

**FINANCIAL STABILITY REPORT PRESS CONFERENCE****Thursday 26 June 2014****Opening Remarks by the Governor**

With the recovery in the UK economy broadening and gaining momentum in recent months, the Bank of England is now focussed on turning that recovery into a durable expansion.

To do so, our policy tools must be used in concert.

The legacy of high indebtedness and structural imbalances means that there are financial stability risks that, if left unchecked, could undermine the durability of the expansion. The biggest risks relate to the housing market.

The FPC is today taking further graduated and proportionate actions to mitigate these risks. By doing so, the FPC can allow the MPC to focus on its primary objective of achieving price stability.

It is not the FPC's role to control house prices, nor can it address underlying structural issues related to the supply of houses. Our role – given to us by Parliament - is to manage risks to financial stability, including the build-up of unsustainable levels of leverage, debt or credit growth.

Prospects for household indebtedness concern us. Although UK households have made progress in repairing their balance sheets, they start from a vulnerable position, with debt at 140% of their disposable income. The share of mortgage lending at high loan-to-income ratios has increased markedly over the past year to a record high. Given the momentum in the housing market, and the underlying shortage of housing supply, it is likely that this trend will continue.

The FPC does not believe that household indebtedness poses an imminent threat to stability. Underwriting standards are more responsible than they were in the past. However, we have seen time and again how quickly responsible can turn to reckless, creating risks that ultimately derail the UK economy. The FPC is concerned that a marked loosening in underwriting standards and an associated significant increase in the number of highly indebted households could pose major direct and indirect risks in future. So we are taking action today to prevent this from happening.

The direct risk arises because mortgage lending is the single largest asset class held by UK banks. This risk is mitigated by the considerable progress in recent years to strengthen bank balance sheets. To ensure banks are sufficiently resilient to withstand a severe housing shock,

the FPC and PRA are currently conducting a major stress test and will recommend any further capital actions that might be necessary later this year.

The indirect risk to financial and economic stability arises because mortgages are the single largest liability of UK households, representing 80% of household debt.

History shows that the British people do everything they can to pay their mortgages. That means cutting back deeply on expenditures when the unexpected happens, potentially slowing the economy sharply. That's why recessions that follow periods of rapid credit growth, like the record one from which the UK is emerging, tend to be deeper and longer lasting.

It is prudent to insure against these risks. The FPC is today making two recommendations to limit the risks to financial stability and the economy from a significant increase in the number of highly indebted households.

**First, we are introducing a new affordability test: mortgage lenders should assess whether borrowers could still afford their mortgage if Bank Rate were to be 3 percentage points higher than at the origination of the loan.**

**Second, we are introducing a cap: no more than 15% of any lender's total number of new residential mortgages should be at or greater than 4.5 times the borrower's income.**

These actions should not restrain current housing market activity. The recommendation on affordability tests is in line with the current practice of prudent lenders. And the current share of new mortgage lending with LTI in excess of 4.5 is around 10%.

These actions will have minimal impact in the future if the housing market evolves in line with the Bank's central view. Specifically, the MPC's latest *Inflation Report* assumed a gradual increase in housing transactions and a moderation in house price inflation over the next year or so. The share of new mortgages at high loan-to-income ratios is expected to increase to around 15% within the next year. The 15% cap could quickly become relevant if house prices grow more than we expect, incomes grow less, or underwriting standards slip.

These actions should not prevent households who can afford mortgages from obtaining them, or impose limits on the availability of lending to support the expansion. The measures are proportionate: they don't prohibit all high LTI mortgage lending. In some cases, such as for first time buyers, these mortgages can be appropriate. Currently, around 5% of all new mortgages are to first time buyers who borrow more than 4½ times their income. Such lending can continue

and even increase under the measures announced today. The decision to extend such loans is for the lenders themselves.

These actions will bite if there is sustained momentum in the housing market over the coming years that is accompanied by a further sharp increase in high LTI lending. They will prevent lending getting too far ahead of income growth. And they will prevent a slide into riskier lending and higher indebtedness that could undermine economic expansion over the medium term.

Because it is acting early, the FPC can take graduated and proportionate steps to reduce the risk of more drastic action being required later on. We recognise that, while tools like this have proven effective in other countries, they are still relatively novel here. By acting, assessing, and if necessary re-calibrating, we can strike the right balance to support durable growth.

Today's actions also demonstrate close co-ordination between authorities.

We welcome the commitment of the PRA and FCA to oversee the implementation of today's recommendations. The PRA will implement new rules as soon as practicable and in the interim will expect firms to act in accordance with the FPC's recommendations. This means the measures are effective from today.

The FPC welcomes the Chancellor's announcement today that no new loans at or above 4.5 times the borrower's income can be included in the Help to Buy mortgage guarantee scheme.

Let me conclude by briefly explaining how we co-ordinate our monetary and macroprudential policies.

The existence of macroprudential tools allows monetary policy to focus on its primary responsibility of price stability. In other words, monetary policy does not need to be diverted to address a sector-specific risk in the housing market. As the MPC has indicated, monetary policy is the last line of defence against risks to financial stability.

Actions of the FPC can in principle affect the path of monetary policy necessary to achieve price stability. But whether or not they do depends on their calibration, and that depends on the nature of the risk they are designed to address. In that regard, there are two broad classes.

First, when the FPC judges there to be a clear and present danger to financial stability it will take actions that immediately curtail credit expansion. Because such action will affect the level of

activity and the outlook for inflation, monetary policy can – all else equal – be expected to follow a different path.

Today's recommendations belong to a second class of macroprudential actions: measures that insure against tail risks and therefore reduce the possibility of future instability. These actions don't affect the central outlook for the economy. In fact, they make it more likely to happen. They are therefore less likely to have implications for the path of monetary policy, which currently anticipates limited and gradual rate rises over the forecast horizon. The MPC will of course conduct a full assessment of the impact of today's actions on the economy when it next meets on 9-10 July.

Regardless of the type of action, there is a need for the MPC, FPC and PRA to work closely together. In the run-up to today's announcements they have done so, by sharing analysis and holding a series of joint discussions to assess the housing market and the interaction of their responsibilities. Working as one Bank, we will continue that approach in future because we recognise that it is by using our policy tools in concert that we can best contribute to the durability of the economic expansion.