

Executive summary

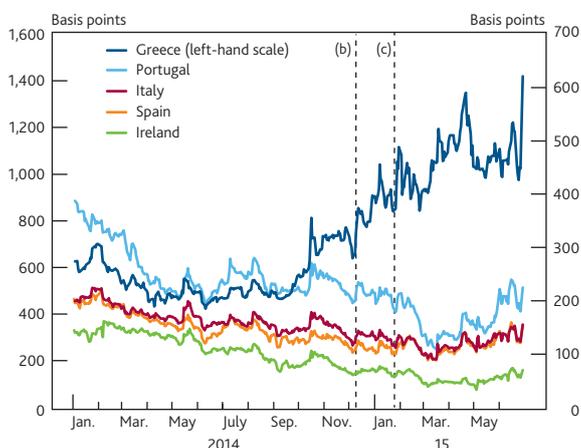
The Financial Policy Committee assesses the outlook for financial stability by identifying the risks faced by the financial system and weighing them against the resilience of the system. Part A of this *Report* identifies the major risks which, in the Committee's judgement, are facing the UK financial system and Part B reports on the resilience of the system. The composition of risks has shifted and the resilience of the system has continued to improve since the December *Report*. Overall, the Committee judges that challenges remain. It judged the outlook for financial stability to have been broadly unchanged over much of the period since December but, as risks associated with Greece began to crystallise in recent days, the outlook had worsened.

The Financial Policy Committee (FPC) has identified the main risks facing the financial system in the United Kingdom as: the global environment; the reduction in market liquidity in some markets; the United Kingdom's current account deficit; the housing market in the United Kingdom; consequences of misconduct in the financial system; and cyber attack. Some risks, particularly around Greece and emerging market economies, have increased since December. Some other risks have declined. Notably, some risks associated with low growth in advanced economies moderated as growth prospects in the euro area improved following actions by the European Central Bank (ECB).

These risks are weighed against the resilience of the financial system, which, as Part B highlights, has continued to strengthen. There has been a modest improvement in the distribution of household debt. Major UK banks have continued to improve capital and funding positions and now report an average common equity Tier 1 (CET1) capital position above 11%. The average leverage ratio is 4.4%. This capital position reflects, in part, the actions taken in response to the 2014 stress test of the major UK banks that captured some of the main risks judged by the FPC to be facing the system.

The FPC has completed its annual review of risks beyond the core banking sector by considering the channels through which activities undertaken by the non-bank financial system could affect UK financial stability. It has concluded on evidence currently available not to recommend a change in how these activities are regulated. But as discussed below it has concerns over market liquidity and it intends to undertake a regular deep analysis of a range of activities. This will start over the next year with the investment activity of investment funds and hedge funds, the investment and non-traditional, non-insurance activities of insurance companies, and securities financing and derivatives transactions.

Chart A Greek government bond spreads have risen sharply
Selected ten-year government bond spreads to German bunds^(a)



Sources: Thomson Reuters Datastream and Bank calculations.

- (a) Data up to 29 June.
 (b) Greek Prime Minister Samaras announces early elections.
 (c) Syriza wins election.

Global environment (pages 12–15)

Some risks from advanced economies have diminished since December. In the euro area, policy action by the ECB has reduced tail risks associated with deflation and high indebtedness. However, at the time of its meeting on 24 June, the FPC judged that the risks in relation to Greece and its financing needs were particularly acute (**Chart A**). Subsequently, those risks began to crystallise. Following the Greek government's decision to call a referendum on the terms of the creditors' proposal, negotiations over an extension to the European Financial Stability Facility (EFSF) programme of financial assistance for Greece, expiring on 30 June, broke off. The Eurogroup then decided not to extend that programme beyond 30 June and the ECB subsequently decided not to raise the ceiling on its Emergency Liquidity Assistance. Just before this *Report* was finalised, Greek authorities imposed a bank holiday and associated capital controls.

The direct exposures of UK banks to Greece are very small. Exposures to peripheral euro-area economies are more significant,

amounting to 60% of CET1 capital. The institutional changes and development of policy tools in the euro area since 2012, alongside economic recovery, the reduction in fiscal deficits in a number of other euro-area Member States and strengthening of banking systems, have all contributed to a reduction in the risk of contagion. On 27 June, euro-area Finance Ministers stated their intent to make full use of all the instruments available to preserve the integrity and stability of the euro area. The ECB Governing Council also stated its determination to use all the instruments available within its mandate.

Nevertheless, the situation remains fluid. The FPC will continue to monitor developments and remains alert to the possibility that a deepening of the Greek crisis could prompt a broader reassessment of risk in financial markets.

The Bank has worked closely with HM Treasury, the FCA and European counterparts to put in place contingency plans. The UK authorities will continue to monitor developments and will take any actions required to safeguard financial stability in the United Kingdom.

After a period of strong capital inflows and rising private sector debt, a number of emerging market economies are experiencing slower growth and may face more difficult financing conditions (**Chart B**). In a number of these countries, businesses have issued a large volume of US dollar-denominated debt. The strengthening of the US dollar, alongside a potential eventual rise in US dollar interest rates, may pose a threat to the ability of those businesses to meet their obligations. Over the past year, the US dollar has appreciated by 18% against a basket of major emerging market economy currencies.

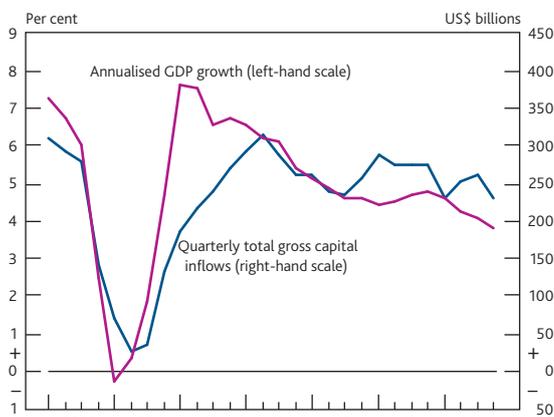
In China, growth has continued to slow since the December *Report* after a rapid build-up of indebtedness. Chinese equity markets have recently been very volatile following rapid increases over the past year. Policymakers continue to face challenges in sustaining growth, managing financial stability and moving towards greater openness. A sharp slowdown in China would be likely to have significant spillovers to the global economy.

UK banks' exposures to China, Hong Kong and emerging market economies amount to about 3.5 times CET1 capital (**Chart C**). So the FPC remains alert to developments and has incorporated stresses in Europe, China and emerging market economies into the 2015 stress test of major UK banks (see Box 3 on pages 38–39).

Market liquidity (pages 16–19)

Some fixed-income markets have become less liquid. Average trade sizes and market depth have fallen and prices are more volatile, as manifest especially in some very sharp intraday price changes in important markets. Greater volatility does not itself threaten financial stability and, to the extent it reflects the introduction of prudential requirements on market-making

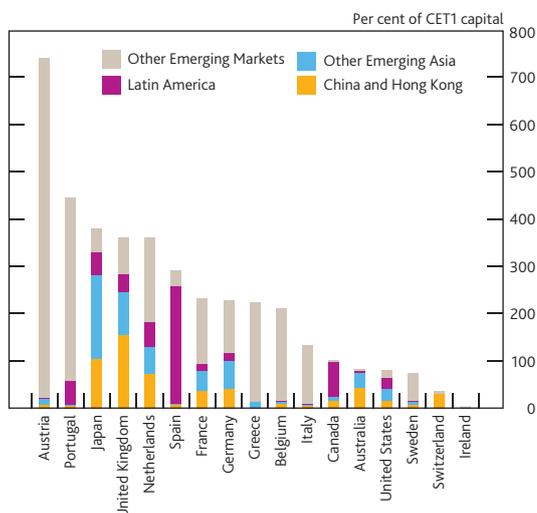
Chart B Capital inflows to EMEs have moderated
EME GDP growth and capital inflows^(a)



Source: IIF.

(a) Four-quarter moving averages.

Chart C UK banks have significant exposures to Emerging Asia and Latin America
Major advanced economies' bank claims on EMEs^(a)

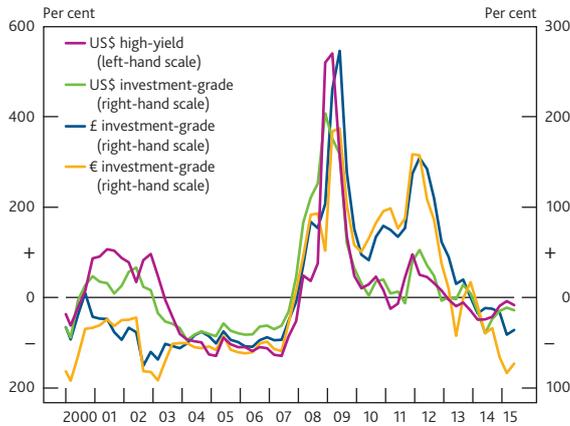


Sources: BIS Consolidated Banking Statistics, SNL Financial and Bank calculations.

(a) Foreign claims of domestically owned banks on an ultimate risk basis, as at 2014 Q4. CET1 capital as at 2014 H2, with the exception of Japan, where it is as at 2014 H1.

Chart D Corporate bond liquidity risk premia remain below historical averages

Deviations of estimated corporate bond liquidity risk premia from historical averages^{(a)(b)}



Sources: Bloomberg, BofA Merrill Lynch Global Research, Thomson Reuters Datastream and Bank calculations.

- (a) Implied liquidity risk premia are estimated using a Merton model as in Leland, H and Toft, K (1996), 'Optimal capital structure, endogenous bankruptcy, and the term structure of credit spreads', *Journal of Finance*, Vol. 51, pages 987–1,019, to decompose corporate bond spreads.
 (b) Quarterly averages of deviations of implied liquidity risk premia from sample averages. Sample averages are from 1999 Q4 for € investment-grade and 1997 Q1 for £ investment-grade, US\$ investment-grade and US\$ high-yield.

intermediaries, it is associated with a welcome increase in the resilience of the core of the financial system.

However, the pricing of a range of securities seems at present to presume that they could be sold in an environment of continuous market liquidity. Estimates of the compensation investors require to bear liquidity risk are similar to before the crisis (**Chart D**). This could be a part of an ongoing search for yield in an environment of low risk-free interest rates and large-scale purchases of assets by central banks across advanced economies. Some reallocation of portfolios is an intended consequence of the stance of monetary policy. However, the compensation for bearing credit and liquidity risk in some markets has declined by more than may be warranted by the future economic and financial environment.

A repricing of risk would threaten financial stability if it were to generate sustained illiquidity in, and dislocation of, important financing markets for financial intermediaries and the real economy. This could also affect the resilience of the core banking system. The Committee is alert to this possibility. Market participants should also be alert to these risks, price liquidity appropriately and manage it prudently.

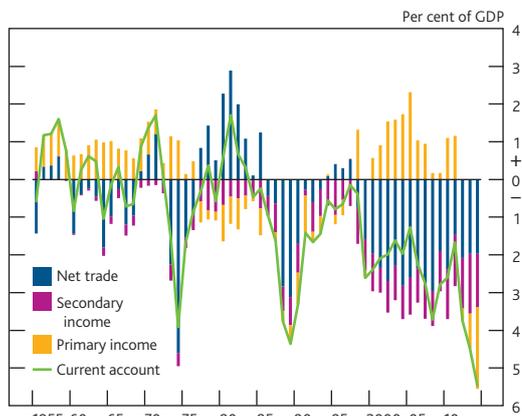
Recognising the risks, the Committee set out in March 2015 a programme of work to clarify the extent of any macroprudential risks associated with market liquidity. The final report from that work will be presented to the Committee in September. The Bank is also actively participating in a programme of international work through the Financial Stability Board (FSB) to assess these risks globally.

UK current account deficit (pages 20–22)

The UK current account deficit, at 5.5% of GDP in 2014, is large by historical and international standards (**Chart E**). The United Kingdom continues to run a trade deficit, with weak demand in its major trading partners limiting export demand, but it is now also experiencing a primary income deficit, as the income earned by UK residents on their overseas investments has fallen in recent years. The United Kingdom has had a current account deficit for most of the period since the 1980s. The continued ease in financing these deficits rests on the credibility of the United Kingdom's macroeconomic policy framework and continuing openness to trade and investment. Analysis of the nature of the capital flows financing the deficit does not suggest a particular vulnerability in addition to the size of the deficit: most of the financing is from foreign direct investment, equity and longer-term debt including gilts. It is not currently associated with rapid growth of bank lending. There is no growing currency mismatch in the UK balance sheet, or in particular sectors of the financial system, so the United Kingdom's flexible exchange rate is able to act as a stabilising mechanism in the event of a shock. And the resilience of the UK banking system to an abrupt adjustment of the United Kingdom's external imbalance was assessed as part of the

Chart E The UK current account deficit has widened in recent years

Decomposition of the UK current account^(a)

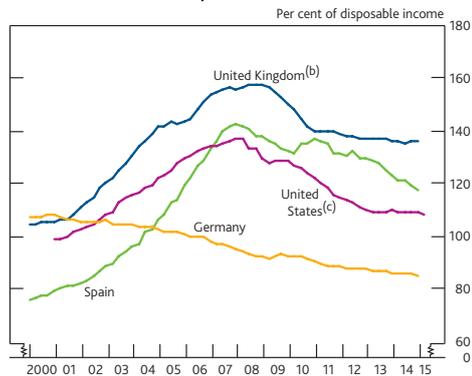


Sources: ONS and Bank calculations.

- (a) Primary income mainly consists of compensation of employees and net investment income. Secondary income consists of transfers.

Chart F Household debt to income is high compared with other developed economies

Household debt to disposable income^(a)

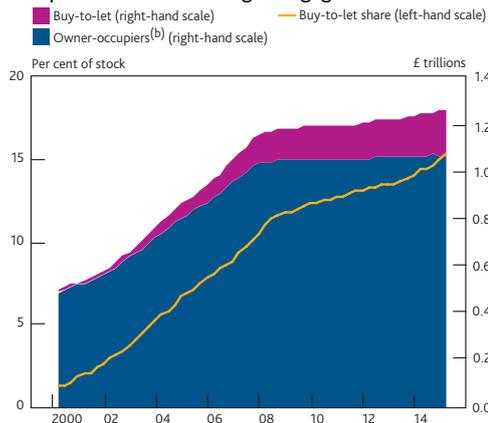


Sources: ECB Statistical Data Warehouse, Federal Reserve, ONS and Bank calculations.

- (a) Households' and non-profit institutions' total financial liabilities as a percentage of a four-quarter moving sum of their disposable income.
 (b) Includes all liabilities of the household sector except for the unfunded pension liabilities and financial derivatives of the non-profit sector. The household disposable income series is adjusted for financial intermediation services indirectly measured.
 (c) US debt to income measure not directly comparable with other countries due to inconsistent definitions of household sector as discussed in www.statcan.gc.ca/pub/13-605-x/2012005/article/11748-eng.htm.

Chart G Buy-to-let lending has accounted for most of the growth in mortgage stock since 2008

Composition of outstanding mortgage stock^(a)

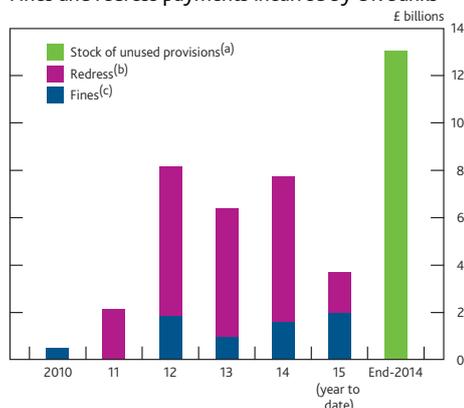


Sources: Bank of England, Council of Mortgage Lenders and Bank calculations.

- (a) Data are non seasonally adjusted.
 (b) Lending to owner-occupiers is calculated as outstanding lending to individuals secured on dwellings less outstanding lending secured on buy-to-let properties.

Chart H UK banks have continued to incur costs related to past misconduct

Fines and redress payments incurred by UK banks



Sources: European Commission, FCA, *Financial Times*, firm submissions, FSA and Bank calculations.

- (a) Major UK banks.
 (b) For mis-selling PPI and interest rate hedging products, includes a small amount of redress paid by non-banks.
 (c) Levied by US authorities, the FSA/FCA and the European Commission.

2014 stress test. But the FPC will continue to monitor the nature of capital inflows that finance the deficit.

UK housing market (pages 23–26)

The FPC continues to monitor closely conditions in UK property markets given high household indebtedness. Aggregate UK household debt to income, while falling gradually since 2010, remains high compared to historical and international norms (Chart F). The distribution of debt has improved marginally, with the tail of households with debt to income ratios greater than 4.0 falling in early 2015. House prices and activity in the housing market have increased again recently, and mortgage rates on many mortgage products are historically low. House prices grew at an annual rate of 5.6% in the three months to May 2015, compared with 3% in 2014 Q4; and 68,000 mortgages were approved in April, compared with 60,000 per month in 2014 Q4. Given this, the FPC judges that the policies it introduced in June 2014 to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households remain warranted. In the buy-to-let mortgage market, lending has continued to grow, with buy-to-let mortgage lending now accounting for 15% of the stock of outstanding mortgages and nearly 20% of the flow in 2015 Q1 (Chart G). As it set out in October 2014, HM Treasury will consult later this year on giving to the FPC the power of Direction to limit residential mortgage lending at high loan to value or high debt to income ratios, including interest coverage ratios, for buy-to-let lending. Parliament provided the equivalent powers to the FPC for owner-occupied lending in April this year.

Misconduct (pages 27–30)

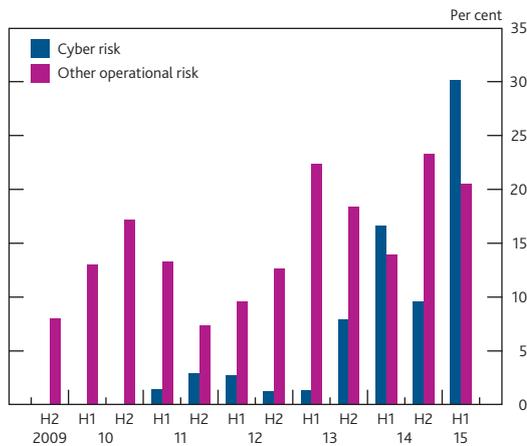
Addressing misconduct is essential for rebuilding confidence in the financial system. Misconduct has undercut public trust and hindered progress in rebuilding the banking sector after the crisis. It has also posed risks to systemic stability, with direct economic consequences. The fines and redress costs paid by UK banks, at £30 billion, are equivalent to around all of the capital that they have raised privately since 2009. Substantial progress has been made in identifying and addressing misconduct, including through reform both of regulation and market and firm-level structures, systems and controls. Further initiatives are set out in the Fair and Effective Markets Review, and the United Kingdom is leading work to shape standards internationally through the FSB. Firms must continue to make adequate provisions for the cost of additional redress (Chart H), align remuneration policy with risk-taking and ensure that accountability of key individuals is clear. The FPC will review the adequacy of sector-wide projections of future misconduct costs in the 2015 stress test.

Cyber risk (pages 31–33)

The financial system continues to face operational risk from frequent cyber attacks and awareness of this risk continues to grow (Chart I). A UK Government survey in 2015 found that 90% of large businesses across all sectors had experienced a

Chart 1 Concern about cyber risk has grown

Systemic Risk Survey: proportion of respondents highlighting operational/cyber risk as a key concern



Sources: Bank of England *Systemic Risk Surveys* and Bank calculations.

malicious IT security breach in the previous year. These breaches can disrupt the financial sector's operational capacity to provide critical services to the economy. While in some areas the financial sector is leading efforts to combat cyber crime, the adaptive nature of the threat means that ways of managing this risk must evolve. As well as looking to build defensive resilience to threats, firms must build the capability to recover quickly from cyber attack, given the inevitability that attacks will occur. The evolving nature of the threat means that strong governance at the most senior levels of banks is required to build this capability in defensive resilience and recovery across technology and personnel.

With this in mind, the FPC has replaced its existing Recommendation with a new Recommendation to regulators that focuses on establishing a regular assessment of the resilience to cyber attack of firms at the core of the financial system. This will include the use of penetration testing developed in response to the FPC's June 2013 Recommendation (known as 'CBEST' tests).

The FPC recommends that:

The Bank, the PRA and the FCA work with firms at the core of the UK financial system to ensure that they complete CBEST tests and adopt individual cyber resilience action plans. The Bank, the PRA and the FCA should also establish arrangements for CBEST tests to become one component of regular cyber resilience assessment within the UK financial system.

The FPC is also asking the Bank, the PRA, FCA and HM Treasury to work together to consider how evolving capabilities in both defensive resilience and recovery would be best established across the financial system and at those firms that provide critical services to the financial system. This will also require effective co-operation with international authorities. The FPC will consider the need for further action based on the outcome of this work programme and has asked for a report by Summer 2016.

Capital framework and countercyclical capital buffer decision

Most of the prudential regulatory reform requirements for banks have been set out — including through the FPC's formal implementation of the leverage ratio requirements it announced last year. The FPC will consider the methodology to determine capital buffers for ring-fenced banks and large building societies, and the overall capital framework for UK banks more broadly, in 2015 H2. This is as part of its medium-term priority of establishing the medium-term capital framework for UK banks that it set out in 2014 (see Box 4 on pages 40–41).

The FPC also has the responsibility for setting cyclical capital requirements, in the form of the countercyclical capital buffer (CCB), on a quarterly basis. The countercyclical capital buffer is a macroprudential instrument that enables the FPC to put banks in a better position to withstand stress through the financial cycle, by requiring them to raise capital ratios as threats to financial stability increase and allowing them to run them down if risks crystallise or if risks ease.

In considering the appropriate setting for the CCB, the FPC considered the risks facing the UK financial system set against the still modest recovery in credit extended to UK households and companies, increased resilience of the financial system and the action taken in response to the 2014 stress test of major UK banks. In the light of these, it decided at its June meeting to leave the countercyclical capital buffer rate for UK exposures unchanged at 0% (see Box 6 on page 51).