BANK OF ENGLAND

Record of the Financial Policy Committee, May 2020

Publication date: 7 May 2020

This is the May 2020 Record of the Financial Policy Committee.

It is also available on the Internet: https://www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-may-2020

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 24 June 2020 and the Record of that meeting will be published on 2 July.

Record of the Financial Policy Committee, May 2020

1. The Financial Policy Committee (FPC) met on 5 May 2020 to review developments in the financial system related to the outbreak and spread of Covid-19 (Coronavirus).

2. Since the Committee's March meeting, authorities around the world had taken action to halt the spread of the pandemic and to support their economies. The spread of Covid-19 and the measures taken to contain it were having a significant impact on the United Kingdom and many countries around the world. Activity had fallen sharply since the beginning of the year and unemployment had risen markedly.

3. As set out in its statement on 9 April, on 7 May 2020 the Committee published its assessment of the risks to UK financial stability and the resilience of the UK financial system to ongoing economic and market shocks in an interim financial stability report (interim FSR), alongside the May *Monetary Policy Report* (MPR) and this Record. The interim FSR would serve as the Record of the Committee's judgments and associated deliberations at its meeting on 5 May[1].

Written decisions taken by the FPC since March

4. Since its March meeting, the FPC had also taken a number of decisions by written procedure. These decisions included agreements to postpone certain planned initiatives to alleviate the operational burden on the Bank and banks, who at the time were rightly focussed on dealing with the Covid-19 disruption, and to support banks' lending capacity to the real economy. These actions, together with the actions agreed by the Committee at its March meeting, would further contribute to ensuring that the UK financial system could be a source of strength to the economy during this challenging period. The Committee emphasised that the decisions had been taken for pragmatic reasons, given the unprecedented current circumstances, and in no way reflected a change in strategic direction for the FPC in relation to the relevant issues.

5. The decisions, and a brief outline of the considerations which factored in the decisions, are outlined in this Record.

Climate BES

6. In June 2019, the Committee had agreed that in its 2021 biennial exploratory scenario (BES) the Bank should stress test the UK financial system's resilience to the physical and transition risks of

---

[1] https://www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-may-2020

climate change (Climate BES). The Bank had subsequently published a Discussion Paper which set out the Bank's proposed framework for the Climate BES in December 2019. At its March 2020 meeting the FPC noted that the Discussion Paper had asked for responses by mid-March 2020. The Committee supported the Bank's intention to take stock of responses, as well as the evolving Covid-19 situation, with a view to announcing the way forward for the exercise in the summer.

7. Recognising current pressures on firms, and in light of the responses to the Discussion Paper, on 1 May the FPC together with the Prudential Regulation Committee (PRC) agreed to postpone the launch of the 2021 Climate BES from the second half of 2020 until at least mid-2021. The delay reflected a desire to maintain the ambitious scope of the exercise whilst giving firms enough time to sufficiently invest in their capabilities to enable them to deliver to a high standard.

8. At the same time, the Committee emphasised that climate change represented a material financial risk to firms and the financial system, and remained a strategic priority for the FPC. Whilst Covid-19 represented a present risk, managing the financial stability risks from climate change would require substantial action over time. The Committee therefore welcomed the Bank's intention to continue its work in this area even during the current stress.

Cyber stress test work programme

9. In 2019 the Bank had launched an exploratory pilot cyber stress test to test firms' ability to meet any future 'impact tolerances', set by the FPC, in severe but plausible scenarios for a cyber attack. The setting of impact tolerances, which establish a timeline for restoring services quickly enough after a cyber interruption to forestall financial instability, and the use of stress tests to understand firms' ability to meet those tolerances, was an important part of the framework of regulation to strengthen the resilience of the UK financial system to cyber risk.

10. On 1 May, the FPC agreed to modify its approach to its cyber stress testing work for at least three months. The outbreak and spread of Covid-19 had affected both the Bank's and firms' resources. As a result, the Bank would seek to take forward its work in a way that sought to reduce resourcing pressures on firms at the current time, while still achieving the policy aims. At the earliest the Committee would return to the issue in 2020 Q3, and the appropriate timeline for this work would be kept under review in light of the evolving Covid-19 context. The Committee nonetheless underlined the importance of this work within its forward agenda.

11. The Committee further noted that that cyber-related risks were at a heightened level in the Covid-19 environment. The Committee therefore determined that at this juncture it was against the public interest to publish the details of its modified approach to cyber stress testing work and decided

to defer publication. It agreed to review this text when the cyber work-stream next returned to the Committee, at the earliest in 2020 Q3.[2]

Leverage ratio treatment of guaranteed lending under Government schemes

12. On 4 May the Prudential Regulation Authority (PRA) announced that it would offer firms a “rule modification by consent” to permit the exemption of loans extended under the UK Government’s Bounce Back Loan Scheme (BBLS) from the total exposure measure of the UK leverage ratio (LR) requirement. Under the BBLS, the Government would provide 100% guarantees for loans to SMEs. The FPC supported this decision.

13. In reaching its decision, the FPC acknowledged that granting exemptions for guarantees went counter to certain principles of the leverage ratio framework (in particular that guarantees were not normally recognised in calculating the exposure measure). But while take-up of the BBLS was very uncertain, initial impact estimates suggested that an exemption of loans under the scheme would have only a small impact on capital requirements. This reflected the fact that the 100% Government guarantee reduced risk-weighted capital requirements for loans under the scheme, and also that few firms were constrained by the leverage requirement. At the same time the economic benefits of the additional lending were potentially significant. The BBLS had been set up with a full guarantee explicitly to facilitate the rapid advance of credit to SMEs, and the modification would ensure that firms’ incentives were aligned with the economic benefits. From the perspective of the FPC’s financial stability objective, the indirect benefit to resilience of better macroeconomic outcomes from extra lending was expected to outweigh the small estimates of the direct cost to resilience of a small reduction in the leverage capital requirement. Furthermore the action would be in line with the FPC’s secondary objective to support Government economic policy.

14. The FPC emphasised that it continued to consider a robust leverage ratio framework, incorporating a comprehensive measure of exposures, to be a critical element of the capital regime in support of its financial stability mandate. The Committee underlined that the decision had been taken in the current extraordinary economic circumstances to facilitate utilisation of a specific Government programme that was expected to contribute to UK economic and financial stability.

Systemic Risk Buffer rates

[2] The text in this and the two preceding paragraphs was omitted from the version of the Record that was initially published on 7 May 2020. The Committee agreed at its 11 March 2021 meeting to publish this text, for the reasons set out in the Record of that meeting.

15. On 9 April 2020, the PRA announced that it would maintain Systemic Risk Buffer (SRB) rates at the level set in December 2019, with the next assessment taking place in December 2021[3]. While decisions on SRB rates are taken by the Prudential Regulation Authority (PRA), the FPC sets the SRB framework. The FPC supported the PRA's decision to maintain rates at the level set in December 2019. The Committee noted that this would avoid the temporary inflation in firms' balance sheets involved in banks meeting credit demand from businesses from leading to higher domestic systemic capital surcharges. This would create a financial stability benefit by preserving the capacity of ring-fenced banks and large building societies to continue lending to the real economy through the current challenging period. The FPC and PRC also reiterated their expectation that all elements of banks' capital and liquidity buffers could be drawn down as necessary to support the economy through the current shock.

Computation of exposure measure for leverage ratio

16. On 9 April 2020, the PRA further announced that it would offer firms a "rule modification by consent" to bring forward the Basel 3.1 / Capital Requirements Regulation (CRR) 2 change to netting of pending settlements, including on reporting and disclosing[4]. The FPC supported this decision. In its July 2016 *Financial Stability Report*, the Committee had judged that the treatment of outright purchases and sales of securities in the UK leverage ratio standard might act to discourage market-making activity and noted that there would be merit in changes to that treatment in any internationally-agreed leverage ratio standard.

17. The Basel Committee on Banking Supervision and the European Union had since adopted changes in their respective frameworks. This rule modification by consent would allow firms to calculate the UK leverage ratio consistent with the FPC's long-standing view on the appropriate treatment of unsettled sales against cash payables relating to unsettled purchases. Consistent with the Committee's views, this was likely to support market making and therefore market functioning.

Financial Stability Strategy

18. The Court of Directors (Court) of the Bank has a statutory responsibility to determine the Bank's strategy in relation to its financial stability objective and to review it at least every three years. Court has delegated the review of the strategy to the FPC, as permitted by the statute; but Court

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/pra-decision-on-srb-rates.pdf?la=en&hash=F2888919B63C42E52BAE8C1BE5E9CE478CD420A4
[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/waivers-and-modifications-of-rules/modification-of-consent-of-the-calculation-of-the-total-exposure-measure-of-the-leverage-ratio.pdf?la=en&hash=278D64FBE23DD10AA06A65379AF73D220D8C9765

retains ultimate responsibility for the strategy. As required by statute, the FPC reviewed the existing strategy[5] on 1 May 2020 – no revisions were proposed at this time, recognising that resources of the Bank and HMT are appropriately focussed on the impacts of, and response to, the economic and market disruption resulting from Covid-19. The FPC and Court agreed that there would be an opportunity to conduct a further review once the immediate disruption from Covid-19 had receded, and that this would benefit from the reflection on and incorporation of any lessons from the current period.

[5] https://www.bankofengland.co.uk/-/media/boe/files/annual-report/2017/boe-2017.pdf?la=en&hash=E221A208FBD6BF5F95AEF2E468BC2FD135EF8525#page=38

At the 5 May meeting, the following members of the Committee were present:

Andrew Bailey, Governor

Colette Bowe

Alex Brazier

Ben Broadbent

Jon Cunliffe

Anil Kashyap

Donald Kohn

Dave Ramsden

Elisabeth Stheeman

Sam Woods

Chris Woolard

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

ANNEX: FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

The FPC has no Recommendations or Directions that have not already been implemented.

Other FPC policy decisions which remain in place

The table below sets out 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 rate	The FPC agreed at its meeting on 9 March 2020 to set the UK CCyB rate at 0% with immediate effect. This rate is reviewed on a quarterly basis. The UK has also reciprocated a number of foreign CCyB decisions – for more details see the Bank of England website[1]. Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Mortgage 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 approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[2] and the FCA has issued general guidance.[3]
Mortgage affordability	At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates: 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. At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.

[1] https://www.bankofengland.co.uk/financial-stability
[2] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[3] https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending