Financial Stability Report Press Conference

27 June 2017

Opening remarks by the Governor

Good morning.

The FPC aims to ensure the UK financial system is resilient to the wide range of risks it faces. Over the past eight years, that resilience has been significantly increased. For example, with the tier 1 capital ratio for major UK banks now at 15.7%, losses that would have wiped out the entire capital base of the banking system in 2006 can now be fully absorbed by bank capital buffers alone.

The job is never done, however, as risks are always evolving. And that motivates the FPC's actions today.

The FPC's latest assessment of financial stability risks

The FPC judges that the overall domestic risk environment is now at the standard level. In other words, most financial stability indicators are neither particularly elevated nor subdued. Nevertheless, there are pockets of risk that warrant extra vigilance. Consumer credit has increased rapidly. Lending conditions in the mortgage market are becoming easier. And lenders may be placing undue weight on the recent performance of loans in benign conditions.

There are also potential risks to financial stability associated with the range of possible outcomes and a number of paths to them under Brexit. In addition the inconsistency between the valuation of some assets, such as commercial real estate and corporate bonds, and the risks implied by very low long-term interest rates make those assets vulnerable to a re-pricing whether through an increase in long-term interest rates, adjustments to growth expectations, or both.

The UK Countercyclical capital buffer

Last year, following the EU referendum, the FPC reduced the countercyclical buffer rate – or CCyB - on banks' UK exposures from 0.5% to 0%. This was consistent with the FPC's intention to allow banks to draw on their substantial capital and liquidity buffers as necessary in order to cushion shocks and maintain the provision of financial services to UK households and businesses. That strategy—combined with timely action by the MPC—has worked by supporting domestic demand during a period of heightened uncertainty.

With domestic risks now back at standard levels, the FPC is increasing the UK countercyclical capital buffer rate from 0% to 0.5%. In addition, consistent with its stated policies for a standard risk environment and of moving gradually, the FPC is announcing that it expects to increase the rate further to 1% at its November meeting.

I would now like to turn to those risks that merit increased vigilance.

Consumer credit

The first is consumer credit whose growth has far outpaced that of household income over the past year, with notable increases across credit cards, personal loans, and auto finance.

In an environment of intense competition, interest margins have fallen and risk assessments have declined. Lenders are therefore more vulnerable to losses in stress. Moreover, the short maturities of consumer credit mean that the credit quality of the stock of lending can deteriorate quickly.

Firms are the first line of defence to ensure that risks are priced and managed appropriately. The second line is supervisory oversight. In this regard, a review by the PRA has found evidence of weakness in some aspects of underwriting and reduced resilience. The FPC therefore supports the plans of the PRA and FCA to publish their expectations of lenders in the consumer credit market.

The third line of defence is macroprudential policy. Today's increase in the CCyB will bolster resilience. In addition, the FPC is accelerating its assessment of stressed losses on consumer credit lending in the Bank's 2017 annual stress test. This will inform the FPC's assessment at its next meeting of whether any additional resilience is required against this lending.

Housing

Turning to risks around housing, in 2014 the FPC put in place the policies to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. These tools require mortgage lenders to:

(i) assess whether borrowers could still afford their mortgages if at any point over the first five years of the loan, Bank Rate were to be three percentage points higher than the prevailing rate at origination; and

(ii) limit the proportion of mortgages at Loan to Income (LTI) multiples of 4.5 and above to no more than 15% of their new mortgages.

Following an extensive review, the FPC now expects these insurance measures to become structural features of the UK housing market. That's because they permit significant access to high LTI mortgages for the type of borrowers they most suit – such as first time buyers – while preventing the slide of underwriting standards from responsible to reckless. For consistency, the FPC is also clarifying that lenders should test affordability at their mortgage reversion rate – typically their Standard Variable Rate – plus three percentage points.

The leverage ratio

A year ago, the FPC took the decision to exclude central bank reserves from its simple measure of bank leverage - an action that was designed to ensure the Committee's leverage standards did not impede the transmission of monetary policy. Consistent with its commitment at the time to offset any loosening implied by this adjustment, the FPC is now recalibrating the minimum leverage requirement from 3% to 3.25% of non-reserve exposures, subject to consultation.

UK withdrawal from the EU

Consistent with its statutory duty, the FPC will continue to identify and monitor the UK financial stability risks associated with Brexit, so that the necessary actions can be taken to mitigate them.

In particular, the FPC will oversee contingency planning in order to help promote an orderly adjustment to the new relationship between the UK and the EU.

There are a range of possible outcomes for the UK's future relationship with the EU and a number of possible paths to that relationship. Consistent with its remit, the FPC is focussed on scenarios that, however unlikely, could have the most impact on UK financial stability. This includes a scenario in which there is no agreement in place at the point at which the UK leaves the EU. Such scenarios are where contingency planning and preparation will be most valuable.

Without such plans, financial stability could be affected directly by impacts on the provision of financial services, and indirectly, through macroeconomic shocks.

The financial stability issues from the direct effects on financial service provision include:

- the need to make the legal and regulatory framework for financial services domestic at the point of withdrawal;
- possible disruptions to the flow of new banking and insurance services to UK customers if entities established in the EEA can no longer operate in the UK;
- "spillbacks" to the UK from the adverse consequences on European clients who lose access to the services of UK-located banks, insurers and financial market infrastructure; and
- higher costs and greater risks for both EU and UK companies and households if there were fragmentation of market-based finance.

In order to maintain consistent provision of financial services to the UK economy, the financial system must be able to absorb any adverse economic shocks that could arise from the UK's withdrawal from the EU.

The Bank of England's regular stress testing aims to ensure that the banking system has the strength to withstand, and continue to lend in, a broad range of severe economic and market shocks. These include scenarios related to Brexit, which, as the MPC has stressed, have the potential to affect the UK economy through supply, demand, and exchange rate channels.

Irrespective of the particular form of the United Kingdom's future relationship with the EU, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned and which itself exceeds that required by international baseline standards.

Cyber

Alongside financial and economic risks, the risks from cyber attacks continue to build and evolve. At the same time, the FPC has catalysed measures to strengthen the resilience of the financial system to these risks, including vulnerability testing of all firms at the core of the financial system.

The FPC is now setting out the essential elements of the regulatory framework for maintaining ongoing cyber resilience, and it will monitor how relevant UK authorities fulfil their elements that affect the financial sector.

Conclusion

The resilience of the UK financial system has strengthened significantly since the crisis. As a result, it has demonstrated its ability to dampen, rather than amplify, the impact of shocks on the real economy. As the UK moves into a more standard risk environment and embarks on the Brexit process with its attendant tail risks, the FPC is committed to ensure that the system continues to have sufficient resilience to withstand potential shocks.

By taking the measures announced today and overseeing contingency plans for Brexit, the FPC will help ensure that the people of the United Kingdom can move forward with confidence that they will be able to access the financial services they need in order to seize the opportunities ahead.