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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETINGS

8 AND 15 DECEMBER 2014

This is the record of the Financial Policy Committee meetings held on 8 and 15 December 2014.

It is also available on the Internet:

<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1412.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 next meeting of the FPC will be on 24 March and the record of that meeting will be published on 7 April.

RECORD OF FINANCIAL POLICY COMMITTEE MEETINGS HELD ON 8 AND 15 DECEMBER

At its meetings on 8 and 15 December, the Financial Policy Committee made no new recommendations.

The FPC decided to maintain the countercyclical capital buffer rate for UK exposures at 0%.

1 The Committee met on 8 December to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. It met subsequently on 15 December to agree its response to the results of the 2014 banking system stress test exercise, in light of the results that had been agreed by the PRA Board.

The macroeconomic and financial environment

2 The Committee reviewed financial system and economic developments since its previous meeting, as set out more fully in the December 2014 *Financial Stability Report* (FSR).

3 In the Committee's view, global risks to the outlook for financial stability had increased since June. Global growth forecasts had been revised down over the past six months and market concerns over geopolitical risks (as highlighted by the Bank of England's Systemic Risk Survey) had increased. These developments could affect the outlook for financial stability in the United Kingdom if concerns about persistent low growth were to lead to a sudden reappraisal of underlying vulnerabilities in highly indebted economies or if a shift in global risk appetite were to trigger sharp adjustments in financial markets and undermine business and household confidence. The Committee considered that these adjustments would be more disruptive if investors' pricing of liquidity risk failed to fully reflect structural changes in market liquidity. Such developments could lead to stress in funding markets for banks and corporates.

4 The Committee discussed the likely implications of the sharp fall in oil prices. The Committee noted the positive impact on global growth and concluded that the decline in oil prices seen to date was unlikely to pose an immediate, significant risk to UK financial stability. If the fall in oil prices were to be sustained, it could impact the ability of some businesses, such as US shale oil and gas exploration firms, to service their debt. US oil and gas firms accounted for 13% of the outstanding debt in US high-yield bond markets; an increase in their perceived or realised credit risk could lead to sales by investors and potentially illiquidity in the broader high-yield bond market. A sustained lower oil price also had the potential to reinforce certain geopolitical risks. There was also a risk that, in economies where core inflation was already weak, particularly some parts of the euro area, low headline readings would further depress expectations of future inflation. This, in turn, could result in slower rates of growth of nominal incomes, increasing the burden of existing debts.

5 Any decline in market confidence in the ability of the authorities to achieve the rebalancing and adjustments required in the euro area would be a particular concern for UK financial stability. This could lead investors to question again the sustainability of debt positions in the most

vulnerable euro-area countries – particularly if core euro-area countries were also affected by a deterioration in global economic growth prospects. In that regard, the Committee noted other international risks to financial stability related to the rapid build-up of debt in China and the possibility of sudden reversals in cross-border capital flows to some large Emerging Market Economies with imbalances.

6 In June, the Committee had highlighted its concern about a further increase in financial stability risks emanating from the UK housing market. Since then, housing market activity had moderated – mortgage approvals and house price inflation had slowed and the latter was forecast to be more in line with earnings growth. The housing-related risks that had concerned the Committee had, therefore, not increased. Nevertheless, debt levels in the UK household sector remained high relative to incomes. And the changes to Stamp Duty announced in the Autumn Statement on 3 December, together with record low mortgage rates, could provide some support to activity. Consequently, the insurance provided by the FPC’s June housing-related recommendations remained warranted.

7 The UK current account deficit, at 5.2% of GDP in 2014 Q2, had remained close to historical highs and the official estimate indicated that the UK net foreign asset position had deteriorated over the past few years. The external balance sheet position could, however, be healthier than implied by official estimates. And, to the extent that fiscal policy was credible and investors were confident in the monetary and fiscal policy frameworks and the United Kingdom’s continuing openness, current account deficits would be easier to finance. The Bank of England’s Systemic Risk Survey had revealed a rise in the number of respondents mentioning UK political uncertainties as a risk.

Risks to financial stability from market liquidity

8 Committee members noted that a sudden reappraisal of economic prospects, as a consequence of the heightened global risks or some other shock, could result in sharp adjustments to asset prices and increased volatility, especially if investors had not fully reflected structural changes in market liquidity in their assessment of liquidity risk. There was a concern that the observed decline in market-making activities by some firms had reduced liquidity in some markets. These developments reflect, in part, changes in the regulatory framework designed to make institutions more resilient. In addition, they could reflect changes in market structure and more direct trading between end-investors.

9 Recent episodes of market volatility had highlighted the Committee's previous concern that market liquidity could suddenly prove illusory and thus contribute to greater market disruption. Episodes of heightened volatility had occurred in some markets since June – such as US Treasury markets – where liquidity would typically be considered to be deep. In the event, financial markets had recovered relatively quickly, in part because longer-term asset holders, such as institutional bond fund managers, had maintained their positions. But tail events could trigger a larger and more prolonged reaction in asset prices and volatility. The Committee noted that some asset managers might be assuming that they could sell assets quickly in the event of redemptions. If many asset managers tried to do this simultaneously, this might amplify price falls and market volatility.

10 As part of its work to assess the diversity and resilience of market-based finance, the Committee considered the vulnerabilities, amplifiers and stabilisers that affected market liquidity. Members noted that it was not essential for all financial markets to be equally liquid; that said, continuously-open funding markets were particularly important for financial stability. Understanding the drivers of market liquidity was a complex issue and there were important interconnections between liquidity in primary and secondary markets. Overall, the Committee agreed that liquidity in any given market segment relied on a diverse investor base, well-understood cashflows and sufficiently transparent trading arrangements. Independent of these underlying factors, however, an illusion of market liquidity could be created by shifts in demand for assets driven by broader conditions in the financial system. It was noted that assumptions about liquidity in some markets could be pervasive and, if ill-informed, these assumptions would be a source of risk. This was an important issue since the major UK financial firms were active in a wide range of global financial markets; developments in these markets could, therefore, have implications for the financing of economic activity in the United Kingdom.

11 In the light of recent developments, the Committee judged that there was a continued need for market participants to be cognisant of these risks and, in particular, to price liquidity risk appropriately. In addition, given that these issues were global in nature, the Committee noted that it would be important for the Bank to continue to contribute to international policymaking in relation to them.

Stress testing and resilience of the UK banking system

12 The Committee considered the results of the Bank of England's stress-test exercise for the UK banking system. This exercise built on the EU-wide exercise that had been coordinated by the

European Banking Authority. The 2014 UK stress test had covered eight major UK banks and building societies; the full results were to be published on 16 December, alongside the FSR.

13 The stress scenario was not a forecast of macroeconomic and financial conditions in the United Kingdom. Rather, it was a coherent, tail-risk scenario that was designed specifically to assess the resilience of UK banks and building societies. Although the exercise assessed the impact of a particular stress scenario, it allowed the Committee to form a more general judgement on the resilience of the UK banking system to a severe macroeconomic downturn, which could be a feature of different possible stressed states. The PRA was responsible for assessing the adequacy of capital positions of individual institutions in the light of the results of the exercise. The FPC's responsibility was on the implications of the stress test results for the resilience of the system as a whole.

14 The Committee noted that UK banks had increased their capital levels in recent years, partly in response to the FPC's 2013 Q1 bank capital recommendations. The major UK banks' average Basel III CET1 capital ratio was 10.7% in 2014 H1, compared with 8.7% a year earlier. These increased capital buffers had served the banks well in the stress test exercise.

15 In the stress scenario, the aggregate Basel III CET1 ratio across the eight participating banks had fallen from 10% (end-2013) to a low point of 7.3% in 2015. This deterioration had not taken into account the effect of potential 'strategic' management actions that banks could take to cushion the effect of the stress on their balance sheets. The fall in CET1 ratios had been driven by two factors. First, most banks were projected to make losses, thereby eroding their resources; and second, for most banks, risk-weighted assets (RWAs) had been projected to increase sharply over the scenario period due to increases in risk weights. There had been substantial variation in the results of the participating banks in terms of the impact of the stress scenario. In part this had reflected differences in business models and geographical footprints of the banks.

16 In assessing the results of the stress test, the Committee looked, among other things, at the number of institutions that suffered sharp declines or low capital ratios in the stress scenario, indications that system-wide bank behaviour in the stress could adversely affect the macroeconomy or the stability of other parts of the financial system and sectoral concentrations in losses.

17 Given balance sheet positions at the end of 2013, the PRA Board had judged that this stress test had not revealed capital inadequacies for five of the eight participating banks. The PRA Board had judged that three of the eight participating banks needed to strengthen their capital

position further. But, given continuing improvements to banks' resilience over the course of 2014 and concrete plans to build capital further going forward, only one of these banks was required to submit a revised capital plan. This plan was subsequently accepted by the PRA Board.

18 In considering the final results from a system-wide perspective, the FPC took account of progress in building capital over 2014, the capital plans agreed by the banks with the PRA Board and that the banking system as a whole was on a transition path to meet higher standards of loss-absorbing capacity.

19 The Committee also considered the management actions proposed by firms in response to the stress. Prior to the stress test exercise, the Bank had set out guidance for the management actions for which banks would be given credit. This guidance had stipulated that 'improving stressed capital ratios through deleveraging (in particular relative to banks' baseline scenarios) would be constrained, especially if it led to a material decline in the aggregate credit supply'.

20 The Committee considered how this guidance should be interpreted in practice. It was agreed that, from a macroprudential perspective, the system should be sufficiently capitalised to ensure that banks were able to maintain the supply of lending in the face of adverse shocks. That being said, the Committee also recognised that in a severe adverse scenario, demand for credit would be expected to fall. Reflecting this, the Committee agreed a general principle that management actions proposed by banks to reduce the size of their loan books would not be accepted, unless these were driven by changes in credit demand that would have been expected to occur in the stress scenario.

21 Committee members recognised that in practice it was difficult reliably to separate out the demand and supply components of changes in credit and that, therefore, judgement would need to be applied in this area. Drawing on a range of model-based estimates, and taking into account that inflation was assumed to rise in the stress scenario, the FPC decided that, for the 2014 scenario, it would be appropriate to reject banks' proposed management actions if they implied a fall in the relevant bank's stock of lending relative to end-2013.

22 It was also agreed that it might be appropriate for the PRA Board to depart from this general principle in idiosyncratic cases if, for example, the actions proposed by the banks would not have a material impact on the market as a whole and not be correlated with actions of other firms operating in the same market.

23 In the Committee's judgement, the stress test results, taken together with the capital plans of the banks, suggested that the banking system would have the capacity to maintain its core functions in the stress scenario. **The Committee concluded, therefore, that no system-wide, macroprudential actions on bank capital were needed in response to the stress test.**

Other considerations

24 The stress-testing exercise had revealed large increases in RWAs under the stress scenario for some UK banks' residential mortgage portfolios – across the eight firms, increasing RWAs had accounted for a material amount of the peak-to-trough fall in CET1 capital ratios in the stress. This, in turn, had reflected increases in the associated mortgage-exposure risk weights derived from these banks' Internal Risk Based models. Under this approach, firms were allowed to use their own models (if approved by the PRA) in order to estimate the probability of default (PD) and the assumed loss given default. The way that the associated capital risk weights responded in stress conditions depended to some extent on choices the firms make in modelling these parameters.

25 Banks typically adopted one of three approaches: (i) a point-in-time approach whereby PD was estimated as a function of prevailing economic and financial conditions; (ii) a through-the-cycle approach whereby the estimated PD was intended to reflect an average default rate for a particular borrower over an entire economic cycle; and (iii) a hybrid approach which reflected elements of both the point-in-time and through-the-cycle approaches.

26 There had been significant variation in the size of this procyclical risk-weight effect across participating firms. This had reflected, among other things, differences in the modelling approaches used by different firms to calculate RWAs.

27 Committee members considered the procyclical behaviour of risk weights revealed by the stress test to be a potential source of structural vulnerability. A procyclical capital framework could exacerbate cyclicality in credit conditions, by encouraging credit exuberance in a boom and deleveraging in a downturn. The Committee asked Bank staff to undertake further work to explore this issue further, as well as considering possible mitigating actions. Members highlighted two considerations to be included in the analysis: (i) the difficulties in estimating the timing of the economic cycle for the through-the-cycle approach; and (ii) the potential increase in risks that might result if all firms were to be required to adopt the same modelling approach given that there were benefits to having some diversity in risk-management practices.

28 Committee members noted that the exercise had revealed a number of areas where stress testing and capital planning frameworks needed to be strengthened. The Committee therefore supported the Bank's intention to work with each of the participating firms on improvements that could be made in order to enhance their stress-testing capabilities. In the first half of 2015, the Committee would consider this issue further as part of a review of the lessons learned from the 2014 stress-test exercise.

29 Committee members also noted that recent misconduct and other operational failings had highlighted that rebuilding confidence in the banking system would require more than financial resilience. Changes to banks' business models in response to commercial and regulatory developments were expected to challenge management capacity over the next few years. In this environment, the Committee judged that strong, effective and well-informed management and governance arrangements would be essential to rebuild confidence in the banking system.

30 A number of banks had issued high-trigger AT1 instruments. Depending on the extent of strategic management actions (such as reductions in dividends and staff remuneration), some of these debt instruments would have been triggered in the stress scenario. The FPC noted that this would act to support the resilience of the banking system in a stress. Committee members emphasised that investors in these instruments needed to be aware of the possibility that this would happen in a real stress event.

31 The Committee had an initial discussion of the nature of the adverse scenario for the next year's stress-test exercise. Reflecting their concerns about the risks emanating from recent developments in the global economic and financial environment, it was agreed that the 2015 exercise should explore a single adverse scenario that would be based on weak global growth and an associated significant market stress; this scenario would include an associated severe UK recession. The FPC agreed that participation in the 2015 exercise would not be extended beyond those banks included in the 2014 exercise.

Setting the countercyclical capital buffer

32 The Committee next considered the countercyclical capital buffer (CCB). The FPC's general approach towards setting the CCB was outlined in its January 2014 Policy Statement.

33 Following the requirements set out in legislation, the Committee considered the 'buffer guide' – a simple metric which provides a guide for the CCB rate based on the gap between the ratio of credit to GDP and its long-term trend. This credit gap measure had reached a record low in 2014 Q2 and was likely to remain negative for a considerable period. A simple mapping from the

buffer guide suggested that the CCB should continue to be set at zero percent. But this was only one indicator that the Committee regularly considered.

34 In addition to the buffer guide, the Committee also reviewed a range of other relevant information, including its core indicators which cover aspects of balance sheet stretch in banks and other sectors, and terms and conditions in markets. Private non-financial sector credit growth had been weaker than the growth rate of nominal GDP since the start of 2009; although, within this measure, the pace of household credit growth had picked up. Aggregate levels of credit in the United Kingdom had continued to fall relative to GDP during 2014, though debt levels remained high. Similarly, the ratio of external debt to GDP had also continued to fall, but remained well above historic averages. One of the indicators considered was the UK current account deficit which (at 5.2% of GDP in 2014 Q2) suggested a potential source of vulnerability.

35 The Committee noted that the trend of steadily easing terms and conditions seen in financial markets over the past couple of years seemed to have halted following the increase in volatility that had occurred in autumn 2014. But, conditions remained in place for ‘search for yield’ activities and so it would be important to continue to monitor the potential for under-pricing of credit risks.

36 Indicators of banks’ resilience – such as capital, leverage and dependence on short-term wholesale funding – had improved markedly over the previous year and, as noted above, the FPC had concluded that no system-wide macroprudential action on bank capital was needed in response to the banking system stress-test results.

37 In light of these considerations, its assessment of the outlook for financial stability and the outcome of the stress test exercise, the Committee agreed to maintain the CCB rate for UK exposures at 0%.

Existing recommendations

38 The Committee reviewed the progress made on implementing its existing recommendations since its previous policy meeting; in all four cases, the Committee decided to leave the status of existing recommendations unchanged.

Stress testing (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.

39 The Committee agreed to review progress on this recommendation in Q1 or Q2 of 2015, after allowing sufficient time to determine the lessons learned from the 2014 exercise.

Resilience to cyber attack (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.

40 The FPC received an update on work by HM Treasury, the Bank and regulators to enhance cyber resilience. All core firms and financial market infrastructures had submitted a self-assessment on cyber resilience, and these had been reviewed by the regulators. These assessments had not revealed any critical shortcomings, but regulators had noted some areas for improvement including a tendency among firms to view cyber threats as a technical problem, rather than an issue which merits Board-level attention given the evolving nature of cyber threats and the key importance of cyber resilience to continuity of financial services. It was noted that supervisors were working with firms to agree timetables for remediation.

41 In addition, a vulnerability testing framework (known as CBEST) had been launched in May 2014, delivering controlled, bespoke cyber-security tests, using the expertise of Government and commercial intelligence providers to simulate the types of threat that systemically important financial institutions face. The findings of both the self-assessments and CBEST together were intended to form the basis for specific and concrete action plans for firms. The Bank of England had undergone a CBEST test and some private sector firms were in advanced discussions to undertake such a test. The FPC judged that there was a need for core firms and financial market infrastructures to undertake this CBEST vulnerability testing as soon as practicable; in some cases this would require coordination with overseas regulators. The regulators would, where appropriate, take this issue up with firms as part of the regular supervisory dialogue. **The Committee agreed to review progress on this recommendation again in 2015 Q2, when it expected that a fuller set of CBEST results would be available.**

Powers of direction over housing instruments (14/Q3/1): The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to: (a) loan-to-value ratios; and (b) debt-to-income ratios, including interest coverage ratios in respect of buy-to-let lending.

42 The Government had published a consultation document on the FPC's proposed powers of direction over the housing market on 30 October; this consultation had closed on 28 November. The Committee noted that the Government intended to lay the final legislation before Parliament in early 2015, alongside publishing a consultation response document and an impact assessment. The FPC agreed that it would publish a draft Policy Statement outlining how it would use these new powers to inform the Parliamentary debate. The Committee noted that HM Treasury intended to consult separately in 2015 on the FPC's proposed LTV/ interest coverage ratio powers for the buy-to-let sector. **The Committee decided to review progress on this recommendation again at its next policy meeting.**

Powers of direction over leverage ratio (14/Q3/2): *The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA to set leverage ratio requirements and buffers for PRA-regulated banks, building societies and investment firms, including: (a) a minimum leverage ratio requirement; (b) a supplementary leverage ratio buffer that will apply to G-SIBs and other major domestic UK banks and building societies, including ring-fenced banks; and (c) a countercyclical leverage ratio buffer.*

43 The Government had published a consultation document on the FPC's proposed powers of direction over the leverage ratio on 7 November; the consultation had closed on 28 November. The Government intended to lay the final legislation before Parliament in early 2015, alongside publishing a consultation response document and an impact assessment. As with the housing instruments, the FPC agreed that it would publish a draft Policy Statement to inform the Parliamentary debate. **The Committee agreed to review progress on this recommendation again at its next policy meeting.**

ESRB recommendation on intermediate objectives

44 In April 2013, the European Systemic Risk Board (ESRB) had issued recommendations on macroprudential policy frameworks to national authorities in EU member states¹. The ESRB had asked relevant authorities to confirm by 31 December 2014 the steps they had respectively taken to give effect to two of these recommendations, relating to the identification of intermediate objectives of macroprudential policy and powers for the macroprudential authority over at least

¹ For further details see: <https://www.esrb.europa.eu/pub/recommendations/html/index.en.html>

one instrument for each intermediate objective. The Committee judged that its existing statutory framework was consistent with the ESRB's recommendations in both regards.

The following members of the Committee were present at the meeting; Richard Sharp joined the meeting by telephone:

Mark Carney, Governor

Jon Cunliffe, Deputy Governor responsible for financial stability

Andrew Bailey, Deputy Governor responsible for prudential regulation

Ben Broadbent, Deputy Governor responsible for monetary policy

Martin Wheatley, Chief Executive of the Financial Conduct Authority

Clara Furse

Donald Kohn

Richard Sharp

Martin Taylor

Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Nemat Shafik, Deputy Governor responsible for markets and banking, also attended the meeting.

As permitted under the Bank of England Act 1998, Anthony Habgood 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/Q2/6 | 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/Q3/1 | The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to: (a) Loan-to-Value Ratios; and (b) Debt-to-Income Ratios, including Interest Coverage Ratios in respect of buy-to-let lending. |
| 14/Q3/2 ⁽²⁾ | The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA to set leverage ratio requirements and buffers for PRA-regulated banks, building societies and investment firms, including: (a) a minimum leverage ratio requirement; (b) a supplementary leverage ratio buffer that will apply to G-SIBs and other major domestic UK banks and building societies, including ring-fenced banks; and (c) a countercyclical leverage ratio buffer. |

⁽¹⁾ Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '13/Q1/6' refers to the sixth recommendation made at the 2013 Q1 meeting.

⁽²⁾ This recommendation was made at the FPC's dedicated meeting on the leverage ratio review held on 15 October 2014.