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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETINGS

17 AND 25 JUNE 2014

This is the record of the Financial Policy Committee meetings held on 17 and 25 June 2014.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1407.pdf

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is established as a sub-committee of the Bank of England's Court of Directors.

The FPC will next meet on 26 September and the record of that meeting will be published on 10 October.

RECORD OF FINANCIAL POLICY COMMITTEE MEETINGS HELD ON 17 AND 25 JUNE 2014

At its meetings on 17 and 25 June 2014, the Financial Policy Committee agreed two recommendations and set the countercyclical capital buffer rate:

1. **When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).**

2. **The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable.**

3. **The FPC set the countercyclical capital buffer rate for UK exposures at 0%.**

The Committee met on 17 June to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. It then met subsequently on 25 June to agree formally the housing policy recommendations, in light of views from the PRA Board and the FCA.

The macroeconomic and financial environment

1. The Committee reviewed financial system and economic developments since its previous meeting, as set out in the June 2014 *Financial Stability Report* and summarised below.

2. The recovery in advanced economies had continued, particularly in the United Kingdom. Despite heightened geopolitical and event risks, according to the Bank's latest Systemic Risk Survey of risk managers at major financial firms, perceptions of tail risks - such as from a euro-area break-up - had decreased: concerns around tail risks were at their lowest levels since the financial crisis.

3. This was against the backdrop of advanced-country central banks generally maintaining highly accommodative monetary policies. Implied and realised volatility in financial markets had been at historically low levels across a range of assets. While growth in emerging economies had generally slowed, there had been an improvement in market sentiment towards a number of countries that had experienced heightened volatility last summer.

4. The Committee noted that higher levels of bank regulatory capital, including in the case of UK banks as a result of steps taken in response to the FPC's March 2013 capital recommendations, had led to an improvement in global banking system resilience.

5. But the Committee judged that financial stability risks remained, including from market participants potentially underestimating risks that could arise either as monetary policy in advanced economies returned to more normal settings or from the materialisation of tail-risk events, to which financial markets were now attaching an unusually low probability. The latter would likely result in more pronounced adjustments in asset prices and volatility than the former. Members discussed a range of event risks, including the forthcoming Scottish referendum,[1] and geopolitical risks. Conditions in the UK housing market were also a concern, as outlined below.

[1] This reference to the Scottish referendum was omitted from the version of the Record that was initially published on 1 July 2014. The Committee agreed at its September 2014 meeting to release this text.

6. In discussing increased signs of an excessive search for yield, members distinguished between potential underpricing in liquidity risk premia and credit risk premia. Some members judged, for example, that although corporate bond spreads had narrowed, particularly for higher yielding assets, they did not necessarily look tighter than might be warranted from a credit risk perspective if economic and monetary conditions evolved as anticipated in markets. But liquidity premia did look tight. Investors appeared to be expecting lower compensation for bearing the risk of secondary market illiquidity; this risk might be accentuated by a potential structural decline in market liquidity stemming from reduced incentives for banks and broker dealers to make markets. Some asset managers appeared to be operating on the basis that they could sell assets quickly in the event of possible redemptions – a strategy which, if pursued simultaneously by many funds, could amplify increases in risk premia and volatility.

7. The Committee had already planned to consider the resilience of market liquidity in more detail as part of its medium-term priority on supporting diverse and resilient market-based finance. In addition, as part of monitoring the search for yield, it would look in more detail at underwriting standards in leveraged lending markets, given recent market intelligence that these had continued to weaken.

The UK housing market

8. The Committee had been closely monitoring conditions in the housing market for some time. The potential for risks to financial stability stemmed from mortgage lending being the largest single asset class on major UK banks' balance sheets and mortgage borrowing accounting for the largest share of household debt.

9. The Committee discussed recent developments, as set out in detail in the June 2014 *Financial Stability Report*. It noted the strong recovery in the housing market over the past year, with members observing that recent falls in mortgage approvals and housing transactions most probably reflected a shortage in residential properties coming onto the market, and delays associated with operational requirements from the introduction of the Mortgage Market Review (MMR), rather than a weakening in demand. Committee members highlighted: sustained increases in the share of mortgages extended at high loan to income (LTI) multiples; a more modest increase in new lending at higher loan to value (LTV) multiples against a backdrop of a broader increase in the number of high LTV products on the market; pronounced house price rises

in London and signs of a broadening to other parts of the United Kingdom; and that overall house prices were growing well in excess of earnings.

10. The Committee also noted the persistent gap between the rate of house building and the growth in demand, as proxied by estimates of desired household formation rates. Most members pointed to this gap as an underlying driver of the rate of UK house price inflation relative to earnings. One member noted that a shortage of housing stock had not been the main cause for increases in house prices in some other countries that had fewer supply constraints than the United Kingdom: there were examples where increases in house prices had been associated more closely with increases in demand from a relaxation in underwriting standards and an increase in the supply of credit.

Risks

11. Against this backdrop, the Committee considered current direct and indirect risks to financial stability stemming from the housing market. Under its primary objective, the FPC was required to '*remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system*'; legislation defined one source of systemic risk as '*unsustainable levels of leverage, debt or credit growth*'. Subject to achieving that objective, the FPC was also required to support the Government's economic policy of '*strong, sustainable and balanced growth*'.

12. Looking at previous episodes of housing market distress, some members felt that there had been limited evidence of UK banks sustaining severe, direct losses from mortgage lending. Others put more weight on evidence from overseas, where losses for banks had been more marked. The Committee agreed that direct risks to UK banks' capital from mortgage lending, and related exposures, would be best assessed through the stress testing exercise that was underway. The Committee had included a severe housing market shock as part of the stress scenario in order to help make that assessment.

13. Given the recent sustained increases in the share of mortgages extended at high LTI multiples, and the possibility of greater increases in the share in the future, the Committee discussed the potential indirect risks to financial stability from UK household indebtedness. It noted international evidence which suggested a strong link between rapid and widespread increases in household debt and financial crises. In the United Kingdom highly-indebted individuals had had to adjust spending more sharply during the recession than other households.

These studies were supported by survey evidence on the likelihood that some households would have to take some kind of action, such as curtailing significantly their spending or seeking to earn more, if interest rates were to rise sharply. The likelihood that households would need to respond in this way, leading to instability in spending and demand which could in turn threaten financial stability, was materially greater for highly-indebted households subject to adverse shocks to incomes or interest rates. Further, highly-indebted households were more likely to fall into arrears and trigger a risk of default on required mortgage payments – creating a direct risk of losses for banks.

14. Given this and current conditions, the Committee considered the possible future path of the share of mortgages extended at higher LTI multiples. The MPC had outlined that forward-looking surveys suggested that recent rates of house price increases would continue in the near term. But looking further ahead, the MPC's central view was that house price inflation would fall back to rise broadly in line with nominal incomes. The FPC estimated that, under such a central scenario, the share of lending at LTI multiples above 4.5 times income would increase from around 10% to 15%. Over the next few years there was also a risk that housing activity could grow more rapidly, and that house prices could increase faster relative to earnings than expected. In that case, the proportion of lending at higher LTI multiples was likely to increase sharply.

15. The Committee looked at debt service ratios (DSRs) – the share of income required to meet monthly mortgage payments – as an alternative indicator of the potential difficulties that borrowers might face in meeting their mortgage obligations. Although DSRs had remained relatively low owing to current low interest rates, they would rise sharply if mortgage rates were to rise significantly. The Committee considered evidence that suggested that in the stable economic period preceding the financial crisis, UK households with gross DSRs in excess of around 40% were more likely to experience payment difficulties. In more volatile periods, such as the early 1990s, payment difficulties had arisen at much lower DSRs. As an approximate guide, at a mortgage rate of 7%, DSRs in the range of 35-40% are roughly equivalent to LTI ratios of around 4.25 – 4.75 for a 25 year mortgage.

16. Taking this evidence together, the Committee assessed that there was the potential for a large adverse impact on aggregate demand from household indebtedness, with this risk more marked in relation to borrowers with higher levels of indebtedness. The Committee judged that the size of that impact on aggregate demand was sufficient to warrant intervening now in the mortgage market, given current conditions and the potential upside risks to the FPC's central view

of the possible future path of the share of mortgages extended at high LTI multiples and hence to overall indebtedness. It therefore discussed possible instruments to insure against these risks.

Policy considerations

17. The Committee started by considering the affordability tests introduced in the FCA's recent Mortgage Market Review (MMR). Under the MMR's affordability test requirement, lenders were required to assess the ability of borrowers to meet their mortgage payments over a five-year period, not just at current mortgage rates but also with reference to expected future rates based on market expectations. Following an earlier FPC recommendation, in May the FCA had amended its MMR rules so that lenders were also required to have regard to FPC guidance on the appropriate interest rate stress to use in assessing affordability.

18. In response to the MMR, many lenders had already been using a stressed interest rate assumption of around 7% in their affordability tests for mortgages, compared with current standard variable mortgage rates of around 4-4.5% for most major lenders. This implied a 'stress' of 2½ to 3 percentage points, which compared to an increase implied by current market expectations of around 2¼ percentage points.

19. The Committee considered that this level of stress seemed prudent, and that it was desirable to prevent any relaxation in the stress level used by most lenders and to ensure that the same level was applied by all institutions. It therefore decided to give guidance on the appropriate stress test to use in assessing affordability.

Recommendation 1

20. **When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).**[2]

21. The Committee was clear that in making this recommendation it was not expressing any view on the likely rise in Bank Rate; rather, it represented a prudent stress test. It judged that the

[2] The Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) 11.6.18(2) states that in coming to a view as to likely future interest rates, a mortgage lender must have regard to market expectations and any prevailing FPC recommendation on appropriate interest rate stress tests.

incremental impact of this guidance on mortgage lending would be relatively small, given that it was broadly in line with current market practice – though it would probably represent a modest tightening for some lenders.

22. Mr Wheatley confirmed that the FCA would monitor how firms have regard to this recommendation as part of its regular monitoring of lenders' implementation of the MMR requirements.

23. The Committee noted that its recommendation might create an incentive for more borrowers to seek 5-year or longer fixed rate mortgages: because the MMR stress test only assessed affordability in relation to mortgage interest rates prevailing over the first 5 years of a new contract, 5-year or longer fixed rate mortgages were, in effect, excluded from it. Some members thought this could be a positive development for financial stability, as households would not face increases in their payment terms over that period, even if Bank Rate were to increase. Others thought that the impact, if this shift were to occur, was unclear as it would depend on interest rates at the end of the 5-year term fixed rate period and the ability of borrowers to service their loans at that point. One member noted that banks would hedge back to floating rate their exposures to 5-year fixed rates; so if any shift to 5-year fixed rate mortgages were large enough, this hedging could affect the yield curve and mortgage pricing.

24. The Committee agreed that if the strength of increases in house prices relative to earnings and in activity over the past year were to moderate, consistent with the MPC's central view, then the flow of mortgage lending would likely lead only to a modest increase in household indebtedness and in the concentration of highly indebted borrowers. But should underlying momentum in the housing market be greater than expected and underwriting standards loosen, then there would be a risk that the proportion of lending at high LTIs would pick up markedly, posing a threat to household resilience and financial stability.

25. Robust affordability tests as part of the MMR could discourage an increase of borrowers with very highly elevated levels of indebtedness. Recently there had been an increase in the proportion of new loans being extended at high income multiples, but which would still be permissible under the MMR rules. While lenders would expect that these borrowers would be likely to be able to continue servicing their mortgages as interest rates rose, payments would become an increasingly large proportion of their income. That could make these borrowers, and the economy as a whole, more vulnerable to adverse shocks.

26. The Committee's primary interest was to ensure that the proportion of very high LTI lending did not become excessive in aggregate. The Committee therefore judged that, while initial indications showed that the MMR would be effective in underpinning current market practices and underwriting standards, from a macroprudential perspective it would be prudent to take action now to insure against the risk of a further significant increase in the proportion of lending extended at very high LTI multiples.

27. In considering how to design such a policy, the Committee was mindful that high LTI mortgages could be appropriate for some individuals: it wanted therefore to limit the proportion of these mortgages in the flow of new lending rather than set an outright cap. Some members noted the example of younger borrowers who may have greater prospects for relatively rapid increases in income, which would mean that their effective LTI would reduce quickly in the early years of the mortgage. A limit on the proportion would provide flexibility such that some borrowers could still access high LTI mortgages but protect against the risk to the system if too great a proportion of lending was done at those levels.

28. Therefore the policy should have two elements – a threshold for LTIs above which a limit would be set, and a limit on the share of mortgages that lenders would be able to extend above that threshold.

29. Some members started from the perspective that it would make sense to set the threshold at a very high LTI multiple and combine that with a relatively tight limit on the amount of mortgage lending that could be done above that threshold. That formulation would restrict the share of lending done at very high LTIs to a small proportion.

30. Others thought the policy could be set at a lower LTI multiple with a greater proportion of lending able to be done above that threshold. That would be appropriate given that the potential adverse impact on aggregate demand outlined earlier could still occur if there was a mass of borrowers entering into mortgages with LTI multiples just below the high threshold. To the extent that there was a risk that the market might see whatever threshold chosen as one that the Committee 'endorsed' as sound from an underwriting perspective, there was also a benefit in choosing a lower threshold.

31. On balance, the Committee agreed that it would set the policy by restricting the flow of lending at very high LTIs. An LTI threshold of 4.25 to 4.75 times, at mortgage interest rates of 7% (which were consistent with Recommendation 1), would be equivalent to a DSR of 35% to 40%; at this level, as outlined earlier, there was evidence that borrowers had been more likely to experience payment difficulties and cut their consumption materially in the face of adverse shocks. Consistent with its aim to insure against upside risks, the Committee judged that the share of lending permitted above this threshold should be calibrated so that it would not have an impact if the MPC's central view of the path for house prices and transactions – and consequent mortgage lending - materialised.

32. The Committee discussed the pros and cons of setting the share limit based on the volume or value of mortgages that banks could extend beyond the LTI threshold. On the one hand, limiting the volume of mortgages extended above the threshold would act directly to limit the proportion of households that could become highly indebted from mortgage borrowing. On the other hand, a values measure would help to capture the fact that any drop in non-mortgage spending in the event of mortgage distress by a high-income household might have a greater impact on aggregate consumption.

33. The Committee recognised that neither measure was ideal in isolation, but that having a dual limit would be complicated. Members therefore agreed to set the policy as limiting the volume of mortgages above the threshold and to ask the PRA in parallel to monitor values of mortgages extended above the threshold.

34. The Committee also agreed that, with a view to proportionality, it would be appropriate to set a *de minimis* threshold for the lenders that would be affected by the policy. It agreed on that basis to exclude mortgage lenders who lent less than £100 million per annum. Based on recent data, a threshold of £100 million would capture nearly 99% of gross lending, but exempt around 75 institutions which were currently active in the mortgage market. The PRA and FCA would monitor activity by the lenders below this threshold.

Recommendation 2

35. **The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential**

mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable.

36. Most lenders were currently lending within this limit, and were expected to continue to do so, based on developments in the housing market implied by the MPC's central view. As such, this action was designed specifically as insurance against the risk that there could be greater momentum in the housing market than currently anticipated and that, as a result, lenders would face growing demand for loans at very high LTIs. The Committee judged that implementation of this recommendation was unlikely to change the prospect that house prices would continue to rise more quickly than earnings over the coming year – indeed it was not the role of the FPC to seek to control house prices, or to tackle the underlying mismatches between housing supply and demand in the United Kingdom. Rather, the role of the FPC was to guard against risks to financial stability emanating from the housing market. The Committee agreed to set out its impact assessment in the *Financial Stability Report*, which would include its assessment that the policies would not impact materially on GDP. In addition to considering the proportionality of its actions, the Committee considered its other legal obligations. The Committee concluded that its recommendations would not prejudice the advancement by the PRA of its objectives or the FCA of its operational objectives, and did not affect the United Kingdom's international obligations.

37. The Committee judged that it was acting early, in a graduated and proportionate way, to reduce the risk that more severe action would be needed at some point in the future. Further, in choosing where to set the limit, the Committee had taken account of the fact that there was inevitable uncertainty about the effect of such macroprudential tools. The policy would be kept under review and would be adjusted if needed as circumstances changed. The Committee would continue to monitor conditions in the housing market closely.

38. The Committee considered the need to monitor mortgage lending activity beyond the scope of the recommendation to ensure that financial stability risks did not shift to other lending institutions or forms of lending. This included close monitoring of the buy-to-let market, which would not be directly affected by this recommendation but where there was scope for financial stability risks to arise from increases in borrower indebtedness. The FPC with the FCA and PRA would monitor developments in this market.

39. The Committee also discussed how this package of macroprudential measures could be considered to interact with monetary policy. They were intended to act as a complement to

monetary policy by insuring against risks arising in specific sectors and therefore seeking to make the central projection in the MPC's forecast more likely. By acting cautiously, it reduced the risk that the measures would have a greater than expected dampening impact on the housing market, and the economic expansion more generally. This was particularly relevant at a time when interest rates were close to the zero bound.

40. Members judged that there would be material benefits of this policy taking effect from the day of announcement. It would avoid the possibility of borrowers and lenders seeking to take advantage of any interim period before implementation to arrange higher LTI mortgages, thereby exacerbating the risk that the FPC was seeking to avoid. This had been a lesson from international experience with similar instruments.

41. It therefore decided to seek the views of the PRA and the FCA prior to announcement. Ahead of the Committee's meeting on 25 June, the PRA Board indicated that, were the FPC to make such a recommendation, it would make it clear to firms that they should have regard to the proposed measures in the way in which they conducted their business prior to any rule changes coming into effect following a consultation. The Consultation Paper would include details of how the PRA intended to implement any rule change – for example, how the flow of mortgages would be measured and over what time period. Mr Wheatley noted that, because of the *de minimis* threshold, only a small number of firms regulated only by the FCA would come into scope of the LTI recommendation. On that basis the FCA would plan to adopt the recommendation for affected firms via general guidance rather than via a rule change and would consult on that basis shortly.

42. In addition, Mr Roxburgh informed the Committee that, as indicated in the Chancellor's Mansion House speech, HM Treasury intended to announce, following the publication of the FPC's recommendations, that no new loans at or above 4.5 times borrowers' income could be included in the Help to Buy mortgage guarantee scheme; the Committee welcomed this development.

Setting the countercyclical capital buffer

43. With effect from May 2014, the FPC had been made responsible by the Government for setting the countercyclical capital buffer (CCB) in the United Kingdom each quarter. At its June

meeting it therefore discussed the appropriate setting for the first time, in light of its views on the outlook for financial stability and its other policy actions.

44. The FPC had previously outlined, as required in legislation, the general approach it proposed to follow in setting the CCB in its Policy Statement published in January 2014. In line with that and requirements in the legislation, the Committee started by looking at the 'buffer guide' - a simple metric identified in Basel III and EU legislation, which provides a guide for the CCB rate based on the gap between the ratio of credit to GDP and its long-term trend. The gap was strongly negative and a number of members noted that it was likely to remain negative for some years.

45. But members noted that there were still risks that could prompt use of the CCB, despite the low level of the buffer guide metric. In its discussion, the Committee emphasised, as it had done in the Policy Statement, that there should be no simple, mechanistic link between the buffer guide and its decisions. It would look beyond the guide at a wider set of core indicators, other relevant economic and financial data, supervisory and market intelligence and, where available, information from stress tests, to judge where to set the CCB rate. When considering where to set the buffer, it would also take account of its other policies, for example the policy decisions it had taken at the present meeting in relation to the housing market.

46. The information that the Committee considered would be set out in Section 5 of the June *Financial Stability Report*. In summary, the Committee discussed the high level of aggregate debt in the United Kingdom, with household and corporate debt levels relative to income remaining elevated. This was in contrast to the negative credit gap on account of weak credit growth in the non-financial private sector as a whole since the peak of the crisis. Some of the FPC's core indicators pointed to an easing in terms and conditions in markets, with some signs of increased risk taking – and as outlined earlier, insights from market intelligence and non-price data provided evidence of an increasing search for yield in some financial markets. On these measures alone, there were signs that some aspects of the financial system might be vulnerable to shocks.

47. However, looking at its core indicators on bank balance sheet strength, the Committee noted that most indicators had improved recently. Levels of resilience were markedly higher than before the crisis, though further improvements were still required as part of the regulatory shift to make the system safer and would be considered as part of stress testing exercises. The 2014 stress

test, which would include shocks to interest rates and the housing market, should help to identify any weaknesses in UK banks' capital resilience.

48. **In light of these considerations, the Committee agreed at its June meeting to set the CCB rate for UK exposures at 0%**. It also agreed to consider later in the year its detailed approach for responding to reciprocal CCB requests from other countries; as outlined in the Policy Statement, it expected to cooperate closely with overseas regulators.

Financial stability risk and regulation beyond the core banking sector

49. The Committee had set out in its response to the remit and recommendations from the Chancellor in 2013 that it would receive regular briefing on the relevant risks to financial stability arising from less regulated sectors and activities. It would also hold, at least annually, a discussion on the appropriate boundaries around, and within, the regulatory perimeter. This recognised that the FPC had a statutory power to make recommendations to HM Treasury relating to the boundaries between and within regulated activities and products.

50. **Based on analysis and discussion at the first of these discussions, the FPC judged that it did not at present see a case for recommending changes to the regulatory framework**, but would return to the issue on an annual basis, or sooner if risks were identified. The analysis underpinning this judgement would be set out in the June 2014 *Financial Stability Report*.

51. In reaching this judgement, it had considered international initiatives to reform and enhance understanding of the non-bank financial system, and noted work in train to reduce data gaps that acted as an impediment to a full assessment of risks. In addition, the Committee requested work to be done on possible systemic risks arising from the growth in asset management, as part of its medium-term priority on supporting diverse and resilient market-based finance. A number of members had noted that it was unclear how the distress of a large hedge fund might transmit through the financial system. Part of the risk here was linked to the depth of market liquidity – again, this would be looked at as part of the medium-term priority on market-based finance.

Leverage review

52. The FPC had published on 27 March 2014 the terms of reference for the leverage ratio review that the Chancellor had asked the FPC to undertake. It expected to publish the review by November 2014.

53. The Committee had been working with Bank staff to produce a Consultation Paper as part of this review to gather views on design features of a leverage ratio framework in the United Kingdom. This consultation paper would be published in the summer. The Committee agreed that topics that would be covered in the Consultation Paper would include:

- The case for setting a leverage ratio in the United Kingdom in parallel to discussions on the possible introduction of an international standard;

- The role of a leverage ratio and its relation to the risk-weighted and stress testing frameworks;

- The quality of capital required to meet a leverage requirement. The Committee was keen to ensure that capital would be fully loss absorbing;

- The scope of firms over which a leverage ratio could be applied, including as part of possible transitional arrangements;

- The arguments for and against proportionate movements of any leverage requirements with risk-weighted requirements;

- The impact of a leverage ratio on different business models, in particular for those firms with high concentrations in low risk-weighted assets;

- The allocation of responsibilities amongst the authorities for different parts of a leverage ratio, including whether the FPC should have the power of direction over the leverage ratio;

- The possible macroeconomic impact of leverage requirements, notwithstanding that the FPC had agreed in March that the numerical level of leverage requirements would be out of scope of this review given the timetable of relevant international initiatives.

Existing recommendations

54. The Committee reviewed the progress made on its existing recommendations since its previous review, with a focus on the outstanding recommendations on capital adequacy made in March 2013. Details would be included in Section 4 of the June 2014 *Financial Stability Report*.

55. <u>Contingency planning (11/Q3/4):</u> In September 2011, *the Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.*

56. At the time of making this recommendation, the interim Committee had been concerned that conditions in Europe could deteriorate rapidly, with the potential to impact across global financial markets. Against that backdrop, it thought that HM Treasury should prepare for a full range of eventualities; in some especially severe scenarios, far-reaching solutions might be required and some members felt that these should extend to the potential write-down of some private sector holdings of bank debt.

57. The Committee had received updates on this contingency planning work during the rest of 2011 and in 2012. It had also monitored during 2013 the development and passage of legislation that gave the authorities bank resolution powers, including on bail-in of bank debt. These powers were made available by the European Bank Recovery and Resolution Directive and the Financial Services (Banking Reform) Act 2013.

58. **Against this backdrop, the Committee judged that it could now close this recommendation**: the powers created by this legislation would be in force in full in the UK by January 2015, by commencement of legislation that was now in place or by transposition into UK law. Importantly, these powers would support the medium-term framework for bank resolution.

59. It also agreed that this recommendation could now be made public. Under section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of its Records if it decides that publication at that point would be against the public interest. When the interim Committee had made the recommendation in 2011, it judged that publication would be against the public interest given the risk of further undermining already fragile market sentiment. The Committee had reviewed this regularly since then. Now that necessary legislation was only awaiting commencement or transposition, the Committee felt that publication was no longer

against the public interest. The full text that had been deferred from previous Records would be published at the same time as the Record of this meeting and would be included in an Annex of this Record.

60. Risks from euro-area stress (12/Q2/3): In June 2012, *the Committee recommended that banks work to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area*.

61. The Committee had been monitoring progress regularly and had noted the reduction in UK banks' exposures to vulnerable euro-area periphery countries and in redenomination risk owing to balance sheet management. Macroeconomic and financial market conditions had also improved since the Committee had first made the recommendation. **The Committee agreed to close this recommendation** and to review risks to UK banks from euro-area exposures as part of the forthcoming 2014 stress test.

62. Capital (13/Q1/2, 13/Q1/4, 13/Q1/5): The Committee received a report from the PRA on progress on the three outstanding recommendations on capital adequacy from the five that were made by the interim Committee in March 2013. The Committee had received early reports at previous meetings.

- *The PRA should take steps to ensure that, by the end of 2013, major UK banks and building societies hold capital resources equivalent to at least 7% of their risk-weighted assets, as assessed on the basis described in Recommendation 13/Q1/1. Relative to that benchmark, major UK banks and building societies in aggregate currently have a shortfall in capital of around £25 billion.*

  The PRA had taken steps to ensure firms addressed the capital shortfalls that arose after making the adjustments suggested by the FPC in March 2013. All major UK banks and building societies had either met the 7% CET1 standard or agreed plans to do so with the PRA. This had led to a material improvement in the capital adequacy of the UK banking system. Recognising that, the Committee noted the PRA's intention to replace the specific adjustment methodology used in the initial exercise with its revised regime[3] and the annual stress testing exercise. **The FPC therefore judged that this recommendation could be closed**.

[3] For further details, see PRA Supervisory Statement SS3/13, 'Capital and leverage ratios for major UK banks and building societies', November 2013, available at http://www.bankofengland.co.uk/pra/Documents/publications/ss/2013/ss313.pdf.

In addition to the 7% equity capital ratio, the Committee also noted that all of the firms on which the PRA had set a 3% Tier 1 leverage ratio standard had also either met that standard or agreed plans to do so with the PRA.

- *The PRA should ensure that major UK banks and building societies meet the requirements in Recommendations 13/Q1/2 and 13/Q1/3 by issuing new capital or restructuring balance sheets in a way that does not hinder lending to the economy. Any newly issued capital, including contingent capital, would need to be clearly capable of absorbing losses in a going concern to enable firms to continue lending.*

The PRA reported that major UK banks and building societies had achieved the improvements in capital ratios through both increases in capital resources and reductions in risk-weighted assets. Where there had been reductions in risk-weighted assets, these had largely been achieved through selling of non-core assets and scaling back of investment bank operations. **The FPC judged that this recommendation could be closed**.

- *The PRA should ensure that major UK banks and building societies have credible plans to transition to meet the significantly higher targets for capital and the leverage ratio that will come into effect in 2019 after full implementation of Basel III, the trading book review and surcharge for systemically important banks, and after HM Government's implementation of the ICB proposals, in ways consistent with sustainable expansion of the UK economy*.

The FPC judged that this recommendation had been superseded by the revised PRA supervisory regime and the introduction of the concurrent stress testing regime, and therefore could be closed.

63. Mortgage affordability instrument: In November 2013, the FPC recommended that *the Financial Conduct Authority (FCA) should require mortgage lenders to have regard to any future FPC recommendation on appropriate interest rate stress tests to use in the assessment of affordability*.

64. The FCA had reported in March that subject to consultation and further consideration by the FCA Board, this instrument could be available to the FPC from its June meeting. The FCA

confirmed that it had amended its mortgage rules with effect from 2 May 2014 to achieve this. **The FPC therefore agreed that this recommendation could be deemed implemented and closed**.

65. Other existing recommendations: the Committee noted that action was under way on its other existing recommendations (which are summarised in the Annex). It planned to conduct a more detailed review of progress on its disclosure recommendations in Q3.

66. Relating to its existing recommendation on developing regular stress tests, the FPC agreed to publish text on the 2014 stress test scenario that it had previously deferred from publication from its March 2014 Record. In March, it had judged that publication would be against the public interest owing to the risk of unnecessary market uncertainty ahead of finalisation of the stress testing framework. The 2014 scenario had subsequently been published on 29 April 2014, after coordination with the EBA, so this concern had now passed. The text that had been deferred from the March 2014 Record would be published at the same time as the Record of this meeting and would be included in an Annex of this Record.

67. Finally, the Governor, on behalf of the Committee, thanked Charlie Bean on the occasion of his final meeting for his contribution to the work of the FPC since it was established including during its first year on a statutory footing.

The following members of the Committee were present at the meeting:

Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Andrew Bailey, Deputy Governor responsible for prudential regulation
Charles Bean, Deputy Governor responsible for monetary policy
Martin Wheatley, Chief Executive of the Financial Conduct Authority
Spencer Dale
Clara Furse
Donald Kohn
Richard Sharp
Martin Taylor
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

In accordance with the relevant provisions of the Bank of England Act 1998, Clara Furse reminded the Committee that as a non-executive director of Nomura Holdings Inc she could be regarded as having an indirect interest in the leverage ratio review given the possible implications for Nomura's UK regulated entities, depending on decisions made on the scope of firms that would be subject to a leverage ratio framework. The Committee decided that Clara Furse should participate in preliminary discussions about the leverage ratio review, in order to benefit from her expertise, but agreed that she would recuse herself from the meeting when the FPC decided initial propositions to be included in the Consultation Paper in relation to the review.

As permitted under the Bank of England Act 1998, Bradley Fried was also present as an observer in his role as member of the Oversight Committee of Court.

ANNEX 1: EXTANT FPC RECOMMENDATIONS

Identifier[1]	Recommendation
13/Q1/6	Looking to 2014 and beyond, the Bank and PRA should develop proposals for regular stress testing of the UK banking system. The purpose of those tests would be to assess the system's capital adequacy. The framework should be able to accommodate any judgements by the Committee on emerging threats to financial stability.
13/Q2/3*	The PRA should continue to work with the banking industry to ensure greater consistency and comparability of the Pillar 3 disclosures of the major UK banks and building societies, including reconciliation of accounting and regulatory measures of capital.
13/Q2/4*	The PRA should ensure that all major UK banks and building societies comply fully with the October 2012 recommendations of the Enhanced Disclosure Task Force (EDTF) upon publication of their 2013 annual reports.
13/Q2/6	HM Treasury, working with the relevant government agencies, the PRA, the Bank's financial market infrastructure supervisors and the FCA should work with the core UK financial system and its infrastructure to put in place a programme of work to improve and test resilience to cyber attack.
14/Q2/1	When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).
14/Q2/2	The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable.

** These recommendations were made on a 'comply or explain' basis, under Section 9Q(3) of the Bank of England Act 1998.*

(1) Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '12/Q2/3' refers to the third recommendation made at the 2012 Q2 meeting.

ANNEX 2: DEFERRED PUBLICATION TEXT

Under section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of its Records if it decides that publication at that point would be against the public interest. At its meeting in June, the FPC decided to publish text that had previously been deferred, in relation to: a) contingency planning; b) stress testing. This text is reproduced below and the Records from which publication was deferred have been updated on the Bank's website.

a) Contingency planning (see para 55-59 in this Record)

Date of Record	Text
Sep-2011	Rec. 11/Q3/4(P) *The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.* The Committee was concerned that conditions in Europe could deteriorate rapidly, with widespread dislocation spreading across interconnected global financial markets. The Treasury member of the Committee noted that HM Treasury already had contingency plans in place to provide capital and funding backstops to UK banks should conditions deteriorate further. The Committee thought that the Treasury should prepare for a full range of eventualities. In some especially severe scenarios, more far-reaching solutions might be required, which some members of the Committee felt should extend to the potential write down of some private-sector holdings of bank debt. The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened. It judged that publishing on 3 October 2011 this recommendation in the record of its meeting would be contrary to the public interest given the risk of further undermining already fragile market sentiment. But in line with the terms set out in the draft Financial Services Bill (section 9R(1)) it would keep that judgement under review and would publish this recommendation as soon as it judged publication no longer to be against the public interest.
Nov-2011	As an important part of the backdrop to its decisions on potential new recommendations, the Committee discussed the contingency arrangements which were being put in place by the UK authorities in case spillovers from the problems in the euro area began to undermine UK financial and economic stability. HM Treasury was establishing contingency plans for the recapitalisation of UK banks. It was also putting in place arrangements to support UK banks in raising term funding, which it could deploy if needed to forestall rapid or disorderly deleveraging. The Bank confirmed that it had arrangements in place to supply sterling liquidity through an extended collateral term repo facility should they be required. Finally, HM Treasury was finalising instructions to Parliamentary Counsel in case emergency

	legislation was required to establish a regime for the resolution of a central counterparty (CCP). The Committee's discussion of, and decisions on, further steps to mitigate risks to the UK financial system were predicated on the understanding that these various measures would continue to be developed and could be activated at short notice, if required.
Jun-2012	The Committee received an oral update on the UK authorities' contingency planning work. It agreed that its initially private recommendation to HM Treasury from September 2011 on contingency planning should remain in place given that the work was ongoing. HM Treasury would prepare a further report, updating on progress, ahead of the Committee's next meeting in September 2012. There was a case for publishing the recommendation, along with associated redacted text from the FPC Record of 20 September 2011, and from the FPC Record of 23 November 2011 to clarify and reassure that work was underway to manage a range of tail risks, including options for restructuring bank liabilities. But publication now, when serious threats remained, might further undermine already fragile market sentiment if it created a perception that the authorities had not done enough. In addition, changes to the resolution regime were now envisaged: the introduction of the relevant legislation might be a natural point to review publication. For these reasons the Committee concluded that publication of this material at this time would be contrary to the public interest. In line with the terms set out in the Financial Services Bill (section 9R(1)), it would keep that judgement under review and would publish the relevant text as soon as doing so was no longer judged to be against the public interest.
Nov-2012	The Committee had received an update on the UK authorities' contingency planning work. It agreed that its initially private recommendation to HM Treasury from September 2011 on contingency planning should remain in place given that the work was continuing. The Committee would receive a further update on progress ahead of its next meeting in March 2013. The Committee reconsidered the case for publishing the recommendation, along with associated redacted text from the September 2011, November 2011 and June 2012 FPC Records. But the Committee continued to judge that publication now, prior to all of the relevant draft legislation being in the public domain, would be contrary to the public interest. In line with the terms set out in the Financial Services Bill (section 9R(1)), the Committee would keep that judgement under review and would publish the relevant text as soon as doing so was no longer judged to be against the public interest.
Jun-2013	<u>Private recommendation on contingency planning</u>: The Committee reaffirmed the private recommendation to HM Treasury from September 2011 on contingency planning, noting that this was likely to remain open until the European Recovery and Resolution Directive was agreed and enabling legislation was in place. *Annex: The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.*

Sep-2013	The Committee agreed that publication of its initial private September 2011 recommendation to HMT on contingency planning [11/Q3/4(P)] remained contrary to the public interest. In the context of late 2011, contingency arrangements for bank recapitalisation and liability restructuring had been discussed because the authorities lacked a sufficiently rich resolution regime, including explicit bail-in powers. Publicising the arrangements contemplated in 2011 risked being misunderstood. The Committee agreed to revisit this judgment once enhanced resolution powers, including bail-in, had been delivered either by the EU or any earlier domestic legislation. *Annex: The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.*
Dec-2013	The Committee agreed that publication of its initially private September 2011 recommendation to HM Treasury on contingency planning [11/Q3/4(P)] remained contrary to the public interest. The Committee agreed to revisit this judgment once the bail-in provisions of the Banking Reform Bill had become law, expected to occur in 2014 Q1. *Annex: The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.*
Mar-2014	<u>Contingency planning [Recommendation 11/Q3/4(P)]</u>. The Committee agreed that publication of its initially private September 2011 recommendation to HM Treasury on contingency planning remained contrary to the public interest. Bail-in powers were now included in UK and EU legislation. The FPC was minded to close this recommendation at its June 2014 meeting, and to consider publication of the associated redacted text then, in the light of progress on commencement of secondary legislation on the relevant special resolution regime powers in the Banking Reform Bill. *Annex: The Committee made an initially private recommendation to HM Treasury that its contingency planning should be as comprehensive as possible and include arrangements for recapitalisation, and the restructuring of bank liabilities in circumstances in which their survival was threatened.*

b) Stress testing (see para 66 in this Record)

Date of Record	Text
Mar-2014	In framing the exercise, the Committee noted that it was precisely because a stress scenario was severe that investors and supervisors could draw confidence from results that indicated that firms would be sufficiently resilient to severe stress, or that steps were being put in place to improve resilience. Footnote: This paragraph, and paragraphs [X] and [Y] were released on [Date]. In its March 2014 meeting, the Committee decided to defer publication of these paragraphs as it was of the opinion that their publication would be against the public interest due to risks of unnecessary market uncertainty ahead of finalisation of the stress testing framework. An adjustment in interest rates could lead to a significant rise in corporate sector stress, including in the commercial real estate sector. To stretch household balance sheets, a coherent stress scenario would need to include rises in short term interest rates, an increase in unemployment and a very sharp fall in house prices. It was hard to gauge the precise degree of stress to apply to house prices, given the limited domestic experience of material falls in house prices. In previous FSA/PRA 'anchor scenarios', house prices had fallen by around 30% in nominal terms. While that was high relative to previous UK housing market downturns, and given that supply restrictions might act as a brake on falls in house prices, some other advanced economies had seen materially larger falls. And it was noted that house prices had risen further since the most recent 'anchor scenario' had been developed. In addition, in a severe downturn it was likely that banks' losses given default might be increased in the event of forced sales of distressed property exposures. The regional pattern of house price falls could also be important: past downturns had suggested that it was not always the case that regions where house prices rose most strongly subsequently saw the largest price falls. Members discussed that, in setting up the stress test, it would be important to communicate to firms and other stakeholders how the authorities were likely to respond to the outcome of the exercise. In doing so, it would be important to be clear that supervisors would be evaluating the appropriate action for firms on the basis of the entire profile of resilience measures over time, and not only by reference to a minimum threshold at a point in time. Clarity would also be needed on the relative weight to be placed on risk-weighted measures of capital adequacy and leverage ratios.