Financial Stability Report Press Conference
28 November 2017
Opening remarks by the Governor

Good morning.

The FPC's job is to ensure that UK households and businesses can rely on their financial system through thick and thin.

To that end, today's FSR and accompanying stress tests address a wide range of risks to UK financial stability. And they will catalyse action to keep the system well-prepared for potential vulnerabilities in the short, medium and long terms.

In particular, this year's cyclical stress test incorporates risks that could arise from global debt vulnerabilities and elevated asset prices; from the UK's large current account deficit; and from the rapid build-up of consumer credit. Despite the severity of the test, for the first time since the Bank began stress testing in 2014 no bank needs to strengthen its capital position as a result.

Informed by the stress test and our risk analysis, the FPC also judges that the banking system can continue to support the real economy even in the unlikely event of a disorderly Brexit. At the same time, the FPC has identified a series of actions that public authorities and private financial institutions need to take to mitigate some major cross cutting financial risks associated with leaving the EU.

The Bank's first exploratory scenario assesses major UK banks' strategic responses to longer-term risks to banks from an extended low growth, low interest rate environment and increasing competitive pressures enabled by new financial technologies. The results suggest that banks may need to give more thought to such strategic challenges.

The Annual Cyclical Stress Test

Today's stress test results show that the banking system would be well placed to provide credit to households and businesses even during simultaneous deep recessions in the UK and global economies, large falls in asset prices, and very large stressed misconduct costs.

The economic scenario in the 2017 stress test is more severe than the deep recession that followed the global financial crisis. Vulnerabilities in the global economy trigger a 2.4% fall in world GDP and a 4.7% fall in UK GDP.

In the stress scenario, there is a sudden reduction in investor appetite for UK assets and sterling falls sharply, as vulnerabilities associated with the UK's large current account deficit crystallise. Bank Rate rises sharply to 4.0% and unemployment more than doubles to 9.5%. UK residential and commercial real estate prices fall by 33% and 40%, respectively.

In line with the Bank's concerns over consumer credit, the stress test incorporated a severe consumer credit impairment rate of 20% over the three years across the banking system as a whole. The resulting sector-wide loss of £30bn is £10bn higher than implied by the 2016 stress test.

The stress leads to total losses for banks of around £50 billion during the first two years - losses that would have wiped out the entire equity capital base of the banking system ten years ago.

Today, such losses can be fully absorbed within the capital buffers that banks must carry on top of their minimum capital requirements. This means that even after a severe stress, major UK banks would still have a Tier 1 capital base of over £275 billion, or more than 10% of risk weighted assets, to support lending to the real economy.

This resilience reflects the fact that major UK banks have tripled their aggregate Tier 1 capital ratio over the past decade to 16.7%.

Countercyclical Capital Buffer

Informed by the stress test results for losses on UK exposures, the FPC's judgement that the domestic risk environment—apart from Brexit—is standard; and consistent with the FPC's guidance in June; *the FPC is raising the UK countercyclical buffer rate from 0.5% to 1% with binding effect from 28 November 2018.*

In addition, as previously announced, capital buffers for individual banks will be reviewed by the PRC in January. These will reflect the firm-specific results of the stress test, consistent with the judgements made by the FPC and PRC in September.

These buffers can be drawn on as necessary during a downturn to allow banks to support the real economy.

Brexit

There are a range of possible outcomes for the future UK-EU relationship. Consistent with its remit, the FPC is focused on scenarios that, even if the least likely to occur, could have the greatest impact on UK financial stability. These include scenarios in which there is no agreement or transition period in place at exit.

The 2017 stress test scenario encompasses the many possible combinations of macroeconomic risks and associated losses to banks that could arise in this event. As a consequence, the FPC judges that, given their current levels of resilience, UK banks could continue to support the real economy even in the event of a disorderly exit from the EU.

That said, in the extreme event in which the UK faced a disorderly Brexit combined with a severe global recession and stressed misconduct costs, losses to the banking system would likely be more severe than in this year’s annual stress test. In this case where a series of highly unfortunate events happen simultaneously, capital buffers would be drawn down substantially more than in the stress test and, as a result, banks would be more likely to restrict lending to the real economy, worsening macroeconomic outcomes.

The FPC will therefore reconsider the adequacy of a 1% UK countercyclical capital buffer rate during the first half of 2018, in light of the evolution of the overall risk environment.

Of course, Brexit could affect the financial system more broadly. Consistent with the Bank’s statutory responsibilities, the FPC is publishing a checklist of steps that would promote financial stability in the UK in a no deal outcome.

It has four important elements:

- First, ensuring that a UK legal and regulatory framework for financial services is in place at the point of leaving the EU. The Government plans to achieve this through the EU Withdrawal Bill and related secondary legislation.

- Second, recognising that it will be difficult, ahead of March 2019, for all financial institutions to have completed all the necessary steps to avoid disruption in some financial services. Timely agreement on an implementation period would significantly reduce such risks, which could materially disrupt the provision of financial services in Europe and the UK.

- Third, preserving the continuity of existing cross-border insurance and derivatives contracts will be necessary. Domestic legislation will be required to achieve this in both cases, and for derivatives, corresponding EU legislation will also be necessary. Otherwise, six million UK insurance policy holders with £20 billion of insurance coverage, and thirty million EU policy holders with £40 billion in insurance coverage, could be left without effective cover; and around £26 trillion of derivatives contracts could be affected. HM Treasury is considering all options for mitigating these risks.

- Fourth, deciding on the authorisations of EEA banks that currently operate in the UK as branches will be important. Conditions for authorisation, particularly for systemic firms, will depend on the degree of cooperation between regulatory authorities. As previously indicated, the PRA plans to set out its approach before the end of the year.

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

Biennial Exploratory Scenario

Over the longer term, the resilience of UK banks could also be tested by gradual but significant changes to business fundamentals. For the first time, the FPC and PRC have examined the strategic responses of major UK banks to an extended low growth, low interest rate environment combined with increasing competitive pressures in retail banking from increased use of new financial technologies.

FinTech is creating opportunities for consumers and businesses, and has the potential to increase the resilience and competitiveness of the UK financial system as a whole. In the process, however, it could also have profound consequences for the business models of incumbent banks.

This exploratory exercise is designed to encourage banks to consider such strategic challenges. It will influence future work by banks and regulators about longer-term issues rather than informing the FPC and PRC about the immediate capital adequacy of participants.

Major UK banks believe they could, by reducing costs, adapt to such an environment without major changes to strategy or by taking more risk.

The Bank of England has identified clear risks to these projections:

- Competitive pressures enabled by FinTech may cause a greater and faster disruption to banks' business models than they currently expect.

- The cost of maintaining and acquiring customers in a more competitive environment could reduce the scope for cost reductions or result in greater loss of market share.

- The future costs of equity for banks could be higher than the 8% level that banks expected in this scenario either because of higher economic uncertainty or greater perceived downside risks.

Conclusion

The FPC is taking action to address the major risks to UK financial stability.

Given the tripling of its capital base and marked improvement in funding profiles over the past decade, the UK banking system is resilient to the potential risks associated with a disorderly Brexit.

In addition, the FPC has identified the key actions to mitigate the impact of the other major cross cutting issues associated with a disorderly Brexit that could create risks elsewhere in the financial sector.

And on top of its existing measures to guard against a significant build-up of debt, the FPC has taken action to ensure banks are capitalised against pockets of risk that have been building elsewhere in the economy, such as in consumer credit.

As a consequence, the people of the United Kingdom can remain confident they can access the financial services they need to seize the opportunities ahead.