulnerabilities in open-ended funds

19. The mismatch between redemption terms and the liquidity of some funds' assets meant there was an advantage to investors who redeem ahead of others, particularly in a stress. This had the potential to become a systemic risk as first mover advantage could prompt a de-stabilising rush to the exits.

20. As part of the ongoing review of open-ended funds by the Bank and FCA, the FPC had established that there should be greater consistency between the liquidity of a fund's assets and its redemption terms. Specifically:

- The liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a vertical slice of those assets or the time period needed for a sale to avoid a material price discount.
- Investors who redeem should receive a price for their units that reflects the discount needed to sell the required proportion of a fund's assets in the specified redemption notice period; and
- Redemption notice periods should reflect the time needed to sell the required proportion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

21. In addition to enhancing financial stability, these changes were expected to promote the overall supply of productive finance to the economy through business and financial cycles. They would both enhance the ability of funds to invest in illiquid investments, and increase investment in funds with longer redemption terms.

22. The Chancellor welcomed the joint nature of the Review. He noted the FPC's view on the importance of the closer alignment of redemption terms and the liquidity of the funds' assets in enhancing UK financial stability and in promoting greater supply of productive finance.

Developments in payments

23. Innovation in payments could bring significant benefits for users, including lower costs and faster processing times. At the same time, the ability to transact safely and smoothly was critical to financial stability. The FPC considered that the current payments

framework would need to be adjusted to accommodate such innovation along the following principles:

- Regulation of payments should reflect the financial stability risk, rather than the legal form, of payments activities.
- The systemic importance of any single firm should be informed by whether its failure could disrupt one or more end-to-end systemic payment chains
- All firms above a certain threshold carrying out the activities that make up the payment chain should provide sufficient information to support the identification of systemically important payments firms as they emerge.

24. Stablecoin-based payment chains, such as Libra, posed additional issues for regulation. He added that payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Where stablecoins are used in systemic payment chains as money-like instruments they should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

25. The Chancellor noted the FPC's views on the principles for the payments framework and the issues posed by stablecoin-based payments and noted these issues will be considered in the Treasury's Payments Landscape Review and the Cryptoassets Taskforce.