FINANCIAL STABILITY REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The FPC judges that the overall outlook for financial stability was broadly unchanged for much of the period since December. However, as the risks associated with Greece began to crystallise in recent days, the outlook has worsened.

Events in Greece have moved very quickly. At the time of its policy meeting, the FPC judged that the associated risks were particularly acute. Just before this *Report* was finalised, the Greek crisis intensified, and Greek authorities imposed a bank holiday and capital controls. The situation remains fluid, and it is possible that a deepening of the Greek crisis could prompt a broader reassessment of risk in financial markets.

The United Kingdom is relatively well insulated from the direct consequences of events in Greece. UK banks' exposures to Greece are very small relative to their capital bases. The footprint of Greek banks in the UK is tiny compared to the size of our economy.

In contrast, our economic and financial exposure to the euro area is considerable. Fortunately, the euro-area economy is stronger than a few years ago. Fiscal deficits have been reduced and banking systems reinforced. Moreover, new institutions and policy tools have been developed to limit the potential for contagion. In recent days, euro-area authorities have made it clear that they "stand ready to do whatever is necessary to ensure financial stability of the euro area."

The Bank has worked closely with HM Treasury, the FCA and our European counterparts to put contingency plans in place. The UK authorities will continue to monitor developments closely and will take any actions required to safeguard financial stability in the United Kingdom.

Looking beyond Greece, some risks have receded in the past six months, especially those arising from the macroeconomic environment in advanced economies. Others have increased, particularly those around emerging market economies. And while the resilience of the institutions at the core of the financial system has continued to strengthen, risks are shifting to the markets that connect them, and to the infrastructure that underpins them.

Risks stemming from the macroeconomic environment in advanced economies have diminished. The risks associated with low inflation and high indebtedness in the euro area have reduced. The outlook for U.S. growth remains firm, supported by robust growth in real incomes.

In the United Kingdom, growth has been solid. The burden of household debt has continued to fall modestly, and its distribution has improved.

Despite this progress, UK debt-to-income remains high by historical standards. And, after having slowed last year, momentum in the housing market is showing signs of returning. The Committee therefore judges that the policies it introduced a year ago, which insured against a marked loosening in underwriting standards and a further significant rise in the number of highly-indebted households, remain warranted.

At around 6 per cent of GDP, the UK's current account deficit is very large by historical and international standards. The risks associated with this deficit are mitigated by the currency composition and long-term nature of the capital flows that are financing it, as well as by the fact that the deficit is not combined with a rapid growth of domestic credit.

However, continued, smooth financing of our current account deficit depends on the credibility of the UK's macroeconomic policy framework, including our openness to trade and investment. The Bank's 2014 stress test assessed what could happen to the economy and financial system if, in an extreme scenario, these assumptions were called into question.

Risks have increased in emerging markets. Over the past year, economic growth has slowed notably in a number of EMEs, including in China. Following a rapid build-up of indebtedness, Chinese policymakers now face a challenging balancing act between sustaining growth, managing financial stability and increasing openness.

More generally, vulnerabilities have increased in a number of emerging markets following a long period of capital inflows and rising private indebtedness, much of which has been financed through the capital markets and in US dollars. The combination of weaker domestic economies, the strengthening of the US dollar and an eventual rise in US interest rates may threaten the ability of those businesses to meet their obligations.

UK banks' direct exposures to emerging markets and China stand at around 3½ times their core equity Tier 1 capital. The FPC will assess the vulnerability of major UK banks to an emerging market downturn in the 2015 stress test.

The risks we have identified should be weighed against the increasing resilience of the banking system, where capital positions have continued to improve in the past six months. As it moves from design to implementation of requirements for banks, the Committee is pivoting to focus on the risks in, and resilience of, markets.

Some fixed income markets have become less liquid since the crisis. The risks arising from Greece and the global economy will test market liquidity and could potentially trigger broader adjustments in financial markets. In many markets, average trade sizes and market depth have fallen and prices have become more volatile, with episodes of particularly sharp intraday price changes.

But greater volatility does not in itself threaten stability. Indeed, to the extent it reflects stronger prudential requirements, it is a product of a welcome increase in the resilience of the core of the financial system. Markets will adjust over time to this new reality.

The risk that concerns the Committee is that an adjustment in risk appetite leads to a persistent dislocation in financing markets—dislocations which could be the product of the interaction between regulation, changes to market structure, and the rapid growth of market participants who take continuous market liquidity for granted. This is one reason why the FPC is interested in the activities of asset managers.

The FPC has been working since March to deepen its understanding of the macroprudential risks associated with changes in market liquidity. It will consider a final report in September, and any potential actions thereafter. The Bank is also working through the FSB to assess these risks globally and will convene an Open Forum of a broad range of stakeholders on November 11th to discuss developments in market functioning and potential measures to improve market resilience.

Financial risks are not the only considerations relevant to financial stability.

Misconduct has undercut public trust in the financial system, exposing fault lines in markets' 'soft' infrastructure and posing risks to systemic stability, with direct economic consequences.

Fines and redress costs paid by UK banks now total £30 billion, roughly equivalent to all of the capital these banks have raised privately since 2009. The Committee will review the adequacy of sector-wide projections of future misconduct costs in the 2015 stress test.

Fines will not rebuild trust in markets. That will require a better balance between firm and individual accountability. The *Fair and Effective Markets Review* shows the way forward with a series of concrete initiatives at domestic and global levels.

The FPC is also alert to operational threats to the 'hard' infrastructure of the financial system. Across all sectors, for example, 90% of large businesses have experienced breaches of IT security over the past year, with financial firms among the most targeted.

The financial sector should continue to build its resilience to cyber risks and its capability to recover quickly. The adaptive nature of the threat means that ways of managing the risk must continually evolve. This requires strong governance at the most senior levels of banks. With this in mind, the Committee is recommending that the resilience of firms and the infrastructure at the core of the system to cyber attacks is regularly assessed.

Conclusion

Financial reform has bolstered the resilience of the core of the UK financial system and made it better able to weather the inevitable shocks which will occur. Given this progress, the FPC is pivoting:

- From the <u>design to the implementation</u> of banking reforms. If necessary, we will make prudent adjustment to measures to address unintended consequences or inefficiencies.

- From <u>banks to markets</u>. Although the core of the financial system is stronger, markets dynamics are changing in ways that are still not well understood. The FPC will examine all avenues to promote the resilience and effectiveness of markets.

- From financial risks to operational and conduct risks. Balance sheets have strengthened since the crisis. The infrastructure that underpins the financial system – both ‘hard’ and ‘soft’ – needs to follow suit.

By building resilience across the system and remaining vigilant as the threats to the system evolve, the FPC will continue to fulfil its remit to promote financial stability for the good of the people of the United Kingdom.