BANK OF ENGLAND

Record of the Financial Policy Committee Meeting on 21 June 2017

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This is the record of the Financial Policy Committee meeting held on 21 June.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2017/record1707.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 a committee of the Bank of England.

The FPC's next policy meeting will be on 20 September 2017 and the record of that meeting will be published on 3 October 2017.

Record of the Financial Policy Committee meeting held on 21 June 2017

At its meeting on 21 June 2017, the Financial Policy Committee (FPC):

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

- Agreed to bring forward the assessment of stressed losses on consumer credit lending in the Bank's 2017 annual stress test, to inform its assessment at its next meeting of any additional resilience required in aggregate against this lending; and supported the intentions of the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to publish, in July, their expectations of lenders in the consumer credit market.

- Clarified its existing insurance measures in the mortgage market, designed to prevent excessive growth in the number of highly indebted households. To achieve this, it withdrew its existing Recommendation on affordability tests and replaced it with the following Recommendation:

    - 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, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product 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). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.

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

- Considered that the Recommendation it made in June 2015 on cyber vulnerability testing had been implemented, and could therefore be withdrawn.

1. The Committee met on 21 June 2017 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action.

2. The FPC discussed the risks faced by the UK financial system and the resilience of the system to those risks. Its aim is to ensure the financial system can continue to provide essential services to the real economy, even in adverse circumstances.

The macroeconomic and financial environment

3. The Committee reviewed financial system and economic developments since its previous meeting in March, to identify the main risks to UK financial stability. These would be set out in detail in the June 2017 *Financial Stability Report*, and are summarised below.

Domestic environment

4. Domestic credit had grown broadly in line with nominal GDP over the past two years. Bank lending to UK households and private companies had grown cumulatively by 7.3% in the two years to 2017 Q1, closely in line with cumulative nominal GDP growth of 7.4%, balancing slightly higher household credit growth with lower corporate credit growth.

5. Household debt remained high by historical and international standards and was growing faster than income – the household sector debt to income ratio had risen by 2.8 percentage points to 135% in 2016. The current cost of servicing this debt for the UK household sector as a whole had remained low, reflecting relatively low interest rates. The number of households whose debt servicing costs exceeded 40% of their income remained small, at just over 1% of households.

6. Despite a recent softening in the housing market, bank mortgage lending had grown by 3.4% in the twelve months to 2017 Q1. Mortgage lending at high loan to income (LTI) ratios was increasing and the spreads and fees on mortgage lending had fallen.

7. Consumer credit had continued to grow rapidly, by 10.3% in the twelve months to April 2017 – markedly faster than nominal household income growth. Growth had been broad based across different types of consumer credit: credit card debt, personal loans and motor finance. Lenders expected to continue to grow their portfolios this year, at the same time as real household income growth was expected to remain particularly weak.

8. In the twelve months to 2017 Q1, bank lending to companies had grown by 2.9% in aggregate.

9. The Committee was required by statute to take into account the Basel credit-to-GDP gap when setting the UK CCyB rate. The gap – defined as the difference between the ratio of credit to

GDP and a simple statistical estimate of its long-term trend – remained significantly negative in 2016 Q4. As the FPC had observed at previous meetings, the long-run trend on which this indicator was based gave undue weight to the rapid build-up in credit prior to the global financial crisis and was therefore not always reliable.

Global environment and asset valuations

10. Near-term growth prospects had strengthened and broadened since the FPC's March meeting and some possible global risks had not crystallised.

11. In China, net capital outflows had stabilised, following substantial declines around the end of 2016. Estimates from the Institute of International Finance suggested that net outflows of capital from China for the first four months of 2017 had been around US$42 billion, down from US$250 billion in the previous four months. But economic growth continued to be accompanied by rapid credit expansion. Non-financial debt to GDP grew further to 257%, after rapid increases in recent years. Though the Chinese authorities had raised policy rates and announced a tightening of bank regulation, total social financing had risen by 15.4% in the year to May 2017. Overall, financial vulnerabilities in China remained pronounced.

12. In Europe, euro area sovereign bond spreads had fallen as some political uncertainties had been resolved. Further progress had been made in strengthening European bank capital positions, and a domestically significant bank in Spain had been resolved in an orderly fashion. However, levels of sovereign debt remained high and medium-term profitability of the euro area banking sector remained subdued.

13. In global financial markets, measures of uncertainty implied by options prices were low. In June, the VIX measure of implied equity volatility, derived from S&P 500 stock index option prices, had reached its lowest level since 1993. The Committee noted that often in periods of low volatility, risks build and later become apparent.

14. Long term risk-free interest rates in advanced economies remained low, consistent with pessimistic growth expectations and high perceived tail risks and unusually low term premia. Though near-term prospects in global growth had improved, growth remained below its pre-crisis average, and geopolitical and policy uncertainty remained high.

15. The valuation of some assets, such as corporate bonds and UK commercial real estate assets, appeared to discount future pay-outs using long-term market interest rates, but did not appear to be consistent with the pessimistic and uncertain outlook embodied in those rates. Spreads on corporate bonds were compressed, most notably in the riskier high-yield sector; in the United

States, this had been accompanied by an increase in corporate leverage. Aggregate UK commercial real estate prices had risen by 0.9% in 2017 Q1 and rental yields remained low by historical standards.

16. In the Committee's view, these asset prices were vulnerable to a repricing, whether through an increase in long-term interest rates or an adjustment of growth expectations, or both. UK banks' exposure to the UK commercial real estate market had halved since 2008 and their resilience to sharp falls in commercial real estate prices had been tested in the Bank's annual stress tests. A correction in prices could still affect the availability of credit to firms given the widespread use of these assets as collateral. Further, the impact of a repricing in some bond markets could be amplified given reduced liquidity in some markets. Banks' ability to withstand these risks was being tested in the 2017 stress test scenario.

Outlook for financial stability and FPC action

17. The FPC assessed the overall risks from the domestic environment to be at a standard level: most financial stability indicators were neither particularly elevated nor subdued. However, as was often the case in a standard environment, there were pockets of risk that warranted vigilance, given the rapid increase in consumer credit and easier conditions in the mortgage market. In these pockets of risk, lenders may be placing undue weight on the recent performance of loans in benign conditions.

18. The FPC assessed that global risks were material, as were risks from some asset valuations. The global environment could influence risks on UK exposures indirectly via its potential effects on UK economic growth.

19. Two days prior to the FPC's meeting, exit negotiations between the United Kingdom and the European Union had begun. There were a range of possible outcomes for, and paths to, the United Kingdom's withdrawal from the European Union.

20. The FPC discussed appropriate policy actions to align resilience to this risk environment.

Countercyclical capital buffer

21. The resilience of the financial system had continued to improve: in aggregate, the major UK banks had a common equity Tier 1 ratio of 13.9% of risk-weighted assets in March 2017, 40 basis points higher than at the time of the November *Report*, and a total Tier 1 capital ratio of 15.7%. In November, the FPC had judged that, as a consequence of the 2016 stress test, the UK banking system was, in aggregate, capitalised to support the real economy in a severe macroeconomic stress.

22. The FPC considered the appropriate setting for the UK CCyB rate, an important part of the overall capital framework for UK banks, on the basis of its assessment of the risk environment.

23. When the FPC had published its strategy for setting the CCyB in December 2015, it had set out that: it expected to set a CCyB in the region of 1% in a standard risk environment; and it expected to vary the CCyB rate gradually. Its view had been that a measured approach to increasing the CCyB was likely to decrease the risk that banks would adjust by tightening credit conditions, thereby minimising the cost to the economy of making the banking system more resilient.

24. In line with this strategy, the FPC had first set a positive UK CCyB rate in 2016 Q1 – at 0.5%. As a one-off, the PRA Board had concluded then that existing supervisory buffers set for individual firms should be reduced, where possible, by up to 0.5%; this reflected the need to transition to the new capital framework, and would avoid duplication in capital required to cover the same risks.

25. At that point, the FPC had made clear that this 0.5% setting was on a path to a setting of 1%, consistent with the FPC's assessment at that stage that the overall threat to banks' UK exposures was at a relatively standard level. In reaching its decision, the FPC had wanted to balance the desirability of having a buffer in the region of 1%, given the environment, with increasing the CCyB gradually.

26. In July 2016, immediately after the EU referendum result, the FPC had decided to reduce the UK CCyB rate from 0.5% to 0%. This had been a pre-emptive response to an increased possibility that material domestic risks could crystallise in the near term, and had served to ensure banks did not hoard capital and restrict lending in those conditions. To give banks the clarity necessary to facilitate their capital planning, the FPC had set out that it expected to maintain a 0% UK CCyB rate until at least June 2017, absent any material change in the outlook. Given this was a pre-emptive response, it had been accompanied by a clear supervisory expectation from the PRA that firms should not increase dividends or other distributions in response to the reduction in the CCyB – the reduction was there to absorb losses, if they were to occur.

27. Now that the FPC's guidance on this indicative period had passed, and the economy was operating in a standard risk environment, the question for the FPC was how to return to its expected setting of 1% for the UK CCyB rate.

28. On the one hand, there were arguments for moving to 1% directly, implemented as normal over the next 12 months. This would set the requirements on the banking system at a level commensurate with the UK risk environment, increasing required system-wide capital by £11.4bn given current risk-weighted assets. Even including a 1% UK CCyB rate, the major UK banks in aggregate had sufficient capital resources to meet expected 2019 requirements – this was the point

by which post-crisis international bank capital requirements were due to be fully phased in. And many expected the FPC to set the UK CCyB rate at 1% by this date, at the latest. Some members noted that a setting of 1% was consistent with moving gradually. Given that the original decision to increase the CCyB had for most banks been accompanied by a reduction in PRA supervisory buffers, and given the PRA's expectation in July 2016 that firms should not increase dividends as a result of the reduction in the CCyB, the majority of banks continued to have resources earmarked to meet a 0.5% UK CCyB rate. For the majority of banks, therefore, an increase to 1% now would in effect be an increase of 0.5%, consistent with the FPC's policy of increasing the CCyB gradually.

29. On the other hand, there were benefits to increasing the UK CCyB rate by a smaller step initially – 0.5% – in Q2, with a view to moving to 1% later in the year, absent a material change in the outlook. This approach was more consistent with the FPC's strategy to increase the CCyB in gradual steps. Though the FPC's expectation was that credit conditions would remain well within the standard range, there might also be merit in proceeding with caution – given some initial signs of an apparent slowdown in consumer spending and demand for housing, in the face of low household real income growth, that could prompt some hoarding of capital. A gradual approach and more time would mitigate any risk that market participants inferred, incorrectly, that the FPC was unusually anxious about the domestic risk environment, given that in the past the FPC had moved in 50 basis point steps. And increases in capital might be more costly at present, given the weak outlook for bank profitability and that most firms were not expecting to accrete substantial capital via retained earnings. This might affect in particular some small and medium-sized UK deposit takers that had not previously built up capital resources earmarked to meet a 0.5% UK CCyB rate. The Committee also agreed that a staged approach would not bind its discretion to increase the CCyB in larger increments if the risk outlook warranted such action. While gradual changes in the buffer made sense in the context of a slow-moving financial cycle, the current risk environment was particularly unusual given the UK's forthcoming exit from the European Union.

30. The FPC discussed the implications of its current action for the effectiveness of the CCyB in future – this was important while the FPC's reaction function on the CCyB was being established with banks and their investors. First, if banks were confident that the CCyB would be returned only gradually after a cut, they might be more likely to use previously built-up buffers as needed when risks crystallised – reinforcing the effectiveness of any future FPC decisions to cut the rate. Second, increasing the UK CCyB rate by a full percentage point in one step risked building an expectation that this would be the typical reaction of the FPC in response to shifts in the risk environment in future. Such an approach increased the likelihood that banks would respond by maintaining significant voluntary buffers over those required by regulators, blunting the effectiveness of FPC decisions.

31. Taking these considerations together, most FPC members preferred to increase the UK CCyB rate gradually: from 0% to 0.5% of risk-weighted assets in Q2, and to accompany this with a further 0.5% increase later in the year, absent a material change in the outlook. This would give banks 18 months to meet the overall increase to a 1% UK CCyB rate, compared to 12 months if a 1% setting was introduced in one step.

32. Following further discussion, the Committee reached a consensus around this position. Those members who had initially favoured setting a 1% UK CCyB rate in Q2 were content to join this consensus, provided it would be clear that the Committee expected to move to a setting of 1% by November, unless there was a material change in conditions by then. By its November meeting, the FPC would have the full set of results from the 2017 stress test of major UK banks.

33. On that basis, the FPC agreed to increase the UK CCyB rate to 0.5%, from 0%, with binding effect from 27 June 2018. Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC agreed that it expected to increase the rate to 1% at its November meeting, with binding effect a year after that.

34. In line with its published policy, the FPC agreed that it stood ready to cut the UK CCyB rate, as it had in July 2016, if a risk materialised that could lead to a material tightening of lending conditions. The FPC reaffirmed that banks' capital buffers exist to be used as necessary to allow banks to support the real economy in a downturn.

UK consumer credit market

35. In March, the FPC had considered the channels through which consumer credit could pose risks to financial stability. It had judged, as set out in detail in the Record of its March 2017 meeting, that the recent rapid growth in consumer credit could principally represent a risk to lenders if accompanied by weaker underwriting standards. Relative to mortgage debt, consumer credit was less likely to pose a risk to broader economic stability through its effect on household spending; in response to adverse shocks, consumer credit borrowers were more likely to default on their debts, rather than to cut spending to meet their repayments.

36. At its meeting in June, therefore, the FPC focused on any further evidence on the potential impact on lender resilience from conditions in the consumer credit market.

37. Loss rates on consumer credit lending were low at present. The Committee discussed the risk that lenders, when assessing potential loss rates, might be placing excessive weight on recent good performance in this sector, given that the current environment was likely to have improved the credit scores of borrowers. Banks' net interest margins on new lending had fallen, for example, and

major lenders were using lower risk weights to calculate the capital they needed to maintain to fund consumer credit exposures. Other things equal, such procyclical behaviour meant lenders had less capacity to absorb losses, either with income from performing loans or with capital buffers. In this context, a review by the PRA, covering a wide range of lenders, had found evidence of weaknesses in some aspects of underwriting and a reduction in resilience.

38. Further, the short maturity of consumer credit meant that the credit quality of the stock of lending could deteriorate quickly if standards were relaxed. Given lenders' growth plans, this risk could be heightened by a softening in credit demand, as pressures to maintain volumes by lowering standards might intensify further.

39. The FPC agreed that firms remained the first line of defence against these risks. Effective governance at firms should ensure that risks were priced and managed appropriately and benign conditions did not lead to complacency by lenders. It supported the intentions of the PRA and FCA to publish, in July, their expectations of lenders in the consumer credit market, following finalisation of their reviews, to underscore this.

40. The Bank's annual stress tests had assessed banks' resilience to risks in consumer credit. And the FPC's decision to increase the UK CCyB rate to 0.5%, with an expected further increase to 1% in November, would bolster resilience more generally. Given the rapid growth in consumer credit over the past 12 months, the FPC agreed to bring forward the assessment of stressed losses on consumer credit lending in the Bank's 2017 annual stress test. This would inform its assessment at its next meeting of any additional resilience required in aggregate against this lending. Should any additional resilience be warranted, regulators had several tools to increase the amount of loss-absorbing capital in the system. These included requirements that applied to all lenders and all UK exposures, to all institutions but only to these exposures, or to individual banks as part of firm-specific supervisory requirements. The appropriate tool would depend on how any risk was concentrated across the system.

UK mortgage market

41. Historically, the build-up of mortgage debt had been a significant risk to financial and economic stability. Highly-indebted households were more vulnerable in the event of unexpected falls in their incomes or increases in their mortgage repayments. In an economic downturn, there was a greater risk that such borrowers might need to cut spending sharply, making recessions deeper. This also increased the risk of losses to lenders, not just on mortgages, but on other lending, too.

42. To insure against these risks, in June 2014 the FPC had introduced a policy package designed to prevent a significant increase in the number of highly indebted households and a marked loosening in underwriting standards. These Recommendations were: a limit on lending at loan to income multiples at 4.5 or above; and guidance to lenders to assess whether new borrowers would be able to afford their repayments if interest rates were to rise.

43. At that point, these measures would not restrain housing market activity unless lenders' underwriting standards eased and the flow of high LTI mortgages increased. The measures were put in place as insurance and complemented the annual stress tests of major lenders, which tested that lenders could withstand sharp economic downturns, including large falls in house prices, while continuing to lend.

44. In November 2016, the FPC had agreed to conduct a review in 2017 of its overall strategy for setting these measures. It had agreed that this review would consider: whether its existing measures should be viewed more as structural policies, whose calibration would remain largely fixed over time, or rather as more time-varying policies; and the interaction of the various tools at the FPC's disposal. Its powers in this area had increased since 2014, and the FPC now had powers of Direction to direct the PRA and FCA to require regulated lenders to place limits on residential mortgage lending – in both owner-occupier and buy to let mortgage markets. In November, it had also reviewed the calibration of the existing measures and deemed that it remained appropriate.

45. The FPC therefore considered its strategy for setting these mortgage market measures in future. Committee members noted again that the affordability test and LTI flow limit were complements in protecting households' ability to service their debt. The affordability test effectively set an LTI cap for each borrower that depended primarily on the term of the mortgage and the borrowers' other spending commitments. The LTI flow limit provided a simple back-stop to the affordability test: it would be more likely to bind if mortgage terms increased, or if lenders loosened the standards through which they assessed affordability.

46. The FPC judged that these measures were having only a modest impact on mortgage lending at present, because they were not significantly binding relative to lenders' own underwriting standards. If lenders were to weaken underwriting standards to maintain mortgage growth, however, the FPC's measures would limit growth in the number of highly indebted households. This would have material benefits for economic and financial stability by mitigating the further cutbacks in spending that highly indebted households made in downturns.

47. The FPC agreed that it expected its measures to remain in place for the foreseeable future and that they would become a structural feature of the UK housing market. It would review the calibration of these measures on a regular basis. And given that the affordability test and the LTI

flow limit complemented one another, the Committee would consider their calibration jointly. One consideration was that, as Bank Rate rose in the future, the affordability test could become more constraining on lending relative to the LTI flow limit. The Committee therefore intended to consider the balance between the two policies if and when Bank Rate rose to a level close to 1%. More generally, the calibration of the policies would depend on the volume of mortgage lending and the FPC's judgement around risks to both interest rates and incomes. The FPC would draw on a range of indicators to inform its judgement about such risks. When assessing potential future changes to interest rates, the Committee would more likely be guided by slow-moving, 'structural' measures of interest rates than by market expectations of future interest rates, which tended to be volatile.

48. The Committee also had powers of Direction over loan to value (LTV) limits. Lending at high LTV multiples primarily posed risks to lenders. The FPC had not yet used these powers: it judged that the combination of stress testing and bank capital requirements, alongside its existing Recommendations, should result in a degree of lender resilience that was proportionate to current risks. The Committee would, however, keep under review risks to lenders stemming from high LTV mortgage lending. And it could in future consider employing LTV limits, as other macroprudential authorities had done in a number of countries.

49. In reviewing its affordability test Recommendation, the FPC noted that it had not specified whether lenders should reference the mortgage rate at origination or the reversion rate in the mortgage contract. This created a risk that firms might use this discretion to loosen the standard at which they test affordability. There had been significant variation across lenders on the stressed mortgage rate used to assess affordability compared to their current standard variable rates.

50. The Committee reviewed the impact of clarifying the Recommendation to achieve greater consistency across lenders. The reversion rate in mortgage contracts was typically the lenders' standard variable rate. Bank staff estimated that mortgage approvals would have been reduced by less than 0.5% in 2016, if the reversion rate had been specified as the appropriate rate on which to apply the affordability stress test.

51. The FPC also noted that, in contrast to its LTI flow limit, the affordability Recommendation did not currently include a de minimis threshold to exempt small lenders, which had been introduced in the LTI flow limit to ensure proportionality. To ensure consistency across the Recommendations, it would be appropriate to include a threshold set at £100 million of mortgage lending per annum. The PRA would monitor lending done by firms below this threshold to ensure they were not being incentivised to take excessive risk.

52. The FPC therefore made the following new Recommendation on affordability stress tests, to replace its existing Recommendation in order to promote consistency across lenders in their application of tests:

- **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, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product 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). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum**.

53. The evidence underpinning the FPC's review would be set out in detail in the June 2017 *Financial Stability Report*.

UK leverage ratio framework

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

55. In doing so, the FPC had not intended a permanent loosening of the leverage standard and had made clear at the time that it would need to make an offsetting adjustment to ensure that the amount of capital needed to meet the UK leverage ratio standard would not decline. It had planned to make this change as part of its broader review in 2017 of the UK leverage ratio framework, in light of progress towards an international leverage ratio standard. Following a delay in the international timetable, in 2017 Q1 the FPC had agreed to go ahead with considering the format of the appropriate offsetting adjustment at this meeting. The FPC would continue to be briefed on ongoing international discussions in the Basel Committee on Banking Supervision.

56. The FPC discussed different options for making this adjustment, to restore the level of resilience delivered by its leverage ratio standard to the level delivered in July 2016, before the FPC had excluded central bank reserves from the leverage ratio exposure measure.

57. Staff had calculated that one way of restoring this level of resilience was to recalibrate the minimum leverage ratio requirement from 3% to 3.25%. When accounting for the impact of fully

phased-in leverage buffers, the amount of capital needed to meet this requirement would be the same in nominal terms as the amount needed in July 2016 to meet the 3% requirement, when central bank exposures were included in the leverage exposure measure. Because of the makeup of individual banks' balance sheets, this change would mean that some banks would require slightly more capital to meet the leverage requirement, and some slightly less. However, for the vast majority of firms, the amount of capital required to meet the leverage standard would still be lower than that required to meet risk-weighted standards – ie the leverage ratio would still not be the binding constraint.

58. A potential downside of this approach was that increasing the minimum leverage requirement to 3.25% could affect banks' incentives to expand certain low-risk activities, including repo activity where the FPC had had concerns about reductions in market liquidity. However, a 3% requirement broadly corresponded to the weighted average of a 0% requirement on central bank reserves and a 3.25% requirement on non-reserves. This meant that increasing the leverage requirement for non-reserve assets to 3.25% would more adequately reflect the average riskiness of any new non-reserve exposures.

59. An alternative approach was requiring banks to hold an additional nominal amount of capital, which would be determined in a comparable way as an add-on to minimum leverage ratio requirements. This would effectively add a new component to the UK leverage ratio framework. It would avoid affecting banks' incentives for any low-risk activities. However, it could, over time, result in banks being subject to different minimum leverage ratios, leading to an undesirable increase in the complexity of the overall framework.

60. The FPC agreed that it preferred the approach of raising the minimum ratio to 3.25%, and this would be the basis on which it would consult. This would ensure that the original standard of resilience was restored, while also preserving the benefits of excluding central bank reserves from the exposure measure. In arriving at this view, members put weight on maintaining the simplicity of the leverage ratio framework.

61. The consultation would also ask for views on excluding from the calculation of the total exposure measure central bank reserves and other claims on central banks where they were matched by deposits accepted by the firm that were denominated in the same currency and of identical or longer maturity.

62. Separate to these proposals, the FPC would still carry out an in-depth review of its leverage ratio framework, pending progress on an international leverage ratio standard, including on expanding the scope of it to other PRA-regulated banks, building societies and investment firms, and its level of application.

Cyber resilience

63. The FPC reviewed progress towards strengthening the resilience of the UK financial system to cyber attack.

64. Regulators were nearing completion of a first round of cyber resilience testing for all firms at the core of the UK financial system, in line with a Recommendation from the FPC in 2015. 31 out of 34 firms, including banks representing more than 80% of the outstanding stock of PRA-regulated banks' lending to the UK real economy, had completed penetration testing and had action plans in place; two further firms were close to completion. The tests had highlighted the importance of firms continuing to invest in employee training and awareness and processes, as well as technology, in order to counter the risks of cyber attack. The results, together with the actions taken to address weaknesses, also demonstrated that core firms had made significant progress in this respect. Supervisors had taken steps to make CBEST a regular component of the supervisory assessment of firms. In light of this, the FPC judged that its 2015 CBEST Recommendation had been implemented and it could therefore withdraw the Recommendation.

65. However, while progress had been made in building resilience to cyber attack, the risk continued to build and evolve. Addressing this would need to build on the lessons from previous work of the FPC and other authorities.

66. The FPC's concern was to mitigate systemic risk – the risk of material disruption to the economy. It discussed the essential elements of the regulatory framework that it would typically expect to be in place for other, more standard, risks, and how these would apply to the cyber threat: clear baseline expectations for firms' resilience that reflect their importance for the financial system; regular testing of resilience by firms and supervisors, to ensure that resilience keeps pace with the evolving nature of the risk; identification of firms that are outside of the financial regulatory perimeter, but which may be important for regulated firms; and clear and tested arrangements to respond to cyber attack when they occur.

67. In order to monitor that each element was being fulfilled by the relevant UK authorities, the FPC asked the Bank, PRA, FCA and HM Treasury for: regular updates on the systemic risks exposed by regular cyber tests and sector-wide exercises; annual updates on the cyber resilience of firms that are outside the regulatory perimeter but which are important for the UK financial sector; and an annual update on the effectiveness of the 'Authorities Response Framework' – the way the authorities coordinated responses to cyber attack that had the potential to affect the financial system – to check that the system had the capacity to respond to and recover from cyber attack.

68. To support the setting of clear baseline expectations, the Committee agreed to focus the next stage of its work on considering its tolerance for the disruption to important economic functions of the financial system in the event of cyber attack, working with the Bank, PRA, FCA and HM Treasury. The Committee recognised that for some of these functions, different authorities may have different tolerances for disruption, reflecting their statutory objectives.

EU withdrawal

69. As the FPC had stated in September 2016, irrespective of the particular form of the United Kingdom's future relationship with the EU, and consistent with its statutory responsibility, the FPC would remain committed to the implementation of robust prudential standards in the UK financial system. This would require a level of resilience to be maintained that was at least as great as that currently planned, which itself exceeded that required by international baseline standards.

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

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

72. The Bank, FCA and PRA were working closely with regulated firms and financial market infrastructures to ensure they had comprehensive contingency plans in place. The FPC would oversee contingency planning to mitigate risks to financial stability as the withdrawal process unfolded. Through this work, the FPC was aiming to promote an orderly adjustment to the new relationship between the United Kingdom and the European Union.

73. Without contingency plans that could be executed in the available time, the FPC agreed that effects on financial stability could arise both through direct effects on the provision of financial services, and indirectly, through macroeconomic shocks that could test the resilience of the financial system. The FPC discussed the evidence available at present on these channels and agreed to set that out in more detail in the forthcoming *Financial Stability Report*.

74. On the direct effects, the FPC noted that a very large part of the United Kingdom's legal and regulatory framework for financial services was directly or indirectly derived from EU law. The United Kingdom's financial services law must therefore become domestic at the point of withdrawal. The Government planned to execute this through the Repeal Bill. Once enacted, this would ensure there

was no legal or regulatory vacuum in respect of financial services when the United Kingdom left the European Union.

75. The Committee also noted that there was no generally applicable institutional framework for cross-border provision of financial services outside the European Union. Globally, liberalisation of trade in services lagged far behind liberalisation of trade in goods. So without a new bespoke agreement, UK firms could no longer provide services to European Economic Area clients (and vice versa) in the same manner as they did today, or in some cases not at all. This created two broad risks. First, services could be dislocated as clients and providers adjusted. Second, the fragmentation of service provision could increase costs and risks.

76. On the indirect risks, to maintain consistent provision of financial services to the UK economy the financial system would have to be able to absorb the impacts on their balance sheets of any adverse economic shocks that could arise in some scenarios for the United Kingdom's withdrawal from the European Union. In some scenarios, heightened uncertainty could reinforce the existing risk of a fall in appetite of foreign investors for UK assets; a material reduction in the appetite of foreign investors to provide finance to the United Kingdom would tighten financing conditions for UK borrowers and reduce asset prices and investment.

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

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

Medium-term priorities and the FPC’s remit response

79. In 2013, the FPC had established three medium-term priorities, in addition to its ongoing assessment of the risk environment. It had agreed at the end of 2016 that it would review and reset these in 2017, including in light of the UK’s decision to withdraw from the European Union.

80. The FPC's priorities in 2013 had been to: establish a medium-term capital framework for banks; end 'too big to fail', including through development of the new resolution regime; and ensure diverse and resilient sources of market-based finance.

81. On capital and ending too big to fail, since 2013, in line with international reforms following the global financial crisis, the FPC had: set the standards for risk-weighted capital and leverage ratio requirements for UK banks; developed its approach to stress testing, to ensure that resilience adapts to the risks that banks face; and monitored and input to the work being done by the Bank to ensure that banks can be resolved when they fail. This had included setting the framework for the systemic risk buffer which formed part of the ring-fencing regime designed to make banking groups more resolvable. The FPC had set out its assessment of progress towards making banks resolvable, and how this affected its assessment of the appropriate level of capital for the banking system, in the Bank's submission to a recent Treasury Committee inquiry on UK bank capital. Together these reforms had made UK banks more resilient, allowing them to serve UK households and businesses even when shocks occurred.

82. On market-based finance, the FPC had initiated and completed an annual review of risks from, and regulation of, market-based finance, to consider whether it needed to make any recommendations to HM Treasury to change the boundaries of regulation. It had also completed in-depth reviews on the activities of open-ended investment funds and insurers, and on changes in market liquidity. These had been published in previous *Financial Stability Reports* since 2014 and summarised in the November 2016 *Financial Stability Report*.

83. The FPC agreed that these areas remained important and that its next medium-term priorities should build on the work done since 2013. In particular, it would be important to take stock of the reforms to the bank capital framework since 2013, including in light of further developments in international regulatory standards. At the same time, the FPC agreed that international regulatory developments since 2013 meant that it was a good time to return to a suggestion from the interim FPC in 2012, to consider the benefits of a time-varying liquidity measure once the international microprudential liquidity standard had evolved. On market-based finance, the FPC would continue with its programme of in-depth reviews and annual assessments, while also undertaking further work to understand how the financial system as a whole was likely to respond to shocks. This would help it to consider whether macroprudential tools were needed to address systemic risks from market-based finance.

84. The FPC therefore agreed the following set of revised medium-term priorities for the next two to three years, alongside its ongoing assessment of the risk environment:

- Finalise, and refine if necessary, post-crisis bank capital and liquidity reforms;

- Complete post-crisis reforms to market-based finance in the UK, and improve the assessment of risks across the financial system;
- Prepare for the UK's withdrawal from the European Union.

85. These revised priorities, and the specific initiatives that the FPC would pursue under each, would be included in the FPC's response to the Chancellor's annual remit and recommendations letter, which the FPC had received from the Chancellor on 8 March. It finalised this response at its meeting.

Regular reviews

FS strategy

86. During May, the FPC had reviewed the Bank of England's financial stability strategy, which had previously been set by the Court of the Bank of England in 2014. This strategy related to the Bank's financial stability objective, which was to protect and enhance the stability of the financial system of the United Kingdom. The Court was required to review the strategy every three years. Earlier in the year, it had delegated this review to the FPC, following changes to the Bank of England Act that enabled it to do so. The Court retained ultimate responsibility for the strategy, even given this delegation.

87. Following its review, the FPC had submitted its proposed revision of the strategy to Court. The revision mainly set out some further guiding principles for the financial stability strategy, and updated the main elements of the strategy reflecting developments since 2013. Subsequently, HM Treasury had been consulted on the revised strategy, as required by statute, and had supported it. At its meeting, therefore, the FPC agreed that the revised strategy could now be taken as final. It would shortly be published in the Bank's *Annual Report*. The FPC agreed that it would publicise the strategy through a variety of channels that would be accessible to different audiences.

Sterling Monetary Framework

88. The FPC confirmed it was content with proposed changes to the framework for engagement between the Bank's Executive and the FPC on the Bank's Sterling Monetary Framework, which had initially been agreed in 2013. Members had been briefed on possible changes at their March 2017 meeting, before these were subsequently approved by the Bank's Court, designed to formalise the FPC's involvement in approving the scope and principles that determine the design of the Bank's liquidity insurance facilities and the ability of those facilities to reduce systemic risk.

Redacted text on interest-rate benchmark reforms and contingency planning

89. The FPC discussed whether it was still against the public interest to publish text from the Record of its March 2017 meeting on the risks to financial stability of Libor and similar interest-rate benchmarks becoming unavailable before any alternatives had been implemented, and on the work being done internationally to address these risks. At its March meeting, it had agreed that publication was against the public interest at that point, because there was a possibility that publication could precipitate the risks that the action underway was seeking to avoid.

90. Since the FPC's meeting in March, the FCA had published a consultation on its powers to compel Libor banks to continue to make submissions on Libor, should that prove necessary. It was doing further work to put Libor on a stable footing for a transitional period, and staff would provide an update on that in Q3. The FPC would review whether it was appropriate to publish its discussion after that update.[1]

[1] The text in this and the preceding paragraph was omitted from the version of the Record that was initially published on 4 July 2017. The Committee agreed at its 20 September meeting to publish this text, for the reasons set out in the Record of that meeting.

The following members of the Committee were present:

Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Ben Broadbent, Deputy Governor responsible for monetary policy
Sam Woods, Deputy Governor responsible for prudential regulation
Alex Brazier
Anil Kashyap
Donald Kohn
Richard Sharp
Martin Taylor
Andrew Bailey, Chief Executive of the Financial Conduct Authority
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

As permitted under the Bank of England Act 1998, Anthony Habgood was present as observer in his role as Chairman of Court.

ANNEX: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

Identifier(*)	Recommendation/Direction
17/Q2/1	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, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product 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). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.

(*) 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)	At its meeting in June 2017, the FPC increased the UK CCyB rate to 0.5%, from 0%. Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC agreed that it expected to increase the rate to 1% at its November meeting. 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 CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Recommendation on loan to income ratios	In June 2014, the FPC made the following Recommendation (14/Q2/2): 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. The PRA and the FCA have published their respective approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[3] and the FCA has issued general guidance.[4]

[2] http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx
[3] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[4] http://www.fca.org.uk/news/fg14-08