Financial Stability Report Press Conference

30 November 2016

Opening remarks by the Governor

Good morning.

There are two main elements to today's announcements:

- First, the FPC's assessment of the major risks and vulnerabilities to UK financial stability;
- And second, the results of the Bank's 2016 stress test.

1. Risks and vulnerabilities

The UK financial system has passed several tests this year.

The year opened with global market volatility spiking due to strains on emerging market currencies and growing scepticism over the ability of some international banks to adjust their business models to the new environments for regulation, growth and interest rates.

In June, developments closer to home brought strains of their own. And in recent weeks, global asset prices have reacted sharply following the US election, with echoes of the pressure, at the start of the year on sovereigns and banks.

Throughout these episodes, the UK financial system has stood up well, dampening rather than amplifying volatility in financial markets.

Households and businesses have, as a result, been able to focus on what they should: whether a new home is right for their families or whether a new investment would help them better serve their clients.

This resilience has been hard won. It's the work of many hands, both here at the Bank and across the financial system.

And the job is never done. Today's stress tests are the next stage of our efforts to maintain the resilience of our financial system as the UK economy adjusts to the UK's new relationship with the EU in an environment of elevated global and domestic risks.

Global risks

The most significant risks to UK financial stability are global.

Growth in China is increasingly reliant on rapid credit expansion. Since the global financial crisis, Chinese non-financial sector debt has risen by around 100 percentage points relative to GDP, and currently stands at 260% of GDP. This is extraordinary leverage for an advanced, let alone, an emerging economy.

There are signs that capital outflows from China and other emerging economies have begun to pick up in recent months and may accelerate further depending on the degree and pace of increases in US market interest rates.

In some euro-area economies, sovereign debt positions remain vulnerable to higher borrowing costs and weaker growth prospects that could be associated with trade or political risks. Moreover, challenges to the resilience of parts of the euro-area banking system remain.

Additional risks to the euro area could emerge as a consequence of the UK's withdrawal from the European Union. Banks located in the UK supply over half of debt and equity issuance by continental firms, and account for over three quarters of foreign exchange and derivatives activity in the EU. If these UK-based firms have to adjust their activities in a short time frame, there could be a greater risk of disruption to services provided to the European real economy, some of which could spill back to the UK economy through trade and financial linkages.

Domestic Risks

One channel by which global risks could affect UK financial stability is via the current account. At 5.9% of GDP, the UK current account deficit remains large by historical and international standards, and its smooth financing depends on foreign investor appetite for UK assets.

A sharp adjustment to capital inflows could test financial stability by tightening financing conditions for the real economy, adding pressure on the currency and worsening the trade-off between growth and inflation.

For example, in recent years, foreign investors have accounted for around half of all commercial real estate transactions. Over the past year such overseas investment has been cut in half and the value of commercial real estate transactions has fallen by one quarter.

The fall in the value of sterling since the referendum suggests market participants expect that the UK's trading arrangements will be less open for a period and that real income growth will be more modest. At the same time, with no apparent change to their job security and with credit available and cheap, consumers are drawing down their savings and borrowing for the first time since the crisis. These developments reinforce existing vulnerabilities from high and rising UK household indebtedness.

To guard against such risks, the FPC has therefore agreed to maintain the Recommendations it made in June 2014 on owner-occupier mortgage underwriting standards. This will help ensure that underwriting standards don't slip from responsible to reckless as they have during past periods of consumption-led growth.

2. Resilience and 2016 stress test

The resilience of the system during the past year in part reflects the consistent build-up of capital resources by banks since the global financial crisis. The aggregate common equity Tier 1 capital of major UK banks is now 13.5% of risk-weighted assets - higher than the level of capital the FPC requires in normal circumstances. As a result the UK banking system is well placed to provide credit to households and businesses during periods of severe stress.

2016 Stress Test

That conclusion is corroborated by the 2016 stress test, the first to be conducted under the Bank's new Annual Cyclical Scenario (ACS) framework. This ACS framework assesses risks emanating from the financial cycle. It is broad, coherent and severe, considering risks across institutions, markets and jurisdictions.

This year's test included synchronised UK and global recessions, with associated shocks to financial asset prices. Annual global GDP growth troughs at -1.9%, as it did during the 2008 global financial crisis. The level of UK GDP falls by 4.3%, and the unemployment rate rises by 4 ½ percentage points. UK house prices fall by over 30% and commercial real estate prices by over 40%. The scenario also includes stressed projections, generated by Bank staff, for potential misconduct costs.

This combination of these stresses lead to system-wide losses of £44 billion over the first two years of the stress—around five times those incurred by the same banks over the two years at the height of the financial crisis. Despite the fact that this year's test is more severe than its two predecessors, the aggregate CET1 low point of the 2016 stress test is higher. This better outcome reflects both the improvements in banks' capital positions and their greater balance sheet resilience.

The stress test judged banks against our new hurdle rate framework, which included so-called Pillar 2A requirements that correct for deficiencies in bank models. And it held systemic firms to an even higher standard, reflecting the phasing-in of additional capital buffers for them.

The test results illustrate how both AT1 instruments and banks' management actions can mitigate the impact of stress. For three banks, AT1 instruments would convert into CET1 capital as their capital ratios fell below 7%; and all banks significantly would cut their dividends payments and variable pay in order to conserve capital. This is exactly how the system should work under stress in order to maintain resilience and still serve UK households and businesses.

The PRA Board judged that, while the test revealed some capital inadequacies for three individual banks, these banks each now have in place the necessary plans to build their resilience further.

Taking the results of the stress test and these plans into account, the FPC judged that, in aggregate, the banking system is capitalised to support the real economy even under a broad, severe and synchronised stress scenario. As a result, the FPC did not require any system-wide macroprudential actions on bank capital.

Countercyclical Capital Buffer (CCyB)

In July, the FPC reduced the countercyclical buffer rate on banks' UK exposures from 0.5% to 0%. This was a response to greater uncertainty around the UK economic outlook and the increased possibility that material domestic risks could crystallise in the near term.

The FPC was concerned that banks could respond to these developments by hoarding capital and restricting lending. The reduction of the CCyB rate was intended to reinforce the FPC's expectation that all elements of capital and liquidity buffers are able to be drawn on to support the real economy.

That position has not changed. **In light of the continued uncertainty around the UK economic outlook and the resilience demonstrated in the 2016 stress test, the FPC agreed to maintain the CCyB rate at 0% and that it expects, absent any material change in the outlook, to maintain this rate until at least June 2017**.

The Bank of England has now conducted three complementary stress tests. Next year, we will, for the first time, conduct both an annual cyclical scenario and a biennial exploratory scenario (BES), which will probe the resilience of the system to risks that are not neatly linked to the financial cycle, such as slow-burn risks affecting the banking sector.

Conclusion

The UK financial system has demonstrated its ability to dampen, rather than amplify, the impact on the real economy of a series of shocks. Its resilience has been further reinforced by the 2016 stress test, and may prove valuable given the elevated likelihood that some UK-specific risks to financial stability could materialise.

It will take time to clarify the UK's new relationships with the EU and the rest of the world. And the orderliness of the UK economy's adjustment to these changes will influence the risks to financial stability.

But irrespective of the United Kingdom's future relationship with the EU, and consistent with its statutory responsibility, the FPC will continue to promote the resilience of the UK financial system. This will require a level of resilience at least as great as currently planned, which itself exceeds that required by international baseline standards.

It is on this basis that the people of the United Kingdom can move forward with confidence that they can access the financial services they need to seize the opportunities ahead.