Financial Stability Report Press Conference

16th December 2019

Opening remarks by the Governor

The FPC works to ensure the UK financial system is prepared for the wide range of risks it could face, so that it can serve UK households and businesses in bad times as well as good.

That requires addressing near and medium term risks to financial stability, as well as implementing structural measures to improve the resilience of the UK economy to shocks and increase the supply of productive finance.

Today's *Financial Stability Report* provides examples of each.

Addressing Near Term Risks

Ensuring the resilience of banks to domestic and global shocks

The 2019 stress test – published today - shows the UK banking system would be resilient to an unprecedented combination of simultaneous recessions in the UK and global economies that are more severe than those during the global financial crisis, large falls in asset prices, and a separate stress of misconduct costs.

All seven major banks and building societies in the test can not only withstand these extreme shocks but also continue to meet the demands for credit from UK households and businesses.

In part, that's because their capital ratios are currently over three times higher than they were at the start of the global financial crisis. Even after stress, their capital ratios would still be more than twice their pre-crisis levels.

Banks' resilience in the test relies in part on their ability to cut dividend payments, reduce employee variable remuneration, and cease coupon payments on additional Tier 1 instruments. If banks had not cut such distributions during the stress they would not, in aggregate, have met the 2019 ACS hurdle rate.

This demonstrates the flexibility of the system but it also underscores that investors should be aware that banks would make such cuts as necessary if a stress were to materialise.

Brexit

The MPC will provide a high-level update on UK economic prospects this Thursday.

The FPC's job is to focus on, and prepare for, worst-case downside risks, including those that could be associated with disorderly forms of Brexit, however unlikely.

The FPC continues to judge that the financial system is ready for Brexit, whatever form it takes.

Reflecting extensive preparations made by authorities and the private sector, most risks to UK financial stability that could arise from disruption to cross-border financial services in a no-deal Brexit have been mitigated.

In particular, the FPC welcomes the European Commission's decision to extend the temporary equivalence arrangements relating to UK CCPs.

Structural actions to improve resilience and increase productive finance

Reforming bank capital requirements

Stepping back from current risks, the FPC, together with the PRC and the Bank, has reviewed the structural level and balance of capital requirements for the UK banking system. As a result:

- The FPC is raising the level of the UK countercyclical capital buffer (CCyB) rate that it expects to set in a standard risk environment from the region of 1% to the region of 2%.
- The new 2% UK CCYB rate will take effect in one year.
- Reflecting the additional resilience associated with higher macroprudential buffers, the PRA will consult next year on proposals to reduce minimum capital requirements in a way that leaves overall loss absorbing capacity in the banking system broadly unchanged.
- The Bank is also clarifying that, in the event of a bank resolution, it expects all

debt that is bailed in to be written down or converted to the highest quality of capital, Common Equity Tier 1 (CET1).

These changes increase **resilience** by shifting the balance of loss absorbing capacity towards higher quality Tier 1 capital while leaving the overall loss absorbing capacity for the banking system broadly unaffected.

Tier 1 capital requirements for major UK banks will remain in line with the benchmark level first set by the FPC in 2015 of 14% of risk-weighted assets. That benchmark balances the need for banks to be able to keep lending through downturns with the need for them to provide the finance to support growth over the medium term.

These changes improve the **responsiveness** of capital requirements to economic conditions by shifting the balance of capital requirements from minimum requirements that must be met at all times towards buffers that can be drawn down as needed.

For example, if the UK CCyB rate were cut from 2% to 0%, this would enable banks to absorb up to £23bn of losses, preserving up to £500 billion of banks' capacity to lend to UK households and businesses.

A higher setting of the UK countercyclical buffer in standard conditions will also allow the FPC to pursue a gradual approach to raising the buffer as risks increase.

Finally these change enhance the **resolvability** of failing banks via the Bank of England's intention to write down or convert debt to CET1 capital. This will make banks more resilient to future losses, supporting their resolution and minimising the wider economic costs of their failure.

Review of FPC mortgage market Recommendations

The FPC has reviewed its mortgage market Recommendations: a 15% limit on the amount of new mortgage lending at or above 4.5 times the borrower's income, and its recommendation that lenders assess whether borrowers could meet their mortgage payments if interest rates rose by 3 percentage points.

Mortgages are the largest financial liability of households and the largest loan exposure of lenders. In the past, as an economic expansion has progressed, lenders' underwriting standards have often shifted from responsible to reckless, leading to a significant increase in highly indebted households.

As a consequence, these households are likely to face greater difficulties and can cut back more sharply on spending to make their mortgage payments. This deepens the recession and worsens the impact on the wider economy.

The FPC's tools maintain financial stability and support economic growth through the cycle, providing benefits that substantially outweigh the macroeconomic costs.

Alternatives to achieve similar benefits would be much more costly to the wider economy.

For example, without the FPC's insurance policies, monetary policy would have to be tightened significantly to address the financial stability risks of deteriorating underwriting standards and rapid credit growth. This would reduce jobs and growth across the economy.

Alternatively, in the face of looser underwriting standards, banks would be required to have materially higher levels of capital. This would raise the cost of credit for everyone.

The FPC has therefore judged it appropriate to maintain both Recommendations and that these structural measures should remain in place through the housing cycle.

The transition away from Libor

Continued reliance of financial markets on Libor poses risks to financial stability that can only be reduced through a transition to alternative risk-free rates. Accordingly, the intention is that sterling Libor will cease to exist after the end of 2021. No firm should plan otherwise.

There are encouraging signs in sterling markets. The FPC endorses the UK industry working group's target to cease new issuance of cash products linked to sterling Libor by Q3 2020. And the FPC agrees with the PRA and FCA that the largest regulated firms with material Libor exposure should have a senior manager responsible for transition.

But gaps remain and efforts will need to accelerate in the first half of 2020. To that end,

- The Bank of England is currently reviewing its risk management approach to Libor-linked collateral delivered in its Sterling Monetary Framework.
- The FPC is considering further potential supervisory tools that could be deployed by authorities to encourage the reduction in the stock of legacy Libor contracts to an irreducible minimum ahead of end-2021, and will keep them under review in light of progress made by firms in the transition.

The FPC is promoting innovation and productive finance

Addressing vulnerabilities in open-ended funds

The mismatch between redemption terms and the liquidity of some funds' assets means there is an advantage to investors who redeem ahead of others, particularly in stress. This has the potential to become a systemic risk as first mover advantage could prompt a de-stabilising rush to the exits.

As part of the ongoing review of open-ended funds by the Bank and FCA, the FPC has established that there should be greater consistency between the liquidity of a fund's assets and its redemption terms. Specifically:

- The liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a vertical slice of those assets or the time period needed for a sale to avoid a material price discount.

- Investors who redeem should receive a price for their units that reflects the discount needed to sell the required proportion of a fund's assets in the specified redemption notice period; and

- Redemption notice periods should reflect the time needed to sell the required proportion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

In addition to enhancing financial stability, these changes are expected to promote the overall supply of productive finance to the economy through business and financial cycles. They will both enhance the ability of funds to invest in illiquid investments, and increase investment in funds with longer redemption terms.

Ensuring that rapidly evolving payment systems support financial stability while improving customer choice

Innovation in payments could bring significant benefits for users, including lower costs and faster processing times.

At the same time, the ability to transact safely and smoothly is critical to financial stability.

The FPC considers that the current payments framework will need to be adjusted to accommodate such innovation along the following principles:

- Regulation of payments should reflect the financial stability risk, rather than the legal form, of payments activities.

- The systemic importance of any single firm should be informed by whether its failure could disrupt one or more end-to-end systemic payment chains

- All firms above a certain threshold carrying out the activities that make up the payment chain should provide sufficient information to support the identification of systemically important payments firms as they emerge.

Stablecoin-based payment chains, such as Libra, pose additional issues for regulation. Payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains.

Where stablecoins are used in systemic payment chains as money-like instruments they should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

Conclusion

As the latest stress test indicates, the core of the UK financial system would be resilient to the crystallisation of a number of current risks ranging from abrupt changes to trading arrangements, sharp movements in asset prices, and deep economic downturns.

Such near-term preparedness is an essential element of the FPC’s job but only part of its responsibilities.

We are also working to improve the structural resilience of the banking sector while increasing its responsiveness and resolvability by reforming bank capital standards.

We are continuing our mortgage measures in order to provide insurance against the encroachment of irresponsible lending standards that have, in the past, contributed to painful recessions.

And we are supporting efforts to replace Libor, to reform open-ended funds and to oversee new payment systems in order to ensure that more sustainable and resilient productive finance is widely, and reliably available.

Through these actions to reduce risks to financial stability and improve the financial system the FPC is doing its part to promote the good of the people of the United Kingdom.