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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETING

26 SEPTEMBER 2014

This is the record of the Financial Policy Committee meeting held on 26 September 2014.

It is also available on the Internet:

<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1410.pdf>

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is established as a sub-committee of the Bank of England's Court of Directors.

The next meeting of the FPC will be on 15 October and the record of that meeting will be published on 31 October.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 26 SEPTEMBER 2014

At its meeting on 26 September, the Financial Policy Committee agreed one recommendation, set the UK countercyclical capital buffer (CCB) rate and recognised CCB rates set by the Norwegian and Swedish authorities:

- 1. The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to:**
 - a. Loan-to-Value Ratios;**
 - b. Debt-to-Income Ratios, including Interest Coverage Ratios in respect of buy-to-let lending.**
- 2. The FPC set the countercyclical capital buffer rate for UK exposures at 0%.**
- 3. The FPC also recognised the 1% countercyclical capital buffer rates set recently by the Norwegian and Swedish authorities. These rates should be applied by UK regulated banks, building societies and investment firms with relevant exposures located in these countries in calculating their institution-specific countercyclical capital buffers from 3 October 2015.**

1. The Committee reviewed economic prospects and the outlook for financial stability, as summarised below.

Scottish referendum

2. In the United Kingdom, there had been intense focus on the referendum on Scottish independence. The Committee had discussed and received briefings on the possible financial stability risks associated with the Scottish referendum and associated contingency planning by the Bank in June, July and September. At those sessions, the Committee had reviewed the developments relating to the Scottish referendum focusing on financial stability implications. In July the Committee had received a detailed briefing on the Bank's contingency planning.

3. The Committee had noted the possible impact of a 'yes' vote on market perceptions of the United Kingdom's creditworthiness. If an independent Scotland were not to accept its proportionate share of the debt, the Committee felt this could have modest implications for the United Kingdom's sovereign credit rating. The implications for the implied credit rating of an independent Scotland could have been more material.

4. The impact of a 'yes' vote on regulated firms would likely have been varied. No significant concerns had been identified for UK financial market infrastructures but there could have been significant effects for those major UK banks and insurers which were domiciled in Scotland or had substantial Scottish assets and liabilities. The main financial stability risks would have arisen if:

- a lack of sufficient clarity over deposit insurance arrangements and/or credibility of central bank liquidity support had led depositors and other creditors of Scottish institutions to transfer their business to other financial firms; and/or
- Scottish-domiciled banks had been subject to ratings downgrades, as implied home government support was reduced, potentially affecting their ability to act as counterparties to other institutions and/or to access wholesale funding markets.

5. The Committee had noted that the main parties in the Westminster Parliament had ruled out a formal currency union with an independent Scotland. It had also noted the potential instability of any informal currency arrangement, such as sterlingisation. In the absence of credible institutions and resources to back financial stability and fiscal credibility, such arrangements could have led to expectations of future redenomination, particularly if an

independent Scotland were seen to be on an overall path of economic divergence from the rest of the United Kingdom.

6. In the extreme, it was possible that the prospect of that risk materialising in the future could have threatened financial stability in the present. If depositors, policyholders and other creditors believed that an independent Scotland would adopt a new currency, they might have preferred not to take the risk that their assets might be redenominated into that new currency. If financial companies believed they would face currency mismatches and therefore potential capital losses in the event that Scotland adopted a new currency, they too might have preferred to reduce their exposures to Scottish assets.

7. The Committee had noted that affected firms were undertaking extensive contingency planning - in liaison with the PRA - in areas such as liquidity management, operations and communications.

8. A number of risks would have been mitigated if Scottish-domiciled banks chose, and were able to announce quickly, and with credibility, their intention to redomicile their holding companies into the rest of the United Kingdom. PRA supervisors had been working with those firms to understand their intentions and ensure their operational readiness. Ahead of the vote, a number of Scottish-based financial services firms had announced that they would redomicile in the event of a 'yes' vote.

9. The Committee had discussed the practical issues associated with redomiciling. It had judged that both the speed and certainty with which firms would be able to redomicile could be significantly improved by new legislation. Any such legislation would have been a matter for the Westminster Parliament, whose view could not be pre-supposed.

10. The Committee noted that redomiciling would not mitigate all risks to financial stability. For example, currency risk could also affect holders of Scottish assets or financial instruments (such as asset-backed securities) which contained underlying Scottish assets. The PRA had been discussing with firms how they would manage their potential currency exposures.

11. Based on regular liquidity monitoring, the PRA had assessed that the large UK banks' wholesale funding positions were stable. Nonetheless, a key element of the Bank's contingency planning work concerned the potential provision of liquidity support to individual institutions. The Committee had noted that the large UK banks had significant liquid asset buffers and that the

Bank's Discount Window allowed banks to access liquidity against substantial amounts of pre-positioned collateral.

12. A routine market-wide Indexed Long-Term Repo operation (ILTR) had been scheduled for 7 October, but the Bank was ready and able to announce extra operations at very short notice. It was subsequently decided by the Bank that, in the event of a 'yes' vote, and as a precautionary measure to backstop sterling money market liquidity, the Bank would immediately announce its intention to conduct additional operations in each of the two succeeding weeks, bridging to the already scheduled 7 October operation.

13. The Committee noted that the Bank had in place arrangements to meet potential increased demand for Bank of England notes from holders of Scottish notes. Under current arrangements, Scottish banknotes are backed fully by their issuers' holdings of Bank of England notes, UK coin and deposits at the Bank of England. This would have been a key public message in the event of a 'yes' vote.

14. The Committee noted that the Bank had been developing and implementing its post-referendum communication plans. In the event of a 'yes' vote it would issue a statement immediately reaffirming its responsibilities for financial stability, prudential regulation, banknotes and monetary policy in the entire United Kingdom, including Scotland, until legislation enacting independence came into force. This statement would be co-ordinated with the FSCS and HM Treasury, as appropriate, to provide a comprehensive explanation of financial stability arrangements during any transition period.

15. The Committee welcomed the contingency measures taken by the Bank and emphasised the importance of readiness of the Bank, in conjunction where appropriate with HM Treasury, to take steps rapidly in the event of a 'yes' vote. It also recognised the need for careful communications in advance of the referendum, both to maintain the political independence of the Bank and to avoid inadvertently triggering the very risks the contingency planning was designed to mitigate.

16. Following these discussions, the Governor had advised the Chancellor of the substance and implications of the Committee's discussion.

The macroeconomic and financial environment

17. The Committee noted that, since its meeting in June, geopolitical and event risks had appeared more marked: the intensification of the conflict in Ukraine had led to further sanctions

on Russia by the European Union and United States; the security situation in Libya had deteriorated; and the conflict in Syria had spread to Iraq.

18. Global economic prospects remained modest. Consensus forecasts for world GDP growth in 2014 had been revised down during the course of the year, reflecting weak data outturns internationally. In Q2, quarterly GDP growth had rebounded in the US but it had been weaker than expected in the euro area.
19. Weak growth and declines in headline inflation in the euro area were a particular source of concern. The Committee noted the risk of a prolonged period of very low euro-area inflation. Members noted that UK banks' exposures to the euro area had fallen in recent years, in part as a result of an earlier FPC recommendation concerning UK banks' management of risks arising from their euro-area exposures. But a more extended period of high indebtedness in the euro-area, as a result of low growth and low inflation, would present greater risks to financial stability. The Committee would continue to monitor developments in the euro area closely, including banks' direct and indirect exposures.
20. In emerging markets, growth forecasts had edged lower since June. Nevertheless, there had been some modest improvements in the current account positions of those countries that had been hit hardest by capital flow reversals in the period of financial market volatility in summer/autumn 2013 (the so-called 'taper tantrum' episode). Committee members remained concerned about the potential for financial stability threats to originate from China as it rebalanced towards a more domestic demand driven economy. The Chinese housing market had been slowing and while annual credit growth had eased it remained close to 20%.
21. Financial markets had remained remarkably resilient to the uncertainties created by geopolitical and event risks. Yield-seeking behaviour in some markets raised the possibility that tail risks were not being priced appropriately. There was evidence, for example, of increasing activity in European leveraged buy-out markets and weaker credit protection by lenders in the form of 'covenant-lite' issuance. Compensation taken by market participants for liquidity risk had also narrowed. There had been some falls in risky asset prices internationally during the summer, but these had proved largely temporary. Implied volatilities in global financial markets had remained relatively close to recent lows across a range of asset classes.
22. The Committee discussed how the current benign market conditions could unwind. While the market had proved resilient to shocks in the recent past, there remained the risk that a shock could be amplified through the financial system. Secondary market liquidity could be impaired in

key market segments by large-scale asset disposals. This potential fragility was heightened by what appeared to have been a structural reduction in market-making capacity in some financial markets.

23. The Committee agreed that this set of risks remained significant. It would continue monitoring developments in this area and would consider the resilience of market liquidity as part of its medium-term priority on supporting diverse and resilient market-based finance.

24. In the United Kingdom, economic growth had been robust and broadly based. At its June Policy meeting, the FPC had focused on developments in the UK housing market amid concerns that sustained increases in house prices relative to incomes could lead to significant rises in household debt and strains in affordability. Since then, there had been some evidence that housing market activity had eased slightly, with mortgage approvals softening. The MPC's latest projections were consistent with the rate of increase in house prices moderating earlier than had previously been expected. This suggested that the FPC's June policy recommendation relating to a limit on the proportion of very high loan to income (LTI) mortgage loans, which was designed as insurance against strong growth in such lending, was less likely to act as a constraint. Further insights into housing finance risks would be gained in Q4 when the results of the 2014 stress tests of UK banks became available.

25. Turning to UK commercial property markets, the Committee observed that in 2014 Q2 capital values had increased by 3.3% across the country. Yields on both prime and secondary market properties had been falling, with prime yields close to pre-crisis lows at 4.3%. This came against a backdrop of strong growth in commercial real estate (CRE) rental values in London, but subdued developments in much of the rest of the country.

26. Loan-level data suggested that the quality of the major UK banks' CRE exposures had improved significantly over the past couple of years. Meanwhile, competition in the market for new CRE lending had increased, with spreads tightening and covenants loosening - much of this appeared to have been driven by non-banks and foreign banks.

27. The Committee concluded that developments in both the CRE and housing sectors should continue to be monitored closely.

28. The Committee noted that euro-area banks had issued over €30 billion of new equity since the start of the year, with much of this coming from banks in the euro-area periphery. This had put issuing banks in a better position ahead of the Asset Quality Review and stress tests that were

being conducted by the ECB and EBA. Nevertheless, given developments in the euro-area economy, continued risks to the resilience of the euro-area banking system remained.

29. Meanwhile, major UK banks remained on a path of improving resilience. Capital ratios had increased over the past year, with an average CET1 ratio of 10.7% in 2014 H1 on a Basel III basis¹, up from 8.3% a year before and UK banks' dependence on short-term wholesale funding remained significantly lower than before the crisis. However, the Committee noted continuing concerns from borrowers about access to finance for SMEs. Stronger capital positions for banks should help to alleviate these concerns over time.

30. Looking forward, the major UK banks expected their capital positions to strengthen further, in line with more demanding regulatory capital requirements. But banks continued to face a mix of known and unknown costs arising from a range of misconduct issues including fines, redress, the cost of administering redress programmes, and litigation.

31. The Committee discussed that misconduct, where it occurred, needed to be punished firmly by the appropriate authorities following due process in order to send a strong message to firms and to disincentivise such behaviour. It was also noted that robust governance at firms was essential to minimise risks of misconduct. However, the Committee also noted the increased uncertainty around some aspects of misconduct-related enforcement action, for instance those implemented by other national authorities, and a lack of clarity in some cases about the basis for computing fines and the severity of possible business activity restrictions. This uncertainty could potentially present risks for financial stability and required careful co-ordination among authorities.

32. One member also noted that regulatory complexity and uncertainty more broadly, not just in relation to misconduct issues, were making banks increasingly risk averse, with potential implications for economic performance. Other members noted that greater risk aversion was an objective of the response to the financial crisis.

¹ Calculated as aggregate peer group common equity Tier 1 levels over aggregate risk-weighted assets, corresponding to the Basel III estimates submitted to the PRA by banks on a best endeavours basis.

Countercyclical capital buffer rate

33. At its June meeting the Committee had set the UK countercyclical capital buffer (CCB) rate for the first time at 0%.

34. As required by legislation, the Committee started by looking at the ‘buffer guide’ – a simple metric developed by the Basel Committee on Banking Supervision and identified in EU legislation, which provides a guide for the CCB rate based on the gap between the ratio of credit to GDP and its long-term trend. The gap remained strongly negative which, other things equal, would clearly suggest maintaining a CCB rate of 0%. However, members noted a number of drawbacks of this measure. While the negative gap partly reflected the weakness in credit growth to the non-financial private sector, it was also driven by a strong upward trend in the credit-to-GDP ratio prior to the crisis; this strong growth trend was clearly not sustainable. As such, the Committee reaffirmed its previous view that there should be no simple, mechanistic link between the buffer guide and the CCB rate.

35. Consistent with its Policy Statement on the CCB, the Committee looked beyond the guide at a wider set of core indicators, as well as at other relevant economic and financial data and supervisory and market intelligence. As noted above, UK banks had made further progress in strengthening their resilience by improving their capital and funding positions, though further progress was anticipated as part of the transition to new international regulatory standards. Stress test results, which would be available in Q4, would provide further information on how banks’ capital positions might evolve through a period of stress. Indicators of imbalances in the UK economy had also improved. Household and private non-financial corporation debt levels had fallen, though they remained at elevated levels. And while the current account deficit remained high, at 4.4% of GDP in 2014 Q1, the UK external debt-to-GDP ratio had fallen sharply in aggregate and at a sectoral level for the banking system. Some of the FPC’s core indicators suggested a further easing of the terms and conditions of credit in some markets, consistent with the possibility that tail risks were not being priced appropriately.

36. In light of these considerations, the Committee agreed that it would maintain the CCB rate for UK exposures at 0%. It would review this position in 2014 Q4, in light of developments in its core indicators and the results of the stress test exercise.

CCB reciprocation

37. The Committee discussed its approach to reciprocating CCB rates set by other countries, as it had signalled it would do at its previous meeting.

38. The Committee noted its responsibility for deciding whether foreign CCB rates should be reciprocated by the UK authorities. Such decisions would be made on an individual basis, taking into account their materiality and effect on the UK financial system in aggregate. The FPC, however, recognised that in most cases reciprocation would enhance the resilience of the UK financial system. The FPC expected, therefore, to reciprocate foreign CCB rates.

39. EU law requires the United Kingdom and other EEA countries to begin reciprocation of CCB rates from 2016. Legislation in force in the United Kingdom since May 2014 allows the FPC to reciprocate before that date. Given the potential benefits of reciprocation, the Committee agreed that it would consider doing so with immediate effect. Such an approach would be consistent with the FPC's responsibility to set the CCB rate for UK exposures which was already being put into effect.

40. In light of the discussion on the approach to reciprocation, and its assessment of the individual cases, the FPC decided to recognise the 1% CCB rates set recently by the Norwegian and Swedish authorities. These rates should be applied by UK regulated banks, building societies and investment firms with relevant exposures located in these countries in calculating their institution-specific CCBs from 3 October 2015. The FPC noted that, where appropriate, it would also seek to reciprocate foreign macroprudential capital actions, other than the CCB, given the likely benefits to UK financial stability and to ensure consistency with the above approach to reciprocating foreign CCB rates.

41. Given the benefits to global financial stability of a coordinated approach across national boundaries, the Committee noted the desirability of other jurisdictions taking a similar approach to reciprocation of macroprudential decisions.

Housing powers

42. The Chancellor of the Exchequer had announced in June that HM Treasury wanted to grant the Committee additional powers to guard against financial stability risks from the housing market, and have powers in place before the end of this Parliament. The Committee therefore discussed its recommendation to HM Treasury on the form of these powers.

43. As discussed in the November 2013 and June 2014 *Financial Stability Reports*, the housing market could pose both direct risks to financial stability through lenders' balance sheets and indirect risks through households' balance sheets. The direct risk occurred because mortgage lending was the single largest asset class on UK banks' balance sheets. An actual or perceived increase in distress on mortgage exposures, particularly if associated with sharp falls in house prices that reduced the value of collateral held against such loans, had the capacity to lower banks' capital, impair their access to finance and so reduce their ability to deliver the financial services the economy needs. The indirect risk occurred because mortgages were the single largest liability on the UK household sector's balance sheet. In the event of a fall in incomes or an increase in interest rates, in order to keep servicing their mortgages, households' initial response could be to cut back on other spending which would have knock-on effects for the rest of the economy and lenders' balance sheets.

44. The Committee noted that there was a risk that both of these channels could be amplified by any cycle of rising house prices and overextension of credit. Because housing was the main source of collateral in the real economy, it could give rise to a self-reinforcing loop of rising house prices and credit growth. As housing valuations increased, rising wealth for existing homeowners and buy-to-let (BTL) investors and higher collateral values for lenders could increase both the demand for and supply of credit, leading to higher valuations. This could be made more acute if rising prices were to generate expectations of further price increases – and the amplification mechanism could work in reverse in a downturn. The Committee viewed this dynamic to be a source of macroprudential risk: decisions by individual borrowers and lenders could accumulate into aggregate risks that were not factored into individual decisions.

45. The Committee's aim was to identify the set of instruments that could work to mitigate these direct and indirect risks to financial stability, and the amplification channel, if they were to occur. The FPC focused on instruments that acted on risks to financial stability, such as those that limited excessive indebtedness. It stressed that it neither sought to control house prices directly, nor could it address underlying structural issues related to the supply of houses.

46. The Committee noted that its existing powers of Recommendation and Direction already provided some scope to manage financial stability risks from the housing market. In discussing the form of further powers, it agreed that it was important to ensure that it had a set of tools sufficient to tackle all of the sources of financial stability risk, given the Chancellor's request, but, importantly, not more than the minimum needed to achieve that. The Committee put weight on the benefits of operating in general with a parsimonious set of Direction powers, including for its

accountability, for policy effectiveness and for helping the financial system and public in understanding the set of instruments that the FPC was likely to consider when forming policy decisions. It noted that there may also be compliance costs to lenders of operating in accordance with too wide a set of Direction powers - for example in setting up systems to monitor potential limits.

47. Given that the Committee could already make Recommendations on the housing market – as it had in June - it also discussed the benefits to being able to use a power of Direction to the FCA and PRA to use their existing powers, for macroprudential ends, to limit risky lending, even though it might still choose to act via a Recommendation to the same end.

48. First, implementation of Directions could be more timely than Recommendations: they required the PRA and FCA to act as soon as practicable and provided scope for HM Treasury to disapply some procedural requirements for consultation periods which could help where urgent implementation was judged necessary. The Committee put weight on this in a market like housing, where quick implementation could be necessary to prevent lenders and borrowers bringing forward transactions in anticipation of policy changes, thereby putting more pressure on the market. Members also noted that there were potential benefits to the extent that there could sometimes be tensions between the objectives of microprudential and macroprudential regulators - for example in a downturn when a macroprudential regulator might put weight on loosening regulatory requirements to protect and enhance system resilience, but a microprudential regulator may put more weight on maintaining standards to ensure the safety and soundness of individual firms. Although such occasions were likely to be rare, the Committee recognised that one of the purposes of a macroprudential body was to be able to consider whether powers to direct microprudential regulators were warranted in those circumstances.

49. Second, there would be a clear framework for the use of Direction powers linked to the macroprudential mandate for varying policies over the cycle. For each Direction power, the FPC would be required under statute to produce and maintain a Policy Statement, including identifying core indicators that would be used as a guide for policymaking. This could help borrowers and lenders to understand and anticipate how the FPC would act to lean against risks in the housing market, which could in itself help prevent the overextension of credit. It would also be an important part of the wider accountability framework within which the FPC had to operate in meeting its objectives.

50. With these principles in mind, the Committee then considered the set of possible housing instruments over which a power of Direction could be sought, drawing both on academic and international evidence.

51. Its existing powers over capital requirements - the CCB and sectoral capital requirements (SCRs) - were one way to address the direct risks channel. Higher capital requirements could also be helpful in preventing an overextension of credit if they led to a rise in the cost of borrowing - though this effect was uncertain and could be relatively weak when confidence was high and lending was rising rapidly.

52. The Committee took note of international evidence that had found that policies that acted upon the flow of new lending - for example by imposing limits on loan to value (LTV) and debt to income (DTI) ratios - had been effective in restraining overextension of credit through the cycle, and were likely to be useful complements to capital tools. And this type of policy action could help to lean against the competitive pressures that might otherwise lead to a loosening in underwriting standards over the cycle. These types of instruments could be implemented more quickly than capital instruments, given the time needed for firms to raise capital. And capital actions were typically taken in relation to banks' modelled risk weights which may be unreliable, while lending limits could be applied directly. Limits on lending to the housing market therefore were likely to have potential advantages as complementary tools to capital instruments.

53. Turning to the range of different instruments for affecting the flow of new mortgage lending, the Committee had recommended in June a limit on the flow of mortgage lending at very high LTI ratios. This had been to address the indirect risks to financial stability from increases in the number of highly indebted households, as it had set out in detail in the June *Financial Stability Report and Record* of its meeting. It judged that having a Direction power over this type of instrument was important for the reasons it had discussed earlier.

54. The Committee discussed whether it would be appropriate to recommend that this power could relate, at the time of a mortgage application, to the overall debt position of households, rather than only the size of the mortgage loan. For UK households, mortgages secured with a first-charge on the borrower's home made up around two-thirds of aggregate household debt. But other forms of debt, either secured on property or unsecured, could also put pressure on household finances and pose similar risks to the economy and financial system. And there was international evidence that suggested that where limits on debt relative to income encompassed first-charge mortgages only, lending activity had been displaced into other forms of debt, thereby undermining

the effectiveness of the policy. Further, this would allow the powers to be in place should debt profiles change in the future.

55. The Committee therefore judged that any new power of Direction in respect of limiting residential mortgage lending should take account also of households' contractual, commercially-extended debt. This would include, for example, first-charge mortgage debt, other mortgage debt such as second-charge loans and other commercially-extended secured and unsecured loans. The definition of debt for the purposes of the FPC's power of Direction would need to be defined in legislation. Subject to this, in using the power of Direction, the FPC would need to decide what definition of household debt would be appropriate and proportionate to managing risks at the point at which it were used.

56. Looking more broadly, the Committee noted that limits on LTV ratios had been one of the most widely used macroprudential measures internationally, and cross-country studies had suggested that they had been effective in attenuating housing and credit cycles as well as reducing direct risks to lenders' balance sheets. These instruments were attractive because they worked on both the direct and indirect channels of financial stability risk and on the amplification channel. In the upswing of a housing cycle, rising house prices could encourage borrowers to take on higher LTV mortgages in order to afford purchases. Rapid increases in house prices could also improve the average LTV ratios on lenders' existing stock of mortgages, which might make them more willing to take on additional risk by offering more new high LTV loans. By extending an increasing share of higher LTV mortgages, lenders would become more likely to face losses if house prices subsequently declined - both because higher LTV loans tended to have higher default rates and because loss given default could be greater. Even if defaults were not to materialise, falls in the value of their collateral could pose a risk by reducing confidence in banks.

57. The Committee then turned to the scope of these potential powers, in particular over both owner-occupied lending and BTL mortgage lending - that is a mortgage secured against a residential property that would not be occupied by the owner of that property or a relative, but would instead be occupied on the basis of a rental agreement.

58. The Committee's starting point was that any powers it received should be able to be applied both to owner-occupied and BTL mortgage lending - although they were different parts of the mortgage market, the underlying housing assets were the same. Ensuring that macroprudential policies could be applied, when necessary and appropriate, to both sectors would be consistent with their treatment in existing macroprudential powers over capital - specifically, BTL lending was in scope of the Committee's existing Direction power over SCRs. And the Committee noted

that it would match the practice seen so far by macroprudential authorities in other countries with BTL sectors.

59. The Committee discussed the ways in which the BTL sector could pose risks to financial stability. On direct channels, members noted the limited amortisation in BTL mortgages because they tended to be interest-only. This meant that an expansion in BTL lending in the upswing of a housing cycle could increase the direct risk to lenders' balance sheets, as the value of exposures would be less likely to fall over time as a result of repayments made. The prevalence of floating, or relatively short-term fixed, mortgage rates for these loans could also heighten their sensitivity to changes in interest rates.

60. On indirect channels, the risks to financial stability posed by increasing debt relative to incomes could arise from the BTL sector in a similar way to the owner-occupied market, albeit less directly. The majority of BTL investors were small-scale landlords - owning fewer than five properties; shocks to their income or interest rates which stretched their borrowing affordability could affect their spending in the same way as it would for owner-occupiers. But the risk that these debt burdens posed to financial stability could be tempered by the rental income BTL investors earn and because they may have a lower marginal propensity to consume to the extent that they have higher incomes. Some members put more weight on this possible mitigating effect than others.

61. BTL activity could also be a significant potential amplifier of housing and credit cycles: any increase in BTL lending in an upswing could add further pressure to house prices, which could prompt owner-occupiers to take on even larger loans, thereby increasing overall risks to financial stability. As an investment asset on which landlords seek not only rental return but also capital gains, the demand for BTL would be likely to be cyclical. Optimistic BTL investors could bolster prices by investing in an upswing, while pessimistic investors who do not already own property could not express a negative view, biasing the market towards over-optimistic expectations. Ahead of the last crisis, there had been evidence of an optimism bias in BTL lending in the United States and United Kingdom.

62. Looking at the current size of the market, the Committee noted that the BTL sector had undergone a rapid expansion since its inception in the mid-1990s. In 2014 Q2, BTL lending had accounted for 12% of the total mortgage flow, having risen from 4% in the early 2000s. Because mortgages were predominantly interest-only and did not amortise, they were likely to account for a higher share of lenders' stock of mortgage lending than the flow data might suggest. Some members noted that, given the significantly different risk characteristics, they were not concerned

about direct financial stability risks from the BTL market - though, as noted in June, the Committee would remain vigilant to developments in the market, in particular if activity was displaced from the owner-occupied market to the BTL market following the FPC's June recommendation.

63. In summary, the Committee agreed that being able to apply a consistent approach to owner-occupied and BTL mortgage lending would be important for macroprudential purposes, given the effects that BTL activity could have on the dynamics of the housing and wider mortgage market, even if it may not be appropriate for other financial or consumer regulation.

64. With this in mind, the Committee therefore agreed the following recommendation.

Recommendation

The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to:

a. Loan-to-Value Ratios;

b. Debt-to-Income Ratios, including Interest Coverage Ratios in respect of buy-to-let lending.

65. If granted, these instruments would sit alongside the FPC's power of Direction on SCRs and its responsibility for setting the CCB rate, and complement the FPC's existing powers of Recommendation. The FPC judged that, taken together, these instruments were necessary, and should be sufficient, to tackle risks to financial stability that could emerge from the housing market in the future, rather than indicating likely FPC policy decisions in the short term.

66. The Committee also identified a range of other tools that might prove useful in tackling risks from the housing market. These included instruments used in some other countries, such as limits on the proportion of lending undertaken at long mortgage tenors, and constraints on the proportion of lending undertaken at particular debt-servicing ratios (DSRs) - the share of income required to meet monthly debt payments.

67. The Committee agreed that DSR and DTI ratios provided similar indicators of potential income stretch and so a power of Direction over DTI ratios should be sufficient to capture these risks. Furthermore, the FPC's existing ability, supported by the FCA's rules, to recommend the

interest rate stress that lenders should apply when assessing affordability provided an additional way in which the Committee could lean against overextension of debt. The Committee noted that an increase in the proportion of mortgages at longer term might in principle pose risks to financial stability, if it implied that household mortgage debt burdens were increasing, and that this risk should be monitored. But there was not strong evidence that mortgage tenor had played the same role over the cycle as other underwriting standards and so it was less likely that the FPC would need to take regular action to tackle such risks. As such the existing powers of Recommendation to the PRA and FCA were likely to be sufficient.

68. The Committee agreed to publish a separate Statement to set out its rationale and supporting material for this recommendation, given the responsibility that came with additional powers and because the Parliamentary timetable that the Chancellor had set did not allow time for the FPC to undertake its own consultation on these tools in addition to the consultation that HM Treasury would need to undertake. In addition, the Committee intended to issue a draft Policy Statement, including the indicators that it would monitor regularly, to inform the Parliamentary debate.

Help to Buy (HTB)

69. The Committee discussed and concluded its first annual assessment of the impact on financial stability of the Help to Buy: Mortgage Guarantee Scheme, as requested by the Chancellor, including whether the parameters of the scheme - the house price cap for eligibility in the scheme and the fee charged to lenders - remained appropriate. The Committee considered this subject in the context of its continuing assessment of the risks to financial stability arising from the housing market, and its responsibility to identify, monitor and take action to remove or reduce risks that affect the stability of the UK financial system as a whole.

70. The Committee noted that the scheme had facilitated a return of lenders to the high (above 90%) LTV market, with many, though not all, major lenders participating in HTB. That said, volumes of lending remained small relative to experience before the financial crisis, and interest rates on high LTV loans remained relatively elevated, with the spread between low and high LTV lending having narrowed only marginally since the introduction of the scheme. Broad estimates suggested that the compensation for credit risk in these spreads appeared sufficient for banks to protect themselves against the losses they might suffer in a severe housing market downturn, though there were of course substantial uncertainties around such judgments.

71. The latest data gave no evidence of looser underwriting standards within the scheme than on wider lending. HTB loans did not seem to have driven an increase in average mortgage tenors for the high LTV market since the launch of the scheme. And while the median LTI ratio for the high LTV market had been rising in recent quarters, it had not exceeded the pre-crisis peak, and indeed it had fallen slightly in Q2. This contrasted with the lower LTV market, where the median LTI had surpassed the previous series high and had continued to increase in Q2. Going forward, the risk of lenders extending loans under the scheme that stretched borrowers' affordability was curtailed both because HTB loans are covered by the Mortgage Market Review and the decision by the Chancellor to cap loans in the scheme at 4.5 times income. This would reduce the direct threat to lender resilience from loans that were particularly risky by virtue of their being both high LTV and high LTI.

72. The Committee concluded that it did not see a case for recommending that the Chancellor change the fee or the house price cap on financial stability grounds at this point. In forming this assessment, the Committee was notified by Charles Roxburgh that HM Treasury had decided to set the fees for the scheme the same for 2015, with prices set on an actuarially fair basis and according to State Aid rules. The Committee noted that it would continue to monitor the impact of the scheme as part of its regular assessment of risks to financial stability and that it could make recommendations on it at any time.

Domestic Systemically Important Banks (D-SIBs)

73. The Committee received an update on HMT's plans to legislate for higher capital requirements to be applicable to ring-fenced banks and large building societies - a key part of the Government's banking structural reform proposals. The Committee noted the plans and their link to the emerging regulatory framework to address risks from D-SIBs in the United Kingdom, as part of EU legislation in CRD IV for implementation of Basel Committee principles on D-SIBs. The FPC agreed that it would assess the UK's D-SIBs framework in 2015, taking into consideration relevant EU legislation and domestic and international developments, for example on resolution, as part of its work on its medium-term priorities on ending too big to fail and establishing the medium-term capital framework for banks.

Existing recommendations

74. The Committee reviewed the progress made on implementing its existing recommendations since its previous review.

75. Disclosure (13/Q2/3 and 13/Q2/4): The Committee received a report from PRA staff on progress on two recommendations on disclosure that it had made in June 2013.

a. *The PRA should continue to work with the banking industry to ensure greater consistency and comparability of the Pillar 3 disclosures of the major UK banks and building societies, including reconciliation of accounting and regulatory measures of capital.*

b. *The PRA should ensure that all major UK banks and building societies comply fully with the October 2012 recommendations of the Enhanced Disclosure Task Force (EDTF) upon publication of their 2013 annual reports.*

76. With regard to the first of these recommendations, the PRA had engaged with the UK banking industry (via the British Bankers' Association) to find ways to improve the usefulness of firms' Pillar 3 disclosures. Improvements had been aligned with, and subsequently incorporated into, firms' implementation of EDTF recommendations for 2013 (see below). All major UK banks and building societies had provided a reconciliation of accounting and regulatory measures of capital in their 2012 reports, and had enhanced those disclosures in their 2013 reports.

Therefore the FPC judged this recommendation to be implemented. It noted that international work was continuing on this issue under the auspices of the Basel Committee's revised Pillar 3 review. The Committee agreed to look again at Pillar 3 disclosures following the completion of this review and to consider then whether to take further action in this area.

77. The major UK banks and building societies had complied with the EDTF recommendations in their 2013 annual reports, with a few exceptions including around asset encumbrance, changes in risk-weighted assets and counterparty credit risk. **Given the overall high level of compliance, and plans to improve disclosure further, the FPC judged that this recommendation had been implemented.**

78. Mortgage affordability test (14/Q2/1): *When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).*

79. **The FPC judged that this recommendation was implemented**, by virtue of an existing FCA rule (MCOB 11.6.18(2)), which had been created in response to a previous FPC

recommendation (13/Q4/1). The Committee agreed that the 3 percentage point stress remained appropriate at present, and it intended to keep this under review at future meetings. The FCA noted it would continue to monitor that mortgage lenders were having regard to the recommendation when carrying out the interest rate stress test.

80. Loan to income limit (14/Q2/2): *The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable.*

81. At the time of the FPC's meeting, the PRA Board was due to finalise the rule that would put into force the FPC's recommendation on a limit on LTI ratios in mortgage lending.² The FCA was implementing the measure for affected FCA-regulated firms via general guidance. Subject to the rules and guidance coming into force as expected, **the FPC judged that this recommendation was implemented**. The Committee would continue to consider whether the LTI limit remained appropriate.

82. Other existing recommendations: the Committee noted that action was under way on its other existing recommendations (which are summarised in the annex). It planned to review progress on its recommendation on cyber security in Q4.

Deferred publication text

83. In June 2013, the FPC had been concerned by the risks to financial stability associated with Libor or other interest-rate benchmark quotes becoming unavailable. In addition, the Committee had felt that this was an area where there had been limited progress internationally, and that market participants and the authorities needed to be ready to respond if rates became unavailable, rather than waiting until any dislocations emerged. In that context, the Committee had made the following private recommendation (13/Q2/7(P)) to the Bank and FCA: *Working with other authorities and bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became*

²The PRA Board subsequently confirmed this rule. See: <http://www.bankofengland.co.uk/pr/Documents/publications/ps/2014/ps914.pdf>

unavailable. They should report to FPC by September 2013 on any perceived gaps in these contingency plans and potential solutions.

84. At the time of making this recommendation, the Committee had decided that publication of the recommendation was against the public interest, because there was a risk it could precipitate the problem that the recommendation was seeking to avoid. The Committee had therefore decided not to publish the recommendation as permitted under Section 9U(8)(b) of the Bank of England Act 1998.

85. **In September 2013, the FPC had closed this recommendation**, as work on interest rate benchmark contingency planning was taking place under the auspices of the Financial Stability Board's (FSB) Financial Benchmarks Contingency Working Group. However, the recommendation had been kept private as the FSB had not disclosed the existence of this group and the group had not yet finalised its report.

86. On 22 July 2014, the FSB published its report on *Reforming Major Interest Rate Benchmarks*,³ which included details on contingency planning. Given that the FSB's recommendations on this issue were now in the public domain, **the FPC judged that publication of its recommendation was no longer against the public interest**. It therefore agreed to publish this recommendation, along with nine paragraphs of associated text that had been deferred from four FPC Records. The full text that had been deferred from previous Records would be published at the same time as the Record of this meeting and is included in an Annex of this Record.

87. **The FPC also agreed to publish a short section of text concerning risks around the Scottish referendum that had been deferred from its June 2014 Record.**

Leverage ratio

88. The FPC's consultation on the Leverage Review had closed on 12 September. A total of 26 responses had been received. The Committee noted that a common theme in the feedback was around the need for guidance over how the proposed framework would be calibrated. In the light of that feedback and to support HM Treasury in its consultation on, and impact assessment of, the Committee's proposals, the Committee decided to bring forward its view on the appropriate

³ http://www.financialstabilityboard.org/publications/r_140722.htm

calibration of the leverage ratio framework. It would hold an additional meeting on this topic on 15 October. Its view would be recorded in its final proposals for the leverage ratio framework, which would be published at the end of October.

The following members of the Committee were present at the meeting:

Mark Carney, Governor

Jon Cunliffe, Deputy Governor responsible for financial stability

Andrew Bailey, Deputy Governor responsible for prudential regulation

Ben Broadbent, Deputy Governor responsible for monetary policy

Martin Wheatley, Chief Executive of the Financial Conduct Authority

Clara Furse

Donald Kohn

Richard Sharp

Martin Taylor

Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Nemat Shafik, Deputy Governor responsible for markets and banking, also attended the meeting.

ANNEX 1: EXTANT FPC RECOMMENDATIONS

Identifier ⁽¹⁾	Recommendation
13/Q1/6	Looking to 2014 and beyond, the Bank and PRA should develop proposals for regular stress testing of the UK banking system. The purpose of those tests would be to assess the system's capital adequacy. The framework should be able to accommodate any judgements by the Committee on emerging threats to financial stability.
13/Q2/6	HM Treasury, working with the relevant government agencies, the PRA, the Bank's financial market infrastructure supervisors and the FCA should work with the core UK financial system and its infrastructure to put in place a programme of work to improve and test resilience to cyber attack.
14/Q3/1	<p>The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to:</p> <ul style="list-style-type: none"> <li data-bbox="523 981 858 1014">a. Loan-to-Value Ratios; <li data-bbox="523 1066 1366 1155">b. Debt-to-Income Ratios, including Interest Coverage Ratios in respect of buy-to-let lending.

⁽¹⁾ Each recommendation is listed with an identifier to allow ongoing tracking of progress. For example, '13/Q1/6' refers to the sixth recommendation made at the 2013 Q1 meeting.

ANNEX 2: DEFERRED PUBLICATION TEXT

Under section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of its Records if it decides that publication at that point would be against the public interest. At its meeting in September, the FPC decided to publish text that had previously been deferred, in relation to: a) interest rate benchmark contingency planning; b) the Scottish referendum. This text is reproduced below and the Records from which publication was deferred have been updated on the Bank's website.

a) Interest rate benchmark contingency planning (see paragraphs 83-86 in this Record)

Date of Record	Text
Jun-2013	<p data-bbox="354 902 571 936">Rec. 13/Q2/7(P)</p> <p data-bbox="354 987 1406 1167"><i>Working with other authorities and bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. They should report to FPC by September 2013 on any perceived gaps in these contingency plans and potential solutions.</i></p> <p data-bbox="354 1196 1453 1554">The Committee agreed that it was important to promote development of contingency plans that would be credible in the event that Libor or other interest-rate benchmark quotes became unavailable. Whether such plans would be needed, and the degree of their effectiveness, was uncertain. On the one hand, some interest-rate benchmark quotes had been withdrawn recently with little impact. And so far, UK banks had remained on Libor panels. On the other hand, the disruption to financial stability could be large in the event that Libor became unavailable, given both the scale of contracts in which Libor was still used as a reference rate and the lack of clarity on the legal position of contracts should Libor or other benchmarks become unavailable.</p> <p data-bbox="354 1585 1422 1877">In addition, the Committee felt that this was the area where there had been limited progress internationally, and that market participants and the authorities needed to be ready to respond if rates became unavailable, rather than waiting until any dislocations emerged. The Committee judged that developing contingency plans would also support medium-term work to develop alternative credible benchmark indices under the auspices of the Financial Stability Board. That work could usefully involve understanding how market participants chose the relevant benchmark rate in their contracts, particularly for derivatives contracts.</p> <p data-bbox="354 1908 1453 2087">Recommendation: Working with other authorities and bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. They should report to FPC by September 2013 on any perceived gaps in these contingency plans and potential solutions.</p>

	<p>The Committee on balance decided not to publish this recommendation, as permitted by Section 9U(8)(b) of the Act. It felt that publication of the recommendation at this stage was against the public interest, because there was a risk of precipitating the problem that the recommendation was seeking to avoid. It was not possible to agree now the date at which the recommendation would be published. But the Committee would keep it under review and reflect initially in September when the Bank and FCA reported back on progress in implementing the recommendation, including, importantly, on any perceived gaps in contingency plans.</p> <p><i>Annex: Working with other authorities and bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. They should report to FPC by September 2013 on any perceived gaps in these contingency plans and potential solutions.</i></p>
Sep-2013	<p>The Committee reviewed progress on its June 2013 recommendation [13/Q2/7(P)] that, working with other authorities and bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. It noted that, since the Committee had last met, a process had been established under the auspices of the international Financial Stability Board (FSB) to ensure the consistency of reviews of existing interest rate benchmarks, to examine the feasibility and viability of adopting additional reference rates and potential transition issues, and to undertake any other tasks requested by the FSB to support the strengthening of interest rate benchmarks. The work was being led by Martin Wheatley in his capacity as Chief Executive of the FCA and Jeremy Stein of the Board of Governors of the Federal Reserve, and drew together senior representatives of central banks, regulators and market participants. On balance, the Committee agreed that, given the international nature of the challenge, this was the right process for taking forward the Committee's concerns, and therefore agreed to close its own recommendation. It was noted, however, that this should not be taken to imply confidence that contingency planning was yet sufficiently well advanced. In the view of some members, that remained a pressing need. The Committee agreed that publication of the original recommendation and subsequent discussion remained against the public interest, given the risk that publication could precipitate the problem that the recommendation was trying to avoid. The Committee would review the state of contingency planning at its next meeting.</p>
Nov-2013	<p>The Committee reviewed the text that had been redacted from its June 2013 Record relating to its private recommendation [13/Q2/7(P)] that, working with other bodies, the Bank and FCA should together promote the development of credible contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. This recommendation had subsequently been closed by the Committee at its September meeting. While it was recognised that potential financial market risks relating to the existence of contingency planning work in this area had diminished, the FSB had not disclosed the existence of its Financial Benchmarks Contingency Working Group and this group had not yet finalised its report. Reflecting these considerations, it was agreed that publication of the Committee's recommendation in this area remained contrary to the public interest; this decision would be revisited once the FSB's contingency planning report had</p>

	been finalised.
Mar-2014	The Committee reviewed the text that had been redacted from its previous Records relating to a private recommendation on the development of contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable. It agreed that publication of the Committee's recommendation and associated text remained contrary to the public interest; this decision would be reviewed once the FSB's contingency planning report had been published.

b) Scottish referendum (see paragraph 87 in this Record)

Date of Record	Text - note that only the text in bold had its publication deferred.
Jun-2014	But the Committee judged that financial stability risks remained, including from market participants potentially underestimating risks that could arise either as monetary policy in advanced economies returned to more normal settings or from the materialisation of tail-risk events, to which financial markets were now attaching an unusually low probability. The latter would likely result in more pronounced adjustments in asset prices and volatility than the former. Members discussed a range of event risks, including the forthcoming Scottish referendum , and geopolitical risks. Conditions in the UK housing market were also a concern, as outlined below.