BANK OF ENGLAND

News release

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Bank of England publishes details of 2015 stress test for largest UK banks and building societies

Today, the Bank of England is publishing the scenario for the 2015 stress test, which will be applied to the largest UK banks and building societies. The scenario has been agreed by the Financial Policy Committee (FPC) and Prudential Regulation Authority (PRA) Board.

The purpose of the test is to ensure that the UK banking system can withstand a severe shock and continue to provide financial services to the real economy. It ensures that the UK financial system is one that absorbs rather than amplifies shocks. Stress testing makes up one of the three pillars of the Bank of England's framework to assess capital adequacy, alongside risk-weighted capital requirements and a leverage requirement.

The 2015 stress test will assess the resilience of the UK banking system to a deterioration in global economic conditions. The stress scenario is not a forecast of macroeconomic and financial conditions in the United Kingdom or other countries, nor is it a set of events that is expected, or likely, to materialise. Rather, it is a coherent, 'tail-risk' scenario that has been designed specifically to assess the resilience of UK banks and building societies to a severe shock.

This year's stress scenario incorporates the following elements:

- A synchronised global downturn affecting Asia and the euro area in particular, and amplifying global disinflationary pressures;
- severe financial market stress with a reduction in global risk appetite, particularly in indebted economies, reductions in market liquidity, and some defaults of counterparties; and
- a slowdown in the UK driven by the downturn in its trading partners, fall in confidence, and correction in market risk appetite. Additional monetary stimulus is pursued in the UK and elsewhere, lowering and flattening yield curves.

Banks' performance in the stress scenario will be reviewed against two key capital adequacy thresholds: a 4.5% CET1 risk-weighted capital ratio and a 3% Tier 1 leverage ratio. Up to 25% of Tier 1 capital can be met using relevant additional Tier 1 (AT1) instruments.

The results will inform the PRA and FPC's judgements respectively on the capital adequacy of individual institutions and on the resilience of the banking system as a whole

As in the 2014 stress test, if a firm's capital ratio is projected to fall below the 4.5% CET1 threshold in the stress, there is a strong presumption that the PRA will require the firm to take action to strengthen its capital position. If a firm's leverage ratio is projected to fall below the new 3% Tier 1 leverage ratio threshold, there is also a strong presumption that the PRA will require the firm to take action to strengthen its capital position. However, depending on the outcomes for specific firms, the PRA may still require action to strengthen capital positions even if the thresholds are met. To determine whether action is needed, the PRA will examine capital adequacy, the adequacy of recovery and resolution plans and the extent to which potentially significant risks are not quantified adequately or fully as part of the stress.

If the exercise reveals inadequate resilience at the level of the system, the FPC will consider a variety of actions, depending on the sources of potential risks, including recommendations to the PRA and Financial Conduct Authority.

The Bank of England will publish the results of the 2015 stress test alongside the Financial Stability Report in December.

Mark Carney, Governor of the Bank of England, said:

"Last year's stress tests demonstrated how much stronger the core of the UK financial system has become since the financial crisis. The results showed that the post crisis reforms have put the UK banking system on a stronger footing and made it better able to support the real economy even in the face of a major domestic shock. This year's test will have a different focus and is equally important. By assessing the resilience of the UK banking system against a major external shock, we will improve further our ability to identify vulnerabilities and we will ensure that banks have plans in place to address a wider range of possible stresses.

"As a forward looking regulator our job is never complete. Our focus is clear. To promote the good of the people of the United Kingdom, we are committed to ensuring that our major banks are resilient, that they can weather shocks without calling on taxpayer support, and that they can continue to lend even in adverse conditions. This year's stress tests will build on last year's work and advance our medium-term stress testing framework."

Key elements of the 2015 stress scenario

Global growth disappoints materially relative to expectations and disinflationary pressures build up further. This triggers a rapid deterioration of market sentiment globally. Risk appetite abruptly diminishes and market participants attempt to de-risk their portfolios, generating safe-haven capital flows to high-quality US assets. The dollar appreciates against a wide range of currencies, especially those of emerging market economies.

Liquidity in some markets becomes seriously impaired and credit risk premia rise sharply. Commodity prices fall further, putting additional downward pressure on global inflation.

In China, policy supports a rebalancing of the economy towards consumption, but that takes time to take effect. Property prices fall sharply and, in turn, investment in residential property and associated industries contracts. Growth slows materially and the Renminbi depreciates against the dollar.

In the euro area, weaker domestic demand, world trade and commodity prices lead to further disinflationary pressures and the rate of deflation increases. This amplifies the downturn in activity, as consumption and investment decisions are delayed. In combination with weak demand and business confidence, unemployment increases materially throughout the euro area. Deflation also increases the real burden of debt and increases market concerns. Although the recession is widespread through the euro area, the increases in credit risk premia are largest for the most highly-indebted sovereigns, households and firms.

These global shocks have adverse implications for activity in a number of emerging market economies, especially China's major trading partners, commodity exporters and economies with large external financing needs. These countries also experience higher risk premia on foreign borrowing, which triggers a sudden stop to capital inflows and a sharp contraction of domestic credit and demand. Businesses that have issued dollar-denominated debt are particularly affected, given the appreciation of the dollar.

The global downturn impacts the United Kingdom. Output growth turns negative as export demand falls sharply. There are additional spillovers, through financial linkages and confidence effects. The household and corporate savings rates increase due to precautionary behaviour and the higher cost of credit as banks face higher funding costs. These mechanisms lead to falls in consumption, investment and property prices. The deterioration of global financial market sentiment is also evident in the United Kingdom – for example through a sharp rise in risk premia on private sector borrowers. In this scenario, it is assumed that policymakers observe these developments as a series of unexpected shocks. Additional monetary policy stimulus is pursued, which has the effect of lowering the yield curve over the course of the stress scenario.

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Notes to Editors

1. Stress testing the UK banking system: key elements of the 2015 stress test
2. Stress testing the UK banking system: guidance for participating firms
3. 2014 stress test results
4. Stress testing the UK banking system: key elements of the 2014 stress test
5. A framework for stress testing the UK banking system - A Discussion Paper
6. In March 2013, the Financial Policy Committee recommended that regular concurrent stress testing of the UK banking system should be developed to assess the system's capital adequacy. The first annual concurrent stress test took place in 2014.