BANK OF ENGLAND

Financial Stability Report
Executive summary

June 2017

This pull-out contains the Executive summary of the *Report* only.
The full *Report* is available on the Bank's website at
www.bankofengland.co.uk/publications/Pages/fsr/2017/jun.aspx

Executive summary

The Financial Policy Committee (FPC) aims to ensure the UK financial system is resilient to the wide range of risks it faces.

The FPC assesses the overall risks from the domestic environment to be at a standard level: most financial stability indicators are neither particularly elevated nor subdued.

As is often the case in a standard environment, there are pockets of risk that warrant vigilance. Consumer credit has increased rapidly. Lending conditions in the mortgage market are becoming easier. Lenders may be placing undue weight on the recent performance of loans in benign conditions.

Exit negotiations between the United Kingdom and the European Union have begun. There are a range of possible outcomes for, and paths to, the United Kingdom's withdrawal from the EU.

Some possible global risks have not crystallised, though financial vulnerabilities in China remain pronounced. Measures of market volatility and the valuation of some assets — such as corporate bonds and UK commercial real estate — do not appear to reflect fully the downside risks that are implied by very low long-term interest rates.

To ensure that the financial system has the resilience it needs, the FPC is:

- **Increasing the UK countercyclical capital buffer rate to 0.5%, from 0%**. Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC expects to increase the rate to 1% at its November meeting.

- **Bringing forward the assessment of stressed losses on consumer credit lending** in the Bank's 2017 annual stress test. This will inform the FPC's assessment at its next meeting of any additional resilience required in aggregate against this lending. The FPC further supports the intentions of the Prudential Regulation Authority and Financial Conduct Authority to publish, in July, their expectations of lenders in the consumer credit market.

- **Clarifying its existing insurance measures in the mortgage market**, designed to prevent excessive growth in the number of highly indebted households. This will promote consistency across lenders in their application of tests to assess whether new mortgage borrowers can afford repayments.

- Consistent with its previous commitment, **restoring the level of resilience delivered by its leverage ratio standard** to the level it delivered in July 2016 before the FPC excluded central bank reserves from the leverage ratio exposure measure. The FPC intends to set the minimum leverage requirement at 3.25% of non-reserve exposures, subject to consultation.

- **Overseeing contingency planning to mitigate risks to financial stability as the United Kingdom withdraws from the European Union.**

- Building on the programme of cyber resilience testing it instigated in 2013, by **setting out the essential elements of the regulatory framework for maintaining cyber resilience**. It will now monitor that each element is being fulfilled by the relevant UK authorities.

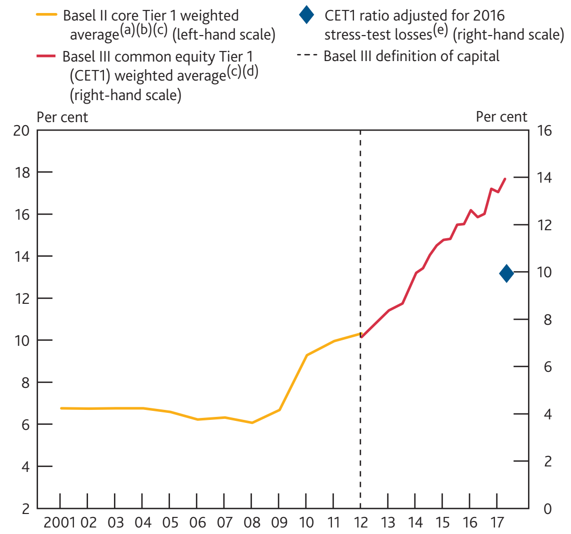
The Financial Policy Committee (FPC) assesses the overall risks from the domestic environment to be at a standard level: most financial stability indicators are neither particularly elevated nor subdued.

As is often the case in a standard environment, there are pockets of risk that warrant vigilance. Consumer credit has increased rapidly. Lending conditions in the mortgage market are becoming easier. Lenders may be placing undue weight on the recent performance of loans in benign conditions.

The FPC is increasing the UK countercyclical capital buffer (CCyB) rate to 0.5%, from 0% (see Box 1). Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC expects to increase the rate to 1% at its November meeting.

- The action will supplement banks' already substantial ability to absorb losses (**Chart A**).

Chart A Major UK banks have continued to strengthen their capital positions
Major UK banks' capital ratios



Sources: PRA regulatory returns, published accounts and Bank calculations.

(a) Major UK banks' core Tier 1 capital as a percentage of their risk-weighted assets. Major UK banks are Banco Santander, Bank of Ireland, Barclays, Co-operative Banking Group, HSBC, Lloyds Banking Group, National Australia Bank, Nationwide, RBS and Virgin Money. Data exclude Northern Rock/Virgin Money from 2008.
(b) Between 2008 and 2011, the chart shows core Tier 1 ratios as published by banks, excluding hybrid capital instruments and making deductions from capital based on FSA definitions. Prior to 2008 that measure was not typically disclosed; the chart shows Bank calculations approximating it as previously published in the *Report*.
(c) Weighted by risk-weighted assets.
(d) From 2012, the 'Basel III common equity Tier 1 capital ratio' is calculated as common equity Tier 1 capital over risk-weighted assets, according to the CRD IV definition as implemented in the United Kingdom. The Basel III peer group includes Barclays, Co-operative Banking Group, HSBC, Lloyds Banking Group, Nationwide, RBS and Santander UK.
(e) CET1 ratio less the aggregate percentage point fall projected under the Bank of England's 2016 annual cyclical stress scenario for the six largest UK banks.

- At its November meeting, the FPC will have the full set of results from the 2017 stress test of major UK banks.

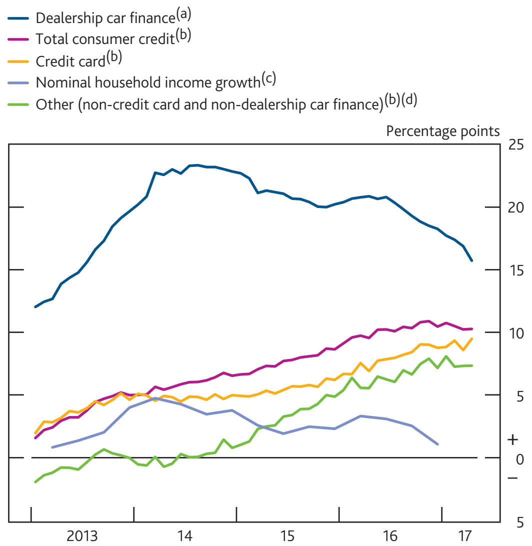
- In line with its published policy, the FPC stands ready to cut the UK CCyB rate, as it did in July 2016, if a risk materialises that could lead to a material tightening of lending conditions. Banks' capital buffers exist to be used as necessary to allow banks to support the real economy in a downturn.

The FPC supports the intentions of the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to publish, in July, their expectations of lenders in the consumer credit market. Firms remain the first line of defence. Effective governance at firms should ensure that risks are priced and managed appropriately and benign conditions do not lead to complacency by lenders.

The Bank's annual stress test assesses banks' resilience to risks in consumer credit. Given the rapid growth in consumer credit over the past twelve months, the FPC is bringing forward the assessment of stressed losses on consumer credit lending in the Bank's 2017 annual stress test. This will inform the FPC's assessment at its next meeting of any additional resilience required in aggregate against this lending.

- Consumer credit grew by 10.3% in the twelve months to April 2017 (**Chart B**) — markedly faster than nominal household income growth. Credit card debt, personal loans and motor finance all grew rapidly.

Chart B Consumer credit has been growing much faster than household incomes
Annual growth rates of consumer credit products and household income



Sources: Bank of England, ONS and Bank calculations.

(a) Identified dealership car finance lending by UK monetary financial institutions (MFIs) and other lenders.
(b) Sterling net lending by UK MFIs and other lenders to UK individuals (excluding student loans). Non seasonally adjusted.
(c) Percentage change on a year earlier of quarterly nominal disposable household income. Seasonally adjusted.
(d) Other is estimated as total consumer credit lending minus dealership car finance and credit card lending.

- Loss rates on consumer credit lending are low at present. Partly as a result, banks' net interest margins on new lending have fallen and major lenders are using lower risk weights to calculate the capital they need to hold. The current environment is also likely to have improved the credit scores of borrowers.

- Other things equal, these developments mean lenders have less capacity to absorb losses, either with income or capital buffers. In this context, a review by the PRA has found evidence of weaknesses in some aspects of underwriting and a reduction in resilience.

- The short maturity of consumer credit means that the credit quality of the stock of lending can deteriorate quickly. Lenders expect to continue to grow their portfolios this year, at the same time as real household income growth is expected to remain particularly weak.

The FPC has clarified its existing insurance measures in the mortgage market, designed to prevent excessive growth in the number of highly indebted households. Lenders should test affordability at their mortgage reversion rate — typically their standard variable rate — plus 3 percentage points. This will promote consistency across lenders in their application of tests to assess whether new mortgage borrowers can afford repayments.

- Historically, the build-up of mortgage debt has been a significant risk to financial and economic stability. Because highly indebted borrowers need to cut spending sharply in a downturn, recessions become deeper. And looser underwriting standards expose banks to bigger losses.

- The FPC put policies in place to guard against these risks in 2014. These Recommendations were: a limit on lending at loan to income multiples at 4.5 or above; and guidance to lenders to assess whether new borrowers would be able to afford their repayments if interest rates were to rise.

- Following a review (see The FPC's approach to addressing risks from the UK mortgage market chapter), the FPC expects its measures to remain in place for the foreseeable future.

- Mortgage lending at high loan to income ratios is increasing and the spreads and fees on mortgage lending have fallen. If lenders were to weaken underwriting standards to maintain mortgage growth, the FPC's measures would limit growth in the number of highly indebted households. This would have material benefits for economic and financial stability by mitigating the further cutbacks in spending that highly indebted households make in downturns.

Consistent with its previous commitment, the FPC is restoring the level of resilience delivered by its leverage ratio standard to the level it delivered in July 2016, before the FPC excluded central bank reserves from the leverage ratio exposure measure. The FPC therefore intends to set the minimum leverage requirement at 3.25% of non-reserve exposures, subject to consultation.

- In July 2016, the FPC excluded central bank reserves from the measure of banks' exposures used to assess their leverage. This change reflected the special nature of central bank reserves and was designed to avoid a situation in which the Committee's leverage standards impeded the transmission of monetary policy.

- The FPC committed last year that it would make an offsetting adjustment to ensure that the amount of capital needed to meet the UK leverage ratio standard would not decline. The FPC did not intend for there to be a permanent loosening of the standard.

- By raising the minimum leverage standard from 3% to 3.25%, the FPC intends to ensure that the original standard of resilience is restored, while also preserving the benefits of excluding central bank reserves from the exposure measure.

Exit negotiations between the United Kingdom and the European Union have begun. There are a range of possible outcomes for, and paths to, the United Kingdom's withdrawal from the EU. The FPC will oversee contingency planning to mitigate risks to financial stability as the withdrawal process evolves (see Box 2).

Irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned, which itself exceeds that required by international baseline standards.

- The United Kingdom's position as the leading internationally active financial centre, with a financial centre that is, by asset size, around ten times GDP, means that the FPC's statutory responsibility of protecting and enhancing the resilience of the UK financial system is particularly important for both the domestic and global economies.

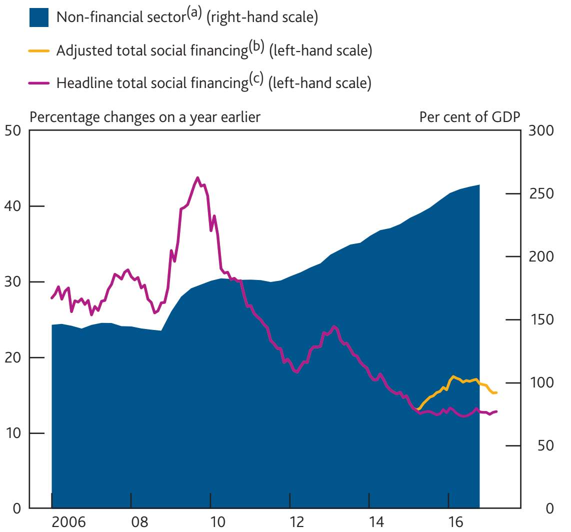
- Absent consistent implementation of standards internationally and appropriate supervisory co-operation, the FPC would need to assess how best to protect the resilience of the UK financial system.

Some possible global risks have not crystallised, though financial vulnerabilities in China remain pronounced. Measures of market volatility and the valuation of some assets — such as corporate bonds and UK commercial real estate — do not appear to reflect fully the downside risks that are implied by very low long-term interest rates. Banks' ability to withstand these risks is being tested in the 2017 stress test scenario.

- Euro-area sovereign bond spreads have fallen as some political uncertainties have been resolved. Further progress has been made in strengthening European bank capital positions, and a domestically significant bank in Spain was resolved in an orderly fashion.

- In China, capital outflows have stabilised, but economic growth continues to be accompanied by rapid credit expansion (**Chart C**).

Chart C Credit continues to grow rapidly in China
China non-financial sector debt and growth of total social financing



Sources: BIS total credit statistics, CEIC and Bank calculations.

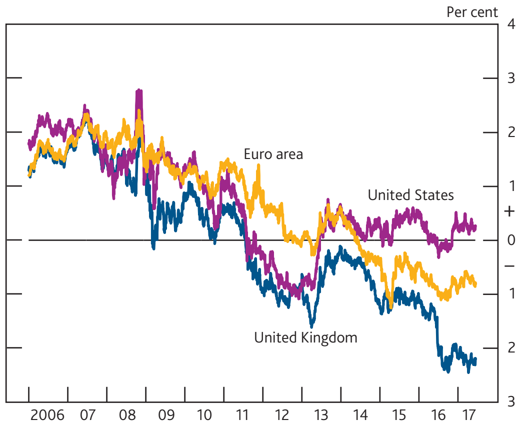
(a) Non-financial sector debt data are to 2016 Q4. Includes lending by all sectors at market value as a percentage of GDP, adjusted for breaks.
(b) Total social financing adjusted for net issuance of local government bonds.
(c) The People's Bank of China stock of total social financing used from December 2014 onwards. Prior to this the stock of total social financing is estimated using monthly 'newly increased' total social financing flows.

- Measures of uncertainty implied by options prices are low (see Asset valuations chapter). Often in periods of low volatility, risks are building and later become apparent.

- In the United Kingdom, ten-year real government bond yields are at around -2% (**Chart D**). Long-term real rates are low across the G7. These levels are consistent with pessimistic growth expectations and high perceived tail risks.

- Some asset valuations, particularly for some corporate bonds and UK commercial real estate assets, appear to factor in a low level of long-term market interest rates but do not appear to be consistent with the pessimistic and uncertain outlook embodied in those rates (**Chart E**).

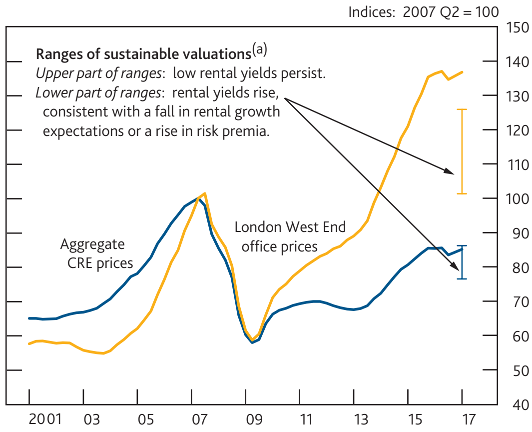
Chart D Advanced-economy risk-free real interest rates remain close to historically low levels
International ten-year real government bond yields[a]



Sources: Bloomberg and Bank calculations.

(a) Zero-coupon bond yields derived using inflation swap rates. UK real rates are defined relative to RPI inflation, whereas US and euro-area real rates are defined relative to CPI and HICP inflation respectively.

Chart E UK commercial real estate prices look stretched based on ranges of sustainable valuations
Commercial real estate prices in the United Kingdom and ranges of sustainable valuations



Sources: Bloomberg, Investment Property Forum, MSCI Inc. and Bank calculations.

(a) Sustainable valuations are estimated using an investment valuation approach and are based on an assumption that property is held for five years. The sustainable value of a property is the sum of discounted rental and sale proceeds. The rental proceeds are discounted using a 5-year gilt yield plus a risk premium, and the sale proceeds are discounted using a 20-year, 5-year forward gilt yield plus a risk premium. Expected rental value at the time of sale is based on Investment Property Forum Consensus forecasts. The range of sustainable valuations represents varying assumptions about the rental yield at the time of sale: either rental yields remain at their current levels (at the upper end), or rental yields revert to their 15-year historical average (at the lower end). For more details, see Crosby, N and Hughes, C (2011), 'The basis of valuations for secured commercial property lending in the UK', *Journal of European Real Estate Research*, Vol. 4, No. 3, pages 225–42.

- These asset prices are therefore vulnerable to a repricing, whether through an increase in long-term interest rates or an adjustment of growth expectations, or both. The impact of this could be amplified given reduced liquidity in some markets.

Progress has been made in building resilience to cyber attack, but the risk continues to build and evolve. Regulators are nearing completion of a first round of cyber resilience testing for all firms at the core of the UK financial system, in line with the Recommendation from the FPC in 2015.

- The FPC's concern is to mitigate systemic risk — the risk of material disruption to the economy.

- With 31 out of 34 firms at the core of the UK financial system, including banks representing more than 80% of the outstanding stock of PRA-regulated banks' lending to the UK real economy, so far having completed penetration testing and having action plans in place, the FPC is satisfied that its 2015 Recommendation has been met.

- Consistent with that, the FPC is also setting out the essential elements of the regulatory framework for maintaining cyber resilience and will now monitor that each element is being fulfilled by the relevant UK authorities.

- Alongside the Bank, PRA and FCA, the FPC will now consider its tolerance for the disruption to important economic functions of the financial system in the event of cyber attack.

The FPC has updated its medium-term priorities (see The FPC's medium-term priorities chapter).

- The FPC's primary responsibility is to identify, monitor and take action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system. It aims to ensure the financial system does not cause problems for the rest of the economy and, if and when problems arise in the economy, the financial system can absorb rather than amplify them.

- To help to meet its objectives, alongside its ongoing assessment of the risk environment, the FPC is prioritising three initiatives over the next two to three years:

  - Finalising, and refining if necessary, post-crisis bank capital and liquidity reforms.
  - Completing post-crisis reforms to market-based finance in the United Kingdom, and improving the assessment of systemic risks across the financial system.
  - Preparing for the United Kingdom's withdrawal from the European Union.

Part A of this *Report* sets out in detail the Committee's analysis of the major risks and action it is taking in the light of those risks. Part B summarises the Committee's analysis of the resilience of the financial system.

Box 1
The FPC's 2017 Q2 UK countercyclical capital buffer rate decision

The FPC is increasing the UK countercyclical capital buffer (CCyB) rate from 0% to 0.5%, with binding effect from 27 June 2018. Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC expects to increase the rate to 1% at its November meeting, with binding effect a year after that. At that point, it will have the full set of results from the 2017 stress test of major UK banks.

The increase to 0.5% will raise regulatory buffers of common equity Tier 1 capital by £5.7 billion. This will provide a buffer of capital that can be released quickly in the event of an adverse shock occurring that threatens to tighten lending conditions. The increase in the CCyB rate will also lead to a proportional increase in major UK banks' leverage requirements via the countercyclical leverage buffer (CCLB).

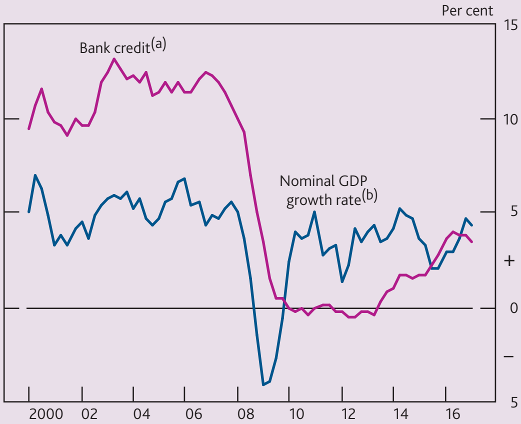
The Committee's decision to increase the UK CCyB rate to 0.5% — with an expectation of a further increase to 1% in November — reflects its assessment of the current risk environment and its intention to vary the buffer in gradual steps.

In its published strategy for setting the CCyB, the FPC signalled that it expects to set a UK CCyB rate in the region of 1% in a standard risk environment. The FPC assesses the overall risks from the domestic environment to be at a standard level: most financial stability indicators are neither particularly elevated nor subdued. Domestic credit has grown broadly in line with nominal GDP over the past two years (**Chart A**). Within the overall risk environment, some indicators are more benign. For example, despite high levels of indebtedness, private sector debt-servicing costs are low, supported by the low level of interest rates. In contrast, risk levels in some sectors are more elevated, notably so in the consumer credit market (see UK consumer credit chapter). Global risks — which could influence the risks on UK exposures indirectly via their potential effects on UK economic growth — are also judged to be material, as are risks from some asset valuations.

The FPC's measured approach is likely to decrease the risk that banks adjust by tightening credit conditions, thereby minimising the cost to the economy of making the banking system more resilient.

In line with its published policy, the FPC stands ready to cut the UK CCyB rate, as it did in July 2016, if a risk materialises that could lead to a material tightening of lending conditions.

Chart A Credit directly financed by the banking system has grown broadly in line with nominal GDP over the past two years
Growth in credit to households and firms compared with nominal GDP growth



Sources: ONS and Bank calculations.

(a) Quarterly twelve-month growth rate of monetary financial institutions' sterling net lending to private non-financial corporations and households (in per cent) seasonally adjusted.
(b) Twelve-month growth rate of nominal GDP.

The cut in the CCyB rate in July 2016 was a response to greater uncertainty around the UK economic outlook and an increased possibility that material domestic risks could crystallise in the near term. The FPC's action served to ensure banks did not hoard capital and restrict lending in those conditions. Banks' capital buffers exist to be used as necessary to allow banks to support the real economy in a downturn.

Under EU law, the UK CCyB rate applies automatically (up to a 2.5% limit, and currently subject to a transition timetable) to the UK exposures of firms incorporated in other European Economic Area (EEA) states. The FPC expects it to apply also to internationally active banks in jurisdictions outside the EEA that have implemented the Basel III regulatory standards. Consistent with this, recent CCyB actions by Czech Republic, Hong Kong and Norway have been reciprocated.

Box 2
Possible financial stability implications of the United Kingdom's withdrawal from the European Union

In March 2017, the UK Government notified the European Council of the United Kingdom's intention to withdraw from the European Union. This initiated, under Article 50 of the Treaty on European Union, a two-year period for the United Kingdom and the European Union to negotiate and conclude a withdrawal agreement. The exit negotiations have now begun.

As the FPC stated in September 2016, irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned and which itself exceeds that required by international baseline standards.(1)

In addition, consistent with its statutory duty, **the FPC will continue to identify and monitor UK financial stability risks, so that preparations can be made and action taken to mitigate them**.

There are a range of possible outcomes for the United Kingdom's future relationship with the European Union and possible paths to that relationship. Consistent with its remit, the FPC is focused on scenarios that, even if they may be the least likely to occur, could have most impact on UK financial stability. This includes a scenario in which there is no agreement in place at the point of exit. Such scenarios are where contingency planning and preparation will be most valuable.

The Bank, FCA and PRA are working closely with regulated firms and financial market infrastructures (FMIs) to ensure they have comprehensive contingency plans in place. The FPC will oversee contingency planning to mitigate risks to financial stability as the withdrawal process unfolds.

Through this work, the FPC is aiming to promote an orderly adjustment to the new relationship between the United Kingdom and the European Union.

Without contingency plans that can be executed in the available time, effects on financial stability could arise both through direct effects on the provision of financial services, and indirectly, through macroeconomic shocks that could test the resilience of the financial system.

(1) Direct effects on the provision of financial services

A very large part of the United Kingdom's legal and regulatory framework for financial services is directly or indirectly derived from EU law. **The United Kingdom's financial services law must therefore become domestic at the point of withdrawal.** The Government plans to execute this through the Repeal Bill. Once enacted, this will ensure there is no legal or regulatory vacuum in respect of financial services when the United Kingdom leaves the European Union.

The European Union's framework for financial services establishes the right of financial companies within the European Economic Area (EEA) to provide services across national borders and to establish local branches in other Member States without local authorisation.

This promotes substantial cross-border provision of a wide range of financial services. Around £40 billion of UK financial services revenues relate to EU clients and markets.(2) These cross-border connections have resulted in more efficient financial services for businesses and households across the European Union.

There is no generally applicable institutional framework for cross-border provision of financial services outside the European Union. Globally, liberalisation of trade in services lags far behind liberalisation of trade in goods. So without a new bespoke agreement, UK firms could no longer provide services to EEA clients (and *vice versa*) in the same manner as they do today, or in some cases not at all. This creates two broad risks. First, services could be dislocated as clients and providers adjust. Second, the fragmentation of service provision could increase costs and risks.

In the United Kingdom, the **flow of new banking and insurance services to UK customers could be disrupted** if EEA firms are unable to operate in the United Kingdom in the same manner as they do today. Around 10% of the outstanding stock of loans to private non-financial corporations in the United Kingdom is extended by UK branches of EEA banks.(3)

Around 7% of **general insurance contracts undertaken in the United Kingdom** and 3% of life insurance contracts are written by EEA insurers.(4) As well as disrupting new business from these providers, fragmentation could require the existing contracts to be transferred to a UK-authorised firm in order to address any legal uncertainties as to the status of, and ability to perform, such contracts.

(1) www.bankofengland.co.uk/publications/Pages/news/2016/033.aspx.
(2) Source: Oliver Wyman, 2016.
(3) Source: Bank of England calculations.
(4) Sources: Firms' published accounts, regulatory data and Bank calculations. Based on premiums relating to insurance contracts.

There could also be material dislocation of some services supplied from the United Kingdom to the European Union. EU clients would need to source substitute services from banks and FMIs established in the EEA or other countries recognised by the European Commission as 'equivalent'. This is particularly relevant to new debt and equity issuance and derivatives business. These dislocations could also disrupt the provision of services to UK clients who rely on EU counterparties.

UK-located banks underwrite around half of the debt and equity issued by EU companies.(1) EU companies could need to find alternative providers of this service to sustain their capital market issuance.

UK-located banks are counterparty to over half of the over-the-counter (OTC) interest rate derivatives traded by EU companies and banks.(2) To support EU-based derivatives trading, substantial operational capacity may need to be established in the European Union and additional capital and balance sheet capacity would probably be needed.

Central counterparties (CCPs) located in the United Kingdom provide services to EU clients in a range of markets. The United Kingdom houses some of the world's largest CCPs. For example, LCH handles over 90% of cleared interest rate swaps globally.

In addition to the potential disruption to new clearing business for EU firms, if EU firms are unable to move their existing derivatives contracts to EU authorised or recognised CCPs, they would face capital charges that are up to ten times higher. Moreover, to move a large stock of existing trades will pose substantial and complex operational and legal challenges.

In addition to the dislocation of services, **fragmentation of market-based finance could result in higher costs and greater risks for both EU and UK** companies and households.

Separation of derivatives clearing would reduce the benefits of central clearing. It would impair the ability to diversify risks across borders and, by increasing costs, reduce incentives for firms to hedge risks. Industry estimates suggest that a single basis point increase in cost resulting from splitting clearing of interest rate swaps could cost EU firms €22 billion per year across all of their business.

Delegation of asset management across borders is a well-established practice. For example, 40% of the assets managed in the United Kingdom are managed for overseas clients; around half of this activity is on behalf of clients outside Europe.(3) UK-located asset managers account for 37% of all assets managed in Europe.(4) If asset management were to fragment between the United Kingdom and Europe, material economies of scale and scope that are currently achieved by pooling of funds and their management would be reduced.

Together, these effects could **increase the reliance of both the UK and EU economies on their banking systems and reduce the diversification and resilience of finance**.

(2) Macroeconomic shocks that could test the resilience of the financial system

To maintain consistent provision of financial services to the UK economy, the financial system must be able to absorb the impacts on their balance sheets of any adverse economic shocks that could arise in some scenarios for the United Kingdom's withdrawal from the European Union.

The Bank of England's regular stress testing aims to ensure that the banking system has the strength to withstand, and continue to lend in, a broad and severe economic and market shock.

The United Kingdom's withdrawal from the European Union has the potential to affect the economy through supply, demand and exchange rate channels.(5)

The supply side of the economy could be disrupted by abrupt increases in the costs of, or obstacles to, cross-border trade. **Demand** could be impacted by the abrupt introduction of restrictions on exports of financial and other services and tariffs on trade in goods with the European Union. A reduction in economic activity in high tax-paying sectors could affect public finances and spending.

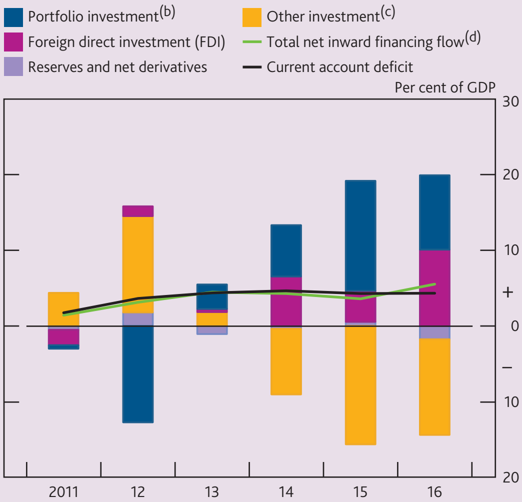
In some scenarios, heightened uncertainty could also reinforce the existing risk of a fall in appetite of foreign investors for UK assets. The United Kingdom relies on inflows of overseas capital to finance its current account deficit — the excess of investment over domestic saving. That deficit, which stood at 4.4% of GDP in 2016, is financed largely through direct investment and portfolio investment in the form of long-term debt and equity (**Chart A**).

A material reduction in the appetite of foreign investors to provide finance to the United Kingdom would tighten financing conditions for UK borrowers and reduce asset prices

(1) Based on Bank analysis of UK-located investment banks' revenues in 2015 for M&A and debt/equity issuance activities, using multiple sources.
(2) Based on Bank calculations and multiple sources, including Bank for International Settlements triennial survey data (2016) which show UK-based dealers account for 82% of European trading in OTC single currency interest rate derivatives.
(3) Sources: Investment Association Annual Survey (2015–2016) and Bank calculations.
(4) Source: Investment Association Annual Survey (2015–2016).
(5) See the May 2017 *Inflation Report*; www.bankofengland.co.uk/publications/Documents/inflationreport/2017/may.pdf.

Chart A The United Kingdom has relied on material inflows of portfolio investment and FDI to finance its current account deficit in recent years

Net inward financing flows(a)



Sources: ONS and Bank calculations.

(a) This is the change in UK foreign liabilities, less the change in UK foreign assets, for each category of investment. These data are presented as annual series using four-quarter averages.
(b) Portfolio investment consists of debt securities (including government debt), equities and investment fund shares.
(c) Other investment consists mostly of loans and deposits.
(d) The total net inward financing flow is equal in magnitude to the current account deficit (plus errors and omissions).

and investment. The effect could be most pronounced in markets that have recently had greater reliance on access to overseas capital, such as commercial real estate (CRE). Around half of the investment in UK CRE since 2015 has been financed by overseas investors (**Chart B**).

All else equal, economic shocks like these would probably depress the **exchange rate, putting upward pressure on inflation**. The combination of shocks could therefore possibly create a more challenging trade-off for monetary policy. The Monetary Policy Committee would have to make careful judgements about the net effect of these influences on demand, supply and inflation.

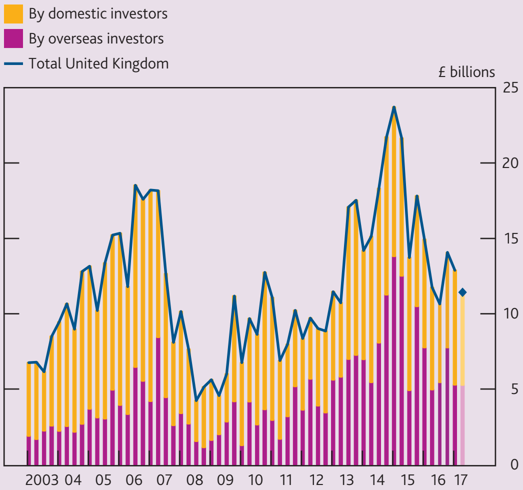
In these circumstances, the maintenance of financial stability would require banks to be able to withstand, and continue lending in, an environment of higher loan impairments, increased risk of default on other assets, and lower asset prices and collateral values.

Mitigating risks to financial stability

The FPC will continue to assess the resilience of the UK financial system to adverse economic shocks that could arise. The FPC will use the information from its regular stress testing of major UK banks and building societies. These test banks' resilience to a range of relevant scenarios, including a snap back of interest rates, sharp adjustment in UK property markets, and severe stress in the euro area.

Chart B Overseas investors have accounted for around half of total investment in UK CRE since 2015

UK CRE transactions (gross quarterly flows)(a)



Sources: The Property Archive and Bank calculations.

(a) Final data points are the sum of three months to May 2017.

The FPC will continue to assess the suitability of firms' contingency plans for emerging risks, in the context of progress on agreements and the continuity of the domestic regulatory framework. This will draw on reviews by the Bank, PRA and FCA of firms' plans, including responses from banks, insurers and designated investment firms to the PRA's April 2017 letter requesting that they summarise their contingency plans for the full range of possible scenarios following the United Kingdom's withdrawal from the European Union.