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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETINGS

25 AND 30 NOVEMBER 2015

This is the record of the Financial Policy Committee meetings held on 25 and 30 November 2015.

It is also available on the Internet:

<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2015/record1512.pdf>

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

The FPC's next policy meeting will be on 23 March 2016 and the record of that meeting will be published on 5 April.

RECORD OF FINANCIAL POLICY COMMITTEE MEETINGS HELD ON 25 AND 30 NOVEMBER 2015

At its meetings on 25 and 30 November, the Financial Policy Committee made no new Recommendations and considered that Recommendation 13/Q1/6 relating to stress testing had been implemented.

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

1. The Committee met on 25 November to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. It assessed the outlook for financial stability by identifying the risks faced by the financial system and weighing them against the resilience of the system. As part of its assessment, it also completed its review of the overall capital framework for the UK banking system in order to clarify where overall requirements would settle. The Committee met subsequently on 30 November to confirm its response to the results of the 2015 banking system stress test exercise.

Risks to financial stability

2. The Committee reviewed financial system and economic developments, as set out more fully in the December 2015 *Financial Stability Report (FSR)*. The Committee identified the main risks as: emerging market economies; financial market fragility; property markets in the United Kingdom; the United Kingdom's current account deficit; and cyber risk.

Emerging market economies

3. The Committee judged that the global macroeconomic environment remained challenging. Risks in relation to Greece and its financing needs had fallen from their acute level at the time of the publication of the July 2015 *FSR*. But, as described in the December 2015 *FSR*, risks in relation to emerging market economies (EMEs) had come into sharper focus.

4. Greece had so far met the conditions of the programme agreed with its European partners in August and upcoming debt repayments were relatively small until the summer of 2016. However, a sustainable solution would probably require an agreement on debt relief.

5. Euro-area quarterly GDP growth had weakened slightly, to 0.3% in Q3. Downside risks remained, particularly given the euro area's relatively strong trade links with EMEs. It was also unclear how economic activity would be affected by the terrorist attacks that had occurred during November. Financial markets' reaction to a series of coordinated terrorist attacks in Paris on 13 November so far had been limited.

6. The central outlook for EMEs had, however, deteriorated further since the Committee's September policy meeting. Following data showing a sharp slowing in activity in the second quarter, the Monetary Policy Committee had in its November *Inflation Report* revised down its

forecasts for growth in EMEs, excluding China. In China, the outlook for growth had not deteriorated, partly reflecting additional monetary and fiscal stimulus.

7. Following material net outflows in the third quarter, capital flows into EMEs appeared to have stabilised during October, before a resumption of net outflows in November. The change in sentiment in November appeared to have been triggered by a firming of market expectations for an increase in the US Federal Funds rate at the Federal Open Market Committee's (FOMC) upcoming meeting on 15 and 16 December.

8. Capital flows had been sensitive to diverging prospects for monetary policy around the world and there was a risk of further volatility in capital flows as that policy divergence progressed. Though the likelihood of a tightening in policy by US policymakers was widely expected, the market reaction to any decision by the FOMC to increase interest rates remained difficult to predict.

9. Given the size of UK banks' exposures to EMEs, there were likely to be risks to UK financial stability associated with the rapid build-up in emerging market debt. Reflecting this, the FPC had incorporated a sharp slowdown in EME GDP growth into its 2015 stress test. In the latest data for June, major UK banks' exposures to EMEs and Hong Kong had totalled 340% of their common equity Tier 1 (CET1) capital, a fall of 20 percentage points relative to the end of 2014. Those exposures were concentrated in Asia, with China and Hong Kong accounting for around 45% of the total. Exposures to Latin America, where there had been the largest contribution to the deterioration in the EME growth outlook since September, made up less than 10% of the total and looked set to fall further given planned divestments in Brazil.

10. Oil prices were now close to the path set out in the 2015 stress test scenario for UK banks. And the IMF's latest growth projections to end-2017 for Brazil, a major commodity exporter, were cumulatively 8% below those made in the IMF's October 2014 World Economic Outlook. These adverse developments meant the likelihood of a further sharp deterioration in the growth outlook was now lower.

Financial market fragility

11. Long-term interest rates in advanced economies were historically low. This partly reflected market expectations of a gradual normalisation of policy rates, but estimates of term premia – that is, the compensation investors required for uncertainty around the expected future

path of interest rates – had also been at very low levels. Furthermore, the compensation that investors demanded for holding risky assets had appeared compressed in some market segments.

12. A further negative reappraisal of the global economic outlook or a crystallisation of risks in EMEs, could lead to a sharp increase in the compensation demanded by investors for holding risky assets. The Committee remained concerned that any correction in market prices – and associated increase in volatility – could be amplified and propagated by fragile market liquidity in some markets. The supply of credit to the real economy, and the transfer of risks to those best placed to manage it, could be impaired if there were sustained illiquidity in and dislocation of core financial markets. Some of these vulnerabilities had come to the fore in August 2015, when an episode of intense volatility in some markets materialised against the backdrop of concerns among market participants about a possible slowdown in economic growth in China. However, this episode had been short-lived and had not had systemic consequences.

13. As the Committee had discussed previously, a number of episodes of high volatility had originated in markets that were largely electronic and often exchange-traded. In these markets, use of passive, and other procyclical, trading strategies and automated trading, that in aggregate could amplify prices, had been growing in importance. There had also been signs of lower liquidity in normal times in some markets, such as cash fixed income markets, that rely on dealers to intermediate between clients.

14. Structural changes in regulation implemented in response to the global financial crisis, to ensure the safety and soundness of core intermediaries, may have discouraged some dealers from using their balance sheets to make markets, including by building and releasing inventories as part of their market-making activity. In these markets, lower routine liquidity needed to be balanced against the benefits of ensuring greater resilience in stress conditions via a more resilient core financial system. As the FPC had set out in its response to the Chancellor's remit to the FPC in August, it would assess the costs and benefits of the cumulative impact of reforms to make the financial system more resilient, including any unintended consequences for the provision of market liquidity in core financial markets. In doing so, it would draw on inputs from the Bank's recent Open Forum.

15. Despite periods of intense volatility, there had been evidence that market and liquidity risks were not being fully reflected in the prices of some financial assets. It was possible that liquidity premia might increase rapidly if fragile market liquidity was exposed in those markets. This could arise, for example, in response to large-scale redemptions from investment funds in the

event of a fall in risk appetite. The Committee agreed that it was important that market participants recognised the underlying risks in different asset classes, and priced them accordingly.

16. As part of its briefing on current trends in market liquidity, the Committee also discussed factors that could influence the behaviour of market participants during episodes of illiquidity, including usage of firms' liquidity buffers to absorb stress and use of the Bank's Sterling Monetary Framework.

17. On 16 November, the Governor had received a letter from the chairman of the Treasury Committee requesting information on the FPC's assessment of the risks to liquidity in the UK gilt market. The letter had also requested the Bank's view regarding the effects on liquidity of the MPC's asset purchases, as well as an explanation of the coordination between the Bank, the Debt Management Office and HM Treasury and between the three policy making committees of the Bank of England. The FPC agreed that the Governor would respond on behalf of the Bank of England. This response would reflect the views of the FPC, for whom consideration of risks in the gilt market formed part of its programme of work over coming meetings to review liquidity considerations across a wide range of markets.

UK property markets

18. Activity and credit growth in the housing market had been gradually picking up over recent months. Mortgage approvals for house purchase had been 69,000 in September 2015, higher than the 62,000 level six months earlier, but well below the 1994-2007 monthly average of 99,000. Mortgage lending growth had been 2.2% in the twelve months to September 2015. House price inflation had risen to 7.8% on a three month on three month annualised basis in October and forward-looking indicators suggested growth would remain strong in the period ahead.

19. The limited growth in mortgage lending had continued to be driven by the buy-to-let sector. In the year to 2015 Q3, the stock of buy-to-let lending had risen by 10%, compared to 0.4% for owner-occupiers.

20. Some of the strength in buy-to-let lending was consistent with an increase in demand for accommodation in the private rental sector. Since 2008 this had appeared to be driven largely by the reduced availability of high loan to value (LTV) mortgage lending to owner-occupiers, which

had increased the age at which many potential first-time buyers were leaving the private rental sector. Population dynamics were also likely to have played a role. These increases in rental demand, alongside low interest rates and low returns on alternative assets in the post-crisis period, had boosted the attractiveness of borrowing for buy-to-let investment.

21. Increased competition among lenders in the buy-to-let sector had not to date led to a widespread deterioration in underwriting standards of UK banks. But some smaller lenders had loosened their lending policies, for example by raising their maximum LTV thresholds. The Committee noted that new loans to buy-to-let investors were often subject to less stringent affordability tests than loans to owner-occupiers.

22. Assessed against relevant affordability metrics, buy-to-let borrowers appeared more vulnerable to an unexpected rise in interest rates or a fall in income. The Committee considered there to be a risk that during an upswing in house prices, investors seeking capital gains would be able to increase leverage through the purchase of multiple properties. The resulting boost in demand could add further pressure to house prices, prompting both buy-to-let and owner-occupier borrowers to take on larger loans, thereby increasing indebtedness. Since 2010, rates of credit loss on buy-to-let loans in the United Kingdom had been around twice those incurred on lending to owner-occupiers.

23. The FPC was alert to financial stability risks arising from rapid growth in buy-to-let mortgage lending and supported the programme of work initiated by the Prudential Regulation Authority (PRA) to review lenders' underwriting standards. The Committee also agreed that it would need to monitor developments in buy-to-let activity closely following the tax changes to the buy-to-let market announced by the Chancellor in the Budget and Autumn Statement.

24. HM Treasury would consult on powers of Direction for the FPC on buy-to-let mortgage lending before the end of the year. Ahead of these powers being finalised, the FPC stood ready to take action if necessary to protect and enhance financial stability, using its powers of Recommendation.

25. Beyond residential property markets, the Committee had become more concerned by developments in the UK commercial real estate (CRE) market recently. UK CRE prices had been rising rapidly. There was some indication of greater use of leverage in the funding of investments, and there had been strong growth in assets under management in open-ended funds

investing in UK CRE. These funds were now holding approximately 5% of the total stock of UK commercial property.

26. Committee members noted that, over the past three years, investment in UK CRE had been driven by overseas investors, notably from the United States and Asia. This could mean the impact of a downturn in the UK CRE market would be spread over a broader set of investors, with a smaller consequent impact on the UK financial system. However, as set out in the December 2015 *FSR*, exposures of the major UK banks to CRE lending averaged around 50% of their CET1 at end-2014. And in addition, a severe downturn in the CRE market could reduce the ability of some UK non-financial firms to access bank finance, given their use of CRE as collateral to support their borrowing. The FPC would continue to monitor closely developments in the UK CRE market.

UK current account deficit

27. In recent years, the UK current account deficit had been large by historical and international standards. As the FPC had noted previously, a persistent current account deficit could lead to a sudden adjustment in capital flows or a depreciation of the exchange rate, with adverse consequences for UK financial stability.

28. Since the Committee last met in September, risks from the current account deficit appeared to have fallen back a little. The deficit had narrowed in 2015 Q2 to 3.6%. In part, this was probably driven by temporary factors. But, the UK external balance sheet appeared more resilient than in the period before the financial crisis. Recent portfolio investment inflows looked to have been concentrated in equity, gilts and private-sector debt securities.

29. Nonetheless, the Committee noted that the ease of financing the current account deficit rested on the credibility of the United Kingdom's macroeconomic policy framework and its continuing openness to trade and investment. The United Kingdom had maintained this confidence in recent years but it was important that this continued.

30. While the widening in the current account deficit since 2011 had coincided with a fall in net saving by the UK private sector, that had not yet been associated with significant growth in overall lending to households and companies. However, the FPC remained vigilant to the possibility that capital inflows might amplify risks in specific sectors such as CRE.

Cyber risk

31. The FPC judged that cyber attack was a serious and growing threat to the resilience of the UK financial system. As set out in the cyber risk chapter of the December 2015 *FSR*, the threat posed by cyber attack had been underscored by several recent high-profile data breaches in the telecoms sector. Awareness of cyber risk had continued to grow. The proportion of respondents to the Bank's *Systemic Risk Survey* highlighting cyber risk as a key concern was 46% in 2015 H2, up from 30% in 2015 H1 and 10% in 2014 H2.

32. The Committee emphasised the need for firms to build their resilience to cyber attacks, develop the ability to recover quickly from attacks, and ensure effective governance – which required viewing cyber risk as a strategic priority, rather than a narrow 'technology' issue.

33. In June 2015, the FPC had made a Recommendation (15/Q2/3) to the Bank, the PRA and the Financial Conduct Authority (FCA) to work with firms at the core of the UK financial system to ensure that they completed cyber vulnerability testing and adopted individual cyber resilience action plans. Firms continued to make progress in relation to this Recommendation, with ten core firms now having completed these vulnerability tests, up from five at the time of the July 2015 *FSR*.

34. The FPC had in July also asked 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. As part of this, effective cooperation with international authorities would be needed. In November 2015, UK and US authorities had conducted a joint exercise with major global financial firms to enhance their cooperation and ability to respond to cyber attacks, by improving information sharing, incident response handling and public communications.

35. The FPC would receive an update on the cyber work programme by summer 2016 and would at that stage consider the need for further action based on the outcome of the work.

36. In the context of elevated geopolitical risks, the FPC emphasised the importance both of strengthening resilience to cyber attacks and of market participants having robust contingency planning arrangements in place that were regularly tested and updated to reflect current threats.

Overall assessment of financial stability risks

37. The Committee then reviewed its overall assessment of financial stability risks.
38. The domestic picture was considered against the backdrop of a global environment that the Committee had agreed remained challenging.
39. Following the global financial crisis, there had been a period of heightened risk aversion and retrenchment from risk taking as financial institutions, businesses and households had sought to repair their balance sheets. The FPC judged that the system had now moved out of that period. In forming that judgement, the Committee had reviewed a broad range of indicators encompassing credit growth, borrower indebtedness, credit conditions and property and asset prices.
40. Credit had been more generally available and four-quarter aggregate private non-financial sector credit growth, at 2.5% in Q2 2015, had risen and was now close to the corresponding growth rate of nominal GDP. Although non-financial private sector indebtedness had fallen since the crisis, household debt was still high relative to income. Lenders' terms and conditions on residential mortgages did not appear unusually lax, though lending at high loan to income ratios remained significant. Sterling investment-grade corporate bond spreads had risen by 23bps since the Committee's 2015 Q2 meeting and were now slightly above historical averages. Sterling high-yield bond spreads had risen by 50bps over the same period but remained compressed.
41. The Committee also considered the Basel 'buffer guide' – a simple metric that the FPC was required by legislation to take into account when setting the countercyclical capital buffer (CCyB), which, alongside other variables relevant to risks to the stability of the financial system, provided a guide for the CCyB rate based on the gap between the ratio of credit to GDP and its long-term trend. The 'buffer guide' implied that the CCyB rate should be set at 0%. But, as the Committee had discussed in previous meetings, there was not a simple, mechanistic link between the 'buffer guide' and the CCyB rate. The Committee noted that the long run trend on which the indicator was based gave undue weight to the period before the crisis and in the view of most members might not be reliable, as the strong growth trend prior to the crisis was clearly not sustainable and might not be consistent with the path in years ahead.
42. Some asset prices and property prices, in particular, appeared elevated relative to incomes or rents. Increases in property prices had, in previous cycles, been associated with a subsequent increase in credit growth. CRE prices had risen strongly in recent years and prime CRE appeared overvalued on some metrics. UK house price inflation had picked up recently. Valuations were

vulnerable to an increase in market interest rates or premia demanded by investors for holding risky or long-term assets.

Resilience of the financial system

43. In assessing the outlook for financial stability, the Committee weighed the level of risks against the resilience of the financial system. In particular, the Committee assessed the resilience of the UK banking system in the light of the 2015 stress test results¹ and the finalisation of the capital framework for the UK banking system. It assessed the resilience of market-based finance in the light of its review of risks to financial stability posed by the activities of open-ended investment funds.

Stress testing and the resilience of the UK banking system

44. The Committee noted that the resilience of the UK banking system had continued to strengthen in recent years, reflecting the introduction of higher regulatory requirements. In September 2015, the major UK banks had an aggregate Tier 1 capital position of 13% of risk-weighted assets and a CET1 capital ratio of 12%.

45. The 2015 stress test exercise had covered seven major UK banks and building societies which, between them, accounted for over 80% of PRA-regulated banks' lending to the UK real economy.

46. The design of the 2015 stress test scenario had reflected the judgement made by the FPC in December 2014 that global and financial risks had increased. In the macroeconomic stress scenario, global growth was materially lower, particularly for China and the euro area. The stress scenario had also incorporated a rapid deterioration in financial market sentiment with liquidity in some markets assumed to become seriously impaired and a sharp rise in credit risk premia. In addition, the stress test had incorporated a stress case projection for potential misconduct redress costs and fines. These costs had a low likelihood of being exceeded and were therefore, by design, much larger than the amounts that had already been paid or provisioned for by banks at the end of 2014.

¹ <http://www.bankofengland.co.uk/financialstability/Pages/fpc/stresstest.aspx>

47. The stress scenario that had been used was not a forecast of the macroeconomic and financial conditions that were expected, or likely, to materialise. Rather, it examined the potential impact of a hypothetical adverse scenario on the health of the banking system and individual institutions within it. Although the 2015 exercise had assessed the impact of a particular stress scenario, the results from this exercise (taken together with the results from the 2014 stress test exercise) allowed the Committee to assess banks' resilience to a range of adverse shocks and to assess their capital adequacy, not just to withstand those shocks, but also to support the real economy if a stress were to materialise.

48. Performance in the stress test had been assessed against two metrics of capital adequacy: a CET1 capital ratio of 4.5% of risk-weighted assets and a 3% threshold for the Leverage Exposure Measure, to be met with Tier 1 capital.

49. 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 for assessing the implications of the stress test results for the resilience of the system as a whole. In this regard, the FPC considered the ability of the banks to maintain an adequate supply of credit to the real economy in the stress scenario. While it was likely that the demand for credit would decline in a stress, the FPC considered it important that any reduction in the amount of credit provided by banks was not greater than the likely reduction in demand for credit. Reflecting this, the stress test framework had required banks' projections for their lending in the stress scenario to be consistent, in aggregate, with a prescribed increase in lending to the UK real economy over the five years of the stress scenario.

50. As set out in full in *Stress testing the UK banking system: 2015 results*, the aggregate Basel III CET1 ratio across the participating banks had fallen from 11.2% at the end of 2014 to a low point of 7.6% in 2016 and the leverage ratio had fallen from 4.4% to a low point of 3.5%.

51. The FPC noted that no banks had fallen below the 3% Tier 1 leverage ratio or 4.5% CET1 ratio thresholds at the trough of the stress scenario and that, after taking account of management actions (including dividend restrictions), no Additional Tier 1 (AT1) instruments were expected to convert into equity. Although, the Committee emphasised that investors should be aware that these instruments would trigger if a stress materialised in which a bank's CET1 ratio fell below these instruments' trigger points. The capitalisation of the system had improved over the course of 2015 and two banks had already announced steps to strengthen further their capital positions. In the view of the FPC, the stress test results and banks' capital plans, taken together, indicated

that the banking system would have the capacity to maintain its core functions in a stress scenario such as the one in the 2015 stress test. No further macroprudential action was required on the basis of the stress test.

Capital framework for UK banks

52. The Committee had set out in 2014 that it would review the overall capital framework for the UK banking system and clarify where the overall requirements for the UK banking system would settle. In particular, the Committee aimed to finalise its view on the overall amount of capital for the UK banking system and the appropriate structure of those requirements; and to set out how the framework of capital requirements was expected to evolve between now and the end position in 2019. It also discussed further its strategy for using the countercyclical capital buffer within this framework.

Calibration of overall capital requirements

53. The Committee noted that the baseline international standards for bank equity and broader loss absorbing capacity had been established and work was now moving into the phase of full implementation of these standards. Since the FPC's September meeting, the Financial Stability Board had published the final standard for the total loss absorbing capacity (TLAC) that globally systemic banks would need to hold. In the United Kingdom, the TLAC standard would be implemented by the Bank of England through 'minimum requirements for own funds and eligible liabilities' that must be set for all banks under the European Bank Recovery and Resolution Directive. The Bank would consult on its approach to setting these requirements shortly.

54. The FPC considered first the overall amount of equity the UK banking system should have, by considering analysis of the economic benefits and costs of bank equity. In trading off these costs and benefits, the FPC sought to ensure that the provision of services to the real economy by the banking system would be resilient to stress, without damaging the capacity of the banking system to support sustainable economic growth over the long term.

55. Previous studies of the economic costs and benefits of higher equity requirements conducted directly after the financial crisis, including those conducted by the Basel Committee on Banking Supervision to inform the calibration of the Basel III standards, had concluded that the appropriate Tier 1 equity requirement was in the region of 16 to 19% of risk-weighted assets.

56. Bank of England staff had updated and extended this analysis to reflect the experience gained since the global financial crisis and to take account of regulatory reforms, in particular the introduction of credible and effective bank resolution regimes. This updated analysis suggested that the optimal Tier 1 equity requirement for the UK banking system as a whole was in the region of 10 to 14% of banks' risk-weighted assets. The detailed analysis would be published in a Bank staff paper.

57. The results depended on the assumptions made on: whether crises had a permanent effect on GDP; the effectiveness of bank resolution arrangements; and whether the transition to higher capital requirements would generate unavoidable and persistent economic costs. The staff analysis showed that if the Committee judged the costs of transitioning to higher bank capital were greater, the optimal level of capital may be in the range of 7-11%. If bank resolution regimes were to prove less effective, the appropriate range could be closer to 15-19%.

58. There was a range of views on these assumptions. Some members placed more weight on the transition costs of raising additional equity, which would imply that the appropriate level of capital might be at the lower end of the range. Others placed more weight on the cost of crises, given that recent studies of financial crises suggested that the economic costs could be higher, which would point to the upper end of the range. On balance, the Committee judged the appropriate Tier 1 equity requirement for the UK banking system in aggregate to be 11% of risk-weighted assets. This also took into account the Committee's intention to make active use of the countercyclical capital buffer.

59. A small part of this could be met with contingent capital instruments in line with existing requirements: the FPC considered the appropriate level of CET1 to be 9.5% of risk-weighted assets. This assessment referred to the structural equity requirements applied to the aggregate system that did not vary through time.

60. The Committee discussed three main reasons why the estimates for the appropriate structural level of going concern equity in this study were materially below earlier assessments.

61. First, the introduction of effective arrangements for resolving banks that fail would reduce materially both the probability and costs of financial crises. An effective resolution regime had been established in the United Kingdom and was being implemented. Banks were restructuring in ways that would facilitate their resolution, including through ring-fencing. And the new requirements for Total Loss Absorbing Capacity for globally systemic banks would ensure these

banks would have resources that could be used to absorb losses and recapitalise them in resolution. These resources, which would not need to be Tier 1 capital instruments, should be roughly equal in size to their equity requirements. The Committee agreed that these standards were appropriate and expected the principle behind them – to facilitate resolution – to be extended across the UK banking system. The Bank of England would consult on this shortly.

62. Second, that the structural changes since the crisis would reduce the exposure of the banking system to risk, including ring-fencing of major UK banks and forward-looking, judgement-led prudential supervision conducted by the Prudential Regulation Authority.

63. Third was the Committee's intention to make active use of the time-varying, countercyclical capital buffer (CCyB). As it had set out when deciding the minimum leverage requirements in October 2014, use of time-varying requirements allowed the Committee to avoid the need to capitalise the banking system for high-risk conditions at all points – an outcome that it judged economically inefficient.

64. The Committee judged that around half of the appropriate equity requirement should be in the form of buffers that could be used to absorb losses when under stress rather than in hard minimum requirements. Such buffers served an important macroprudential purpose. By absorbing the impact of stress they reduced the need for banks to withdraw critical services, such as the provision of credit to the real economy.

65. The Committee's judgement about the appropriate equity requirement for the UK banking system was broadly in line with internationally agreed Basel III requirements, which would be fully phased in by 2019. It was not therefore seeking further structural increases in capital requirements for the system as a whole.

66. These requirements comprised: a 6% Tier 1 minimum; a 2½% capital conservation buffer that established a baseline ability to absorb stress across the system; and an additional buffer of equity for banks judged by the Financial Stability Board to be globally systemic. These buffer requirements for globally systemic banks would at present range between 1% and 2½% of risk-weighted assets, such that for the system as a whole, they would add equity of around 1½% of risk-weighted assets.

67. In addition, for the United Kingdom, legislation required that ring-fenced banks and large building societies should also be subject to a systemic risk buffer (SRB) of between 0 and 3% of

risk-weighted assets from 2019, to be implemented via a framework set by the FPC. The SRB was expected to add around ½% of risk-weighted assets to equity requirements of the system in aggregate.

68. The FPC would consult on the framework for the SRB in January 2016. Ahead of the consultation being finalised, the Committee considered a number of options for the framework. The purpose of the SRB was to increase the capacity of ring-fenced banks and large building societies to absorb stress, thereby increasing their resilience relative to the system as a whole. This reflected the additional damage these firms could cause to the economy when they were close to failure, such as reducing credit supply. The Committee intended that the size of a firm's buffer should reflect the relative costs on the economy if the firm fell into distress.

69. There were a number of criteria that could be used to determine how costly an individual firm's distress could be for the economy, including the firm's role in supplying credit to the UK economy and the interconnectedness of that firm with other parts of the financial system, such as its role in payment systems. The FPC considered a range of variables that could be used to inform these criteria, such as total assets, core deposits and a firm's share of household or corporate lending. In order to put in place a framework that would capture the most important determinants of systemic importance while remaining relatively straightforward, the Committee agreed that the framework should determine systemic importance with reference to a firm's total (not risk-weighted) assets.

70. Using this framework, banks and building societies in scope with less than £175bn of assets would be subject to an SRB of 0%, because the Committee judged the effect of distress at these firms to be no greater than for the system as a whole. The Committee also agreed that, on current plans, the largest buffer rate in effect would be 2½%. The 3% rate would be unused. However, were some firms to expand further their total assets could fall into a range covered by the 3% buffer.

71. The FPC noted that its view of the appropriate level of equity for the UK banking system as a whole would not apply to each and every bank and building society – there would be a distribution across firms reflecting their systemic importance and the risks faced by each business relative to the system as a whole.

72. The Committee's assessment of the appropriate level of equity for the banking system assumed an accurate measurement of risk-weighted assets in which all the shortcomings in the

current regime had been corrected. These shortcomings included defined-benefit pension deficits or risk weightings that were too low. There was a programme of work domestically and internationally to address some of these issues. If no definitional corrections were made and the prevailing risk-weighted measures remained in place, the system would require Tier 1 equity of around 13½% of risk-weighted assets as currently measured.

73. The FPC noted that the aggregate Tier 1 capital position of major UK banks was 13% of risk-weighted assets in September 2015. The measured level of equity in the system therefore had a little further to increase before 2019 in order to meet planned requirements. The Committee considered this to be manageable: it noted that over the previous six months, major UK banks had increased their CET1 ratios from an aggregate of 11.4% of risk-weighted assets in March 2015 to 12% in September 2015.

74. The Committee continued to view leverage requirements as an essential part of the capital framework. These leverage requirements, for equity relative to total, rather than risk-weighted, exposures, managed the problems with risk-weighting. The FPC noted that its leverage framework required major banks and building societies to satisfy a minimum leverage ratio of 3%. In addition, as a guiding principle, leverage ratio buffers would be scaled up in proportion to any countercyclical capital buffer on UK exposures and also for systemically important banks.

Countercyclical capital buffer strategy

75. The Committee had agreed in 2015 Q3 that the objective of the countercyclical capital buffer (CCyB) was to increase the resilience of banks so that they could absorb losses in a stress, enabling banks to continue to support the real economy without amplifying the stress by seeking to contract their balance sheets to maintain their capital ratios. Increasing the CCyB may also restrain credit growth somewhat, but the effect was unlikely to be substantial. Using the CCyB for this purpose was not its primary objective and would not generally be expected to guide its setting. At its meeting, the FPC noted that other macroprudential tools, such as those aimed directly at lending standards or sectoral capital requirements, were probably better placed to address excessive growth of credit.

76. The FPC discussed when and how quickly it would increase the CCyB as it observed risks building. There were two strategies: to act early, raising the CCyB gradually as risks emerged but before they reached elevated levels; or to act later and raise the CCyB only when it was clear that risks were high. The Committee noted the uncertainty involved in measuring risks and therefore knowing which risk phase the financial system was in, and the twelve month time lag between a

decision and full implementation of increases in the CCyB. It observed that increasing the CCyB early and in smaller steps was likely to mean lower costs to banks of building additional resilience, as it would allow banks to adjust via retained earnings. Conversely, the costs of large, unexpected increases in the CCyB could potentially be non-linear, if banks adjusted by excessive deleveraging.

77. Reflecting these factors, the Committee expected to move the CCyB in gradual increments in order to minimise its impact on the real economy while achieving the necessary degree of resilience of the banking system. To facilitate this gradual approach, the FPC expected the CCyB to be raised from zero before the risks facing the banking system were elevated.

78. By applying the CCyB in this way, the FPC would increase banks' resilience as the risk of losses increased. The Committee agreed that the process was symmetric: if risks abated the CCyB would be reduced. In particular, if risks crystallised, the FPC expected to cut the CCyB substantially, in order to enable banks to continue to lend to support the real economy.

79. An implication of this strategy was that during periods after the recovery and repair phase that typically followed a financial stress ended, but before the risks facing the system had become elevated, the CCyB would be above zero. Although the exact setting of the CCyB would always reflect the Committee's assessment of the level of risk at the time, the Committee considered whether there might be benefit in providing some guidance on the magnitude of CCyB rate that it might consider setting in these periods. The Committee's current assessment was that during these periods the UK CCyB rate might be in the region of 1%. There were a range of views amongst members regarding how firmly they held this as their central expectation for setting the CCyB during these periods. Some expressed concern that the announcement of such an expectation might constrain the Committee's ability to vary the CCyB to emerging, though not yet elevated, risks, or in response to insights from the annual stress tests. The Committee agreed to set out this guidance but to keep it under regular review.

80. The risks currently captured by existing supervisory requirements had some overlap with those that would in future be captured by the FPC's intended approach to using the UK countercyclical capital buffer. The Board of the PRA would review individual requirements to reflect the FPC's CCyB strategy, alongside its regular updating of supervisory requirements in 2016 Q1. The result of this process would mean an increase in the countercyclical capital buffer that would probably not change the overall capital requirements for individual banks.

81. The Committee judged there to be a number of benefits from replacing this component of microprudential buffers related to UK exposures with a macroprudential buffer effected through an increase in the CCyB. The change in the composition of capital buffers would increase transparency and avoid potential overlap between microprudential and macroprudential requirements. And a larger role for the CCyB in the setting of banks' overall capital buffers would mean that a greater proportion of those buffers would be regularly reviewed from a macroprudential perspective. That would create more scope for required capital buffers that had been built up to be cut, possibly rapidly, were risks to crystallise or recede.

Current setting of the countercyclical capital buffer

82. In the light of its strategy, the FPC noted that financial conditions had shifted out of the post-crisis phase and were consistent with considering a move to a positive setting for the CCyB.

83. The Committee also discussed whether there might be a case for increasing the CCyB by a greater amount than the overlap with existing microprudential buffers and thereby effecting an increase in the overall capital requirements on UK exposures.

84. In the view of some members, it was too soon to consider an increase in capital buffers on UK exposures. Though overall credit growth had increased it remained below that of nominal GDP and below pre-crisis averages. Some members had judged the UK corporate sector to have been more risk averse recently and conditions in capital markets to have tightened, with some spreads more elevated than historical averages.

85. In the view of other members, however, there could be a case for such an overall increase soon. The Committee's approach of increasing capital buffers gradually implied that it would take time for additional capital to be built up through the CCyB. The ability to support the economy in the future through cuts in the CCyB, as risks crystallised, required a meaningful buffer of additional capital that could then be released. With credit availability continuing to improve and banks sufficiently profitable to be able to build capital through retained earnings, there could be scope for capital buffers to increase.

86. In parallel, the Committee noted that any decision to increase overall capital buffers was best left until after the PRA Board's review of microprudential capital buffers in 2016 Q1.

87. In the 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

countercyclical capital buffer rate for UK exposures at 0%. It reached this decision by consensus. The FPC would carefully review the setting of the CCyB in March, in view of the pending review by the PRA Board of individual requirements on banks.

88. The Chair also raised the process by which the Committee would arrive at decisions on the future setting of the CCyB. The Committee would change the CCyB in the light of its assessment of the overall risks to financial stability from banks' UK exposures. Given that assessment of risks was inevitably highly judgemental, it acknowledged that there would usually be a range of views across the Committee on the appropriate setting of the CCyB that was warranted at any point in time. Whilst the legislation required the Chair of the Committee to seek decisions of the Committee to be reached by consensus wherever possible, the discrete nature of the decision on the CCyB might not always lend itself to a consensus-based process. The Chair noted that the legislation allowed the Committee to vote on the setting of the CCyB when the Chair forms the opinion that consensus cannot be reached. The Committee agreed that it would be flexible in its approach to deciding how to set the buffer.

Resilience of market-based finance

89. The FPC had a statutory responsibility to identify, assess, monitor and take action in relation to financial stability risk across the whole financial system, including risks arising from beyond the core banking sector. In July 2015, the Committee had discussed a high-level review of the potential sources of fragility relating to thirty types of activity beyond the core banking system. Following up on this work, and in the context of more fragile market liquidity, the Committee had asked the Bank and the FCA to analyse the risks associated with the activities of open-ended funds offering short-notice redemption.

90. In September, the FPC had reviewed the initial assessment of Bank and FCA staff of investment funds, including results of a survey of 17 asset management firms covering 143 investment funds. The Committee had asked for further work on the possible impact of correlated investment behaviour by investment funds and the measures those funds could deploy under stress. The recent rapid growth in open-ended funds, and their continued investment in less liquid assets, had reinforced the risk that large-scale investor redemptions could result in sales of assets by funds that might overwhelm markets' ability to absorb them.

91. The Committee considered three channels through which the activities of open-ended investment funds might exacerbate large-scale asset sales and lead to market disruption:

- *First-mover advantage* – were investors remaining in a fund to bear some or all of the costs of meeting redemptions, this might create additional incentives for investors to redeem ahead of others. This could increase the scale of subsequent asset sales during periods of stress.
- *Pro-cyclical behaviour by end-investors and fund managers* – end investors could have the potential to behave pro-cyclically, redeeming in large scale following poor fund performance.
- *Leverage* – fund leverage had the potential to increase the volume of sales, and hence risks to market liquidity, that occurs from a given level of redemptions.

92. The Committee concluded that the risks relating to the *first-mover advantage* issue appeared minimal given how UK authorised funds had the ability to apply mechanisms – such as swing pricing and dilution levies – that allow the costs associated with meeting redemptions to be reflected in the amount received by redeeming investors. But it was important that investors understood these regulations and their implications for the lack of first mover advantage.

93. The Committee thought the risks relating to possible *pro-cyclical behaviour by end-investors and fund managers* were likely to be more material. There were a number of reasons as to why the investment decisions of fund managers may be correlated. Committee members noted that the share of interest-sensitive assets held in investment fund portfolios had increased and that fund performance was often evaluated against common benchmarks. In addition, if performance was evaluated against other funds, this might create an incentive for funds to invest in securities that were widely held by their peers, in order to avoid differing performance.

94. The impact of fund asset sales on market functioning might be partially offset by the behaviour of other investors, particularly UK defined-benefit pension funds. The Committee noted, however, that the extent to which pension funds would act countercyclically, by buying corporate bonds sold by asset managers in stressed market conditions, was not certain.

95. With regard to the third channel, the FPC judged risks from financial, or balance sheet, *leverage* to be contained. UCITS regulations limited fund borrowing to 10% of the value of their net assets on a short-term basis and, according to the survey, only four funds had borrowing in excess of two per cent of their net assets over the previous year. It was possible, however, for funds to gain leverage through their use of derivatives as part of more complex investment strategies. The Committee noted that the lack of a standardised measure of this synthetic leverage reported consistently across funds prevented it from reaching a full assessment of risks in this area. In this regard, the Committee supported the FCA's recent consultation on the rules for UK

investment funds, including the standardisation of derivatives reporting, and it noted the related international initiatives in this area.

96. In addition to action on standardising reporting, the Committee thought there were a number of other actions that it would be beneficial to pursue to address the risks posed by procyclical behaviour of investment funds:

- a. The Committee supported the FCA's intention to assess whether investors understand the liquidity risk associated with investment funds, in its forthcoming market study. The Committee considered it important that investors were aware of the potential for funds to use exceptional liquidity management tools, including the application of swing pricing and suspensions. If investors were aware of these tools, it might reduce the likelihood of large-scale redemptions following their use.
- b. The Committee supported the recent Financial Stability Board (FSB) statement that encouraged appropriate use of stress testing by funds to assess their ability individually and collectively to meet redemptions under difficult market liquidity conditions.
- c. The FPC also supported the Bank's intention to explore how investment funds could be incorporated into system wide stress-testing, and in the near-term to assess the resilience of markets to large-scale fund redemptions.
- d. The Committee noted the importance of ongoing international efforts, through the FSB, to address vulnerabilities in relation to asset management activities.

Existing recommendations

97. The Committee reviewed the progress made on implementing its existing Recommendations and Directions since its previous policy meeting. The full text of the outstanding Recommendations and Directions is in Annex 1 of this Record (identifiers in brackets below refer to that annex).

98. 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.* On 21 October 2015, the Bank had published its approach to stress testing the UK banking system. This document set out the Bank's plans for stress testing for the three years to 2018, taking into account the responses received to the Bank's October 2013 Discussion Paper on stress testing, as well as experience of

stress testing since then. As the Bank's approach to stress testing had now been published, the Committee agreed that this Recommendation had been implemented.

99. Powers of Direction over housing instruments (14/Q3/1): The FPC had been granted powers of Direction over mortgage lending for owner-occupied properties earlier in 2015. The outstanding part of this Recommendation related to the powers of Direction over buy-to-let mortgage lending, on which HM Treasury intended to consult before the end of the year. The FPC agreed to review this Recommendation once HM Treasury's consultation had taken place.

100. Leverage ratio (15/Q2/1(D); 15/Q2/2): In response to the FPC's Direction, the PRA had launched a consultation on implementing a UK leverage ratio framework. This consultation had closed on 12 October 2015, and the PRA intended to publish a policy statement, finalised rules and supervisory statements by the end of 2015, with the new rules for the leverage ratio framework coming into force on 1 January 2016. The FPC therefore agreed to review the implementation of this Direction, and associated Recommendation on relevant capital instruments to meet the leverage Direction, once the leverage ratio framework had come into force.

101. CBEST vulnerability testing (15/Q2/3): In June 2015, the FPC had recommended 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, and that 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. Since then, as discussed earlier, progress on CBEST testing had continued, with ten core firms having completed CBEST tests, up from five at the time of the FPC's Recommendation. As agreed at its previous meeting, the Committee intended to review this Recommendation alongside a report from the UK authorities on their wider cyber resilience work programme, expected by summer 2016.

ESRB recommendations

102. The European Systemic Risk Board (ESRB) had asked relevant authorities to confirm that they had complied with three recommendations, issued during 2013 and 2014. These recommendations related to: (i) establishing and assessing policy strategies for the use of macroprudential instruments; (ii) the use of indicators in setting the CCyB; and (iii) assessing the impact of credit institutions' funding plans on the real economy.

103. The Committee judged that its existing policies were consistent with all three recommendations. On the first recommendation, the FPC maintained statements of published policies in relation to each of its macroprudential instruments and periodically assessed the appropriateness of these instruments. On the second, the FPC noted that every quarter it used the standardised Basel credit to GDP gap, alongside other quantitative and qualitative information, to decide on the appropriate setting of the CCyB. The FPC also published a list of its core indicators on the Bank's website. On the third recommendation, the FPC noted that Bank staff considered banks' funding and lending plans and compared these to the Monetary Policy Committee's forecasts in the *Inflation Report*. The findings had also been shared with the FPC and MPC.

The following members of the Committee were present:

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

Tracey McDermott, Acting Chief Executive of the Financial Conduct Authority

Alex Brazier

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: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

Identifier ^(*)	Recommendation/Direction
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.
15/Q2/1(D)	<p>The FPC directs the PRA to implement in relation to each major UK bank and building society on a consolidated basis measures to:</p> <ul style="list-style-type: none"> • require it to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3%; • secure that it ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific countercyclical capital buffer rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points; • secure that if it is a global systemically important institution (G-SII) it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate. <p>The minimum proportion of common equity Tier 1 that shall be held is:</p> <ul style="list-style-type: none"> • 75% in respect of the minimum leverage ratio requirement; • 100% in respect of the countercyclical leverage ratio buffer; and • 100% in respect of the G-SII additional leverage ratio buffer. <p>Common equity Tier 1 may include such elements that are eligible for grandfathering under Part 10, Title 1, Chapter 2 of Regulation (EU) No 575/2013 as the PRA may determine.</p>
15/Q2/2	The FPC recommends to the PRA that in implementing the minimum leverage ratio requirement it specifies that additional Tier 1 capital should only count towards Tier 1 capital for these purposes if the relevant capital instruments specify a trigger event that occurs when the common equity Tier 1 capital ratio of the institution falls below a figure of not less than 7%.
15/Q2/3	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.

(*) Each Recommendation and Direction is listed with an identifier to allow tracking of progress. For example, '14/Q3/1' refers to the first Recommendation made at the 2014 Q3 meeting.

Other FPC policy decisions which remain in place

The table below sets out previous FPC decisions, which remain in force, on the setting of its policy tools. The calibration of these tools is kept under review.

Topic	Calibration
Countercyclical capital buffer (CCyB)	The current UK CCyB rate is 0%. This rate is reviewed on a quarterly basis. The United Kingdom has also reciprocated a number of foreign CCyB decisions — for more details see the Bank of England website. ² Under PRA rules, foreign CCB rates applying from 2016 onwards will be automatically reciprocated if they are less than 2.5%.
Prevailing FPC Recommendation on mortgage affordability tests	<p>When assessing affordability in respect of a potential borrower, UK mortgage lenders are required to have regard to any prevailing FPC Recommendation on appropriate interest rate stress tests. This requirement is set out in FCA rule MCOB 11.6.18(2).³ In June 2014, the FPC made the following Recommendation (14/Q2/1):</p> <p><i>When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).</i></p>
Recommendation on loan to income ratios	<p>In June 2014, the FPC made the following Recommendation (14/Q2/2):</p> <p><i>The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The Recommendation should be implemented as soon as is practicable.</i></p> <p>The PRA and the FCA have published their respective approaches to implementing this Recommendation: the PRA has issued a Policy Statement, including rules,⁴ and the FCA has issued general guidance.⁵</p>

² <http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx>

³ <https://www.handbook.fca.org.uk/handbook/MCOB/11/6.html>

⁴ <http://www.bankofengland.co.uk/pru/Documents/publications/ps/2014/ps914.pdf>

⁵ <http://www.fca.org.uk/news/fg14-08>