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RECORD OF THE FINANCIAL POLICY COMMITTEE MEETINGS

28 JUNE AND 1 JULY 2016

This is the record of the Financial Policy Committee meetings held on 28 June and 1 July 2016.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1607.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. At the date of its meetings, the FPC was established as a sub-committee of the Bank of England's Court of Directors.

The FPC's next policy meeting will be on 20 September 2016 and the record of that meeting will be published on 3 October.

RECORD OF FINANCIAL POLICY COMMITTEE MEETINGS HELD ON 28 JUNE AND 1 JULY 2016

At its meeting on 1 July, following its discussion on 28 June, the Financial Policy Committee:

- Reduced the UK countercyclical capital buffer rate from 0.5% to 0% of banks' UK exposures with immediate effect.

- Recommended to the Prudential Regulation Authority (PRA) that, where existing PRA supervisory buffers of PRA-regulated firms reflect risks that would be captured by a UK countercyclical capital buffer rate, it reduce those buffers, as far as possible and as soon as practicable, by an amount of capital which is equivalent to the effect of a UK countercyclical capital buffer rate of 0.5%.

- Agreed in principle that central bank reserves should be excluded from the measure of exposures used to calculate banks' leverage ratios. It agreed to schedule an additional meeting in the summer in order to take the necessary action to implement this change in practice and announce it alongside the publication of the Monetary Policy Committee's August *Inflation Report*, in order to avoid giving an unintended signal about the future path of monetary policy.[1]

- Welcomed the Bank of England's announcement that it will continue to offer indexed long-term repo operations on a weekly basis until end-September 2016. This is a precautionary step to provide additional flexibility in the Bank's provision of liquidity insurance, further reinforcing the ability of firms to draw on their own liquidity buffers.

- Supported the position of the PRA to allow insurance companies to use flexibility in Solvency II regulations to recalculate transitional measures. These measures smooth the impact of those new regulations.

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[1] Publication of the text in this paragraph and in paragraphs 70 to 73 was deferred from the version of the Record that was initially published on 12 July 2016. The Committee agreed following its 25 July 2016 meeting to release this text, for the reasons set out in the Record of that meeting.

1. The Committee met on 28 June and 1 July to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. The Committee's meetings took place shortly after the 23 June referendum on the United Kingdom's membership of the European Union.

2. The FPC assessed the outlook for financial stability by identifying the risks faced by the financial system and weighing them against the resilience of the system.

Risks to financial stability

3. The Committee reviewed financial system and economic developments since its meeting in March 2016, as set out in detail in the July 2016 *Financial Stability Report*. Immediate developments were dominated by the referendum.

4. In the days following the referendum, financial market prices had moved sharply. Between 23 June and 1 July, the sterling exchange rate index had fallen by 9% and short-term volatility of sterling against the dollar had risen to its highest level in the post-Bretton Woods era. Equity prices of UK banks had fallen on average by 20%, with UK-focused banks experiencing the largest falls. Equity prices of domestically focused companies had fallen by 10%. The ten-year UK government bond yield had fallen by 52 basis points. In the view of the FPC, these moves reflected an increase in risk premia on UK assets, a perceived weaker growth outlook, and anticipation of some future deterioration in the United Kingdom's terms of trade and supply capacity.

5. However, rises in funding spreads for investment-grade borrowers and banks had been more than offset by falls in risk-free interest rates. Between 23 June and 1 July, investment-grade corporate bond yields had fallen by around 25 basis points. Wholesale debt funding costs for the major UK banks had fallen by a similar amount. Overall bank funding costs – taking into account any increase in the cost of equity and the change in wholesale debt funding costs – were broadly unchanged since the referendum.

6. The FPC reviewed these market moves, recent other economic data, and market and supervisory intelligence, to consider whether risks that it had identified prior to the referendum were beginning to crystallise. Consistent with its remit, the FPC had identified in March the risks

around the referendum as the most significant near-term domestic risks to financial stability. It had set out its assessment of those risks in the Statement following, and the Record of, its March meeting.

7. Since then the FPC had been monitoring these channels of risk closely. At its meetings, it reviewed each in turn.

Current account deficit

8. For some time the FPC had identified the financing of the United Kingdom's large current account deficit as a potential risk to financial stability. It was high by historical and international standards – at 6.9% of GDP in 2016 Q1. The financing of the deficit was reliant on continuing material inflows of portfolio and foreign direct investment, which had been used to finance the public sector deficit and corporate investment, including in commercial real estate. The Committee had noted previously that the ease of financing the current account deficit rested on the credibility of the United Kingdom's macroeconomic policy framework and its continued openness to trade and investment. A sudden shift in the supply of foreign capital and in the current account deficit would be associated with a sharp increase in risk premia and adjustment in sterling.

9. In the run-up to the referendum, there had been signs that foreign portfolio inflows into UK equities had slowed. Following the referendum, sterling had experienced its largest two-day fall against the dollar in the post-Bretton Woods era. Risk premia on UK assets had increased. This would be consistent with a reduction in the willingness of foreign investors to hold sterling assets.

Commercial real estate

10. The FPC had identified in March that risks relating to the UK commercial real estate (CRE) market could be exacerbated by uncertainty around the referendum. This market had experienced particularly strong inflows of capital from overseas over recent years. Foreign investors accounted for around 45% of the value of total transactions since 2009. Valuations in some segments of the market, notably the prime London market, had become stretched.

11. Overall there had been a sharp slowdown in activity in the UK CRE market in the first half of 2016. In 2016 Q1, transactions had fallen by £6 billion, or 34%, relative to the previous

quarter. This had been largely driven by a fall in activity in London, where transactions were down by 53%. Monthly data had suggested continued falls in UK CRE transactions in April and May. CRE prices were broadly flat in 2016 Q1; rental yields had continued to fall. Valuations were vulnerable to higher risk premia and lower expectations of future rental growth.

12. Foreign inflows of capital to the UK CRE market had fallen by almost 50% in the first quarter of 2016. More recently, share prices of real estate investment trusts had fallen sharply, reflecting the risk of future marked adjustments in CRE prices. The Committee had previously highlighted the risks around open-ended property funds. Since the referendum, these had seen increased redemption pressures. The FPC was briefed by the FCA on the extent of outflows from these funds and on the possibility that funds could suspend redemptions in the near term.

UK household indebtedness

13. The FPC had identified in March that uncertainty around the referendum had the potential to reinforce existing vulnerabilities for financial stability. Such vulnerabilities included the high level of UK household indebtedness, the vulnerability to higher unemployment and borrowing costs of the capacity of some households to service debts, and the potential for buy-to-let investors to behave procyclically, amplifying movements in the housing market.

14. Given that the outlook for economic activity and employment had deteriorated, credit conditions might tighten. At its June meeting, the Monetary Policy Committee had reported growing evidence that uncertainty about the referendum had led to delays to major economic decisions, which past evidence suggested could increase unemployment. There were early signs that these effects had continued since the referendum.

15. Survey evidence on the housing market had been difficult to interpret in recent months because of the impact of the pre-announced increase in stamp duty on additional properties, which had taken effect in April. Nevertheless, the Royal Institution of Chartered Surveyors (RICS) survey had showed that expectations of housing market activity and price growth had slowed sharply in May. New buyer enquiries in May were at the lowest level since 2008.

16. The proportion of households with high mortgage loan to income (LTI) and total debt to income ratios had declined in the four years to 2015. Growth in high LTI mortgage lending

appeared to have been restrained by the LTI flow limit that the FPC had put in place in June 2014. At around 9% in 2016 Q1, the aggregate share of new mortgage lending above the FPC's 4.5 threshold remained well below the 15% limit set by the FPC. But, declines in the proportion of highly indebted households had not continued in the first half of 2016. And there had been an increase in the proportion of new mortgages extended at LTI ratios just below 4.5. Notwithstanding the difficulty in interpreting recent data, growth in buy to let lending, and in consumer credit, had been strong over the past two years.

Subdued growth in the global economy

17. The FPC had previously identified that subdued growth in the global economy, including the euro area, could be exacerbated by a prolonged period of heightened uncertainty. This came at a time when banks in some vulnerable euro-area countries were still working through legacy issues from the financial crisis and were facing challenges from operating in a low nominal interest rate environment.

18. Since the referendum, long-term interest rates in the euro area had fallen further. Between 23 June and 1 July, the equity prices of banks in Italy and Spain had fallen by 27% and 15% respectively. And the cost of default protection on banks associated with some vulnerable euro-area economies had risen. Some periphery euro-area banks both had elevated levels of non-performing loans (NPLs) and a reliance on deferred tax assets (DTAs) to meet capital requirements.

19. Elevated and growing debt levels had left some emerging market economies (EMEs) vulnerable to a tightening in financial conditions. Across EMEs, exchange rate depreciations had been largely confined to emerging Europe, reflecting their close trade links with the European Union and the prospect of reduced euro-area demand. Though spillovers to other EMEs were more muted, a number remained vulnerable. Policy measures taken by the Chinese authorities had supported growth in the near term and helped to stabilise capital flows, but had been accompanied by an increase in credit growth.

Fragilities in financial market functioning

20. In March, the FPC had judged that the risks from existing fragilities in financial market functioning could be increased by uncertainty around the referendum – including reductions in the

provision of market liquidity services in a number of core financial markets such as government and corporate bond markets. These fragilities could be tested during a period of elevated market activity and volatility.

21. Following the referendum, the foreign exchange market had experienced particularly high volumes of transactions relative to normal levels with no apparent impairment of price discovery. Electronically traded markets had proved resilient to volumes of transactions much higher than normal levels. Activity in some fixed income markets had been subdued but largely orderly. The volume of transactions in short-term gilt repo markets had been below, but close to, its average daily level since 2016. This meant that the capacity of these markets had not to date been tested materially by market adjustments.

Overall assessment of financial stability risks and further challenges

22. The FPC concluded that some of the risks to financial stability from the referendum had begun to crystallise.

23. The FPC recognised that there would be a period of uncertainty and adjustment following the result of the referendum. It would take time for the United Kingdom to establish new relationships with the European Union and the rest of the world. Some market and economic volatility was to be expected as this process unfolded. The degree of uncertainty and nature of adjustment had been evident in financial market prices, which have moved sharply following the referendum. The extent of any future moves would probably depend on the evolution of market participants' expectations of the future relationship of the United Kingdom with the European Union.

24. The Committee would continue to monitor risks closely. In particular, given the channels it had identified so far, it would monitor the risks of:

- *Further deterioration in investor appetite for UK assets*. During a prolonged period of heightened uncertainty, the risk premium on UK assets could rise further and overseas investors could continue to be deterred from investing in the United Kingdom. Persistent falls in capital inflows would be associated with further downward pressure on the exchange rate and tighter funding conditions for UK borrowers.

- *Adjustments in commercial real estate markets tightening credit conditions*. Any adjustment in CRE markets could potentially be amplified by the behaviour of leveraged investors and investors in open-ended commercial property funds. Although they had a range of measures to manage stressed levels of redemptions, these open-ended funds could be forced to sell illiquid assets to meet redemptions if conditions persisted beyond funds' notice periods. Any such amplification of market adjustments could affect economic activity by reducing the ability of companies that use commercial real estate as collateral to access finance.

- *Increasing numbers of vulnerable households and pro-cyclical behaviour of buy-to-let investors*. Since their implementation in 2014, the FPC's recommendations on owner-occupier mortgage underwriting standards had guarded against a sharp increase in the proportion of households that were very highly indebted. However, the ability of some households to service their debts would be challenged by a period of weaker employment and income growth. These vulnerable households could affect broader economic activity by cutting back sharply on expenditure in order to continue to service debts. In March, the FPC welcomed the PRA's Supervisory Statement on underwriting standards in the buy-to-let market. The FPC would monitor the behaviour of buy-to-let investors, which had the potential to amplify movements in the housing market.

- *The outlook for the global economy.* The FPC had previously highlighted the risks from rapid credit growth in China. Though policy stimulus measures looked to have stabilised the economy in the near term, that had been associated with even more rapid growth of credit, increasing financial fragility over the medium term. This could have potentially significant spillovers to EMEs and the global economy more broadly. Diminished global risk appetite and a further appreciation of the US dollar could also bring vulnerabilities associated with high, and growing, levels of debt in a number of EMEs into sharper relief. Although spillovers to date had not been widespread, a prolonged period of uncertainty associated with the referendum could affect the global economy, particularly the euro area. The euro area accounted for around two-fifths of the United Kingdom's trade and around one-third of UK foreign direct investment. Major UK banks' exposure to the euro area amounted to around 200% of their core equity capital.

- *Reduced and fragile liquidity in core financial markets.* Further adjustment of market prices was possible, with the potential for a material rebalancing of investor portfolios. This could test the liquidity of core financial markets. In such an environment, prices could tend to move discontinuously and overshoot in response to shocks. An abrupt rise in liquidity premia would amplify adjustments in market prices and tighten credit conditions for UK corporate borrowers.

Resilience of the UK financial system

25. The Committee assessed the level of risks against the resilience of the UK financial system. The resilience of the financial system, upon which financial stability depends, is its ability to withstand economic and financial shocks without amplifying their effect on the real economy by restricting the provision of financial services, including the supply of credit and support for market functioning.

26. In the Committee's view, the resilience of the UK financial system, given the risks it was facing, was grounded on:

- *Substantial capital and liquidity buffers of the UK banking system* – which had been shown in repeated stress tests to enable banks to absorb extremely severe economic and market shocks without amplifying those shocks. They gave UK banks the flexibility they needed to continue to lend to UK households and businesses, even during challenging times.

- *The United Kingdom's regulatory framework for financial services* – which allows the system to draw upon these capital and liquidity buffers, as needed, to allow the system to cushion shocks and maintain the provision of financial services. This means that shocks to the economic and financial environment can be cushioned, rather than amplified, by the system. Nothing in financial regulation had changed as a result of the referendum. It would not change until the process of the United Kingdom's withdrawal from the European Union was complete, and until EU law ceased to have effect in the United Kingdom. The Bank of England was continuing to implement the current regulatory framework until any new arrangements with the European Union took effect. That framework implemented internationally agreed standards.

- *An institutional framework that promotes co-ordinated, evidence-based responses to risks.* In advance of the referendum, the resilience of the UK financial system had been further enhanced by the actions of the Bank of England, alongside other domestic authorities and international authorities, and financial companies themselves, to put extensive contingency plans in place, including through supervision by the PRA. The

FPC had been briefed on, and reviewed, these plans in advance of the referendum. The measures would continue to support institutional resilience and market functioning during the period of heightened uncertainty.

Resilience of the UK banking system

27. Over the past eight years, major UK banks had raised more than £130 billion of capital. The major UK banks' aggregate Tier 1 capital amounted to 13.5% of risk-weighted assets and 4.9% of aggregate exposures.

28. The Bank of England had stress tested banks against extremely severe economic scenarios. In 2014, the scenario used to stress test the major UK banks had included an abrupt slowing in capital flows, a fall in the sterling exchange rate index of 30%, falls in residential and commercial property prices of around 35% and 30% respectively, around a 3.75 percentage point increase in Bank Rate to anchor inflation expectations, a severe recession and around a 4.5 percentage point increase in unemployment. The 2015 stress test scenario was based around a severe downturn in EMEs, Europe and the global economy, and a squeeze on net interest income as Bank Rate was cut to zero. That test led to losses twice as large as those incurred in the global financial crisis. By the end of each test, it had been confirmed that the UK banking system would have the capacity to continue lending to the real economy under such stresses.

29. Major UK banks also held more than £600 billion of high-quality liquid assets, which was around four times the level they held before the financial crisis. These were reflected in the Liquidity Coverage Ratios of banks – a measure of a bank's liquid assets as a proportion of the outflows it might face if funding positions became stressed. UK banks' Liquidity Coverage Ratios were 118% in aggregate, and all were above 100%, in advance of the European timetable that required firms to reach 100% by 2018. Major UK banks had also positioned collateral with the Bank of England that created the capacity to access more than £250 billion of additional funds through the Bank's normal operations and facilities.

30. In addition, as well as meeting normal expectations of sufficient liquidity on an aggregate basis, in the run up to the referendum and given the nature of the risk, the PRA had asked large firms to maintain sufficient liquidity in individual currencies to withstand a sustained and severe 'lock-out' from foreign exchange funding markets. As a precautionary measure, supervisors had also asked large firms to report their liquidity positions to the Bank of England daily rather than weekly.

31. Together, these capital and liquidity buffers gave UK banks the flexibility they needed to continue to lend to UK households and businesses, even during challenging times. The United Kingdom's regulatory framework provides that around half the level of capital that the largest banks are expected to hold in normal conditions should take the form of capital buffers that can absorb shocks in times of stress. The framework also provides for liquidity buffers that must, as with capital buffers, be maintained in normal conditions. These are supplemented by liquidity facilities from the Bank of England and other central banks. For commercial banks, the ability to draw down these buffers, if needed, allows them to continue to lend to UK households and businesses; for firms with investment banking functions, it allows them to continue to provide services that support the liquidity and functioning of core financial markets.

32. In the Committee's view, this resilience of the UK banking system had also been demonstrated by market moves since the referendum. Although bank equity prices had fallen sharply, reflecting new perceptions of the economic outlook and prospects for bank profitability, bank funding costs remained significantly lower than during previous episodes in which bank equity prices had fallen sharply.

33. Prior to the referendum, valuations of major UK banks in many cases had reflected perceptions of weak future returns on equity, which had fallen since the financial crisis and remained subdued. Persistently weak returns posed challenges for the ability of banks to generate capital internally and, at the margin, reduced their resilience to shocks. The failure of returns on assets to recover, even as impairments had fallen and operating costs had been reduced, was explained largely by charges relating to past misconduct and by lower trading income.

34. Since the referendum, equity prices of major UK banks had fallen by 20% on average. Changes were largest for UK-focused banks. Equity prices for other major UK banks had been broadly flat in sterling terms.

35. The Committee reviewed analysis of the macroeconomic outlook being priced in to equities of major UK-focused banks using banks' performance in the 2014 and 2015 stress tests. It considered the fall in equity prices that would, other things equal, be implied by the fall in net interest income in its 2015 stress test scenario coupled with a reduction in all other earnings from its 2014 stress test scenario. The falls in equity prices for major UK-focused banks since the referendum were just over half of those implied by that comparison. This suggested that banks were priced for a macroeconomic outlook materially less severe than that against which their resilience had been tested in 2014 and 2015. As the Committee had discussed, in those tests

major banks had been resilient enough to withstand the stress and continue to supply the credit demanded by the real economy.

36. Despite concerns about profitability and the macroeconomic outlook, which had been adversely affected by the results of the referendum, the spreads on wholesale bank debt relative to risk-free rates had risen only a little. Allowing for the fall in risk-free interest rates, debt funding costs had fallen slightly. This suggested that market participants continued to view the banking sector as fundamentally resilient.

Resilience of insurance companies

37. The FPC was briefed on the PRA's position to allow insurance companies to use the flexibility in Solvency II regulations to recalculate transitional measures. These measures smoothed the impact of those regulations. Without them, the regulations, which had come into force in January, would tighten regulatory constraints on insurance companies following sharp falls in market interest rates. At the margin, the recalculation of transitional measures was likely to reduce immediate pressure on insurance companies to sell corporate securities and other risky assets. The FPC supported the position of the PRA, particularly in the light of sharp market moves since the referendum.

Market functioning and the resilience of market-based finance

38. In March, the Committee had welcomed the Bank of England's announcement that it would provide additional sterling liquidity to banks, building societies and broker dealers around the referendum, through three additional indexed long-term repo operations.

39. As the Committee had discussed earlier, eligible counterparties had positioned collateral with the Bank of England that created the capacity to access more than £250 billion of additional funds through the Bank's normal operations and facilities. On 30 June, the Bank had announced that it would continue to offer indexed long-term repo operations on a weekly basis until end-September 2016. The FPC welcomed this as a precautionary step to provide additional flexibility in the Bank's provision of liquidity insurance, further reinforcing the ability of firms to draw on their own liquidity buffers.

40. The Bank was able to provide substantial liquidity in foreign currency, if required, using existing swap lines in place with the Federal Reserve, the European Central Bank and other central banks.

41. Market functioning was also supported by the operational resilience of central counterparties and their management of financial risks using collateral calls from clearing members. Clearing of trades had not been disrupted and had been resilient to the record volumes of trading seen following the referendum. The ability of banks to meet margin calls through buffers of liquid assets had been assessed.

Outlook for financial stability and FPC actions

42. The FPC judged that the current outlook for UK financial stability was challenging.

43. Having consistently built the resilience that was necessary for the system to face this challenging outlook, the FPC agreed that it should remain focused on promoting a financial system that dampened, rather than amplified, the impact of uncertainty and adjustment on the real economy. This meant reducing any pressure on firms to restrict the provision of financial services, including the supply of credit and support for market functioning.

44. In March, the FPC had begun to supplement regulatory capital buffers with the UK countercyclical capital buffer. This reflected its assessment that the risks the system could face were growing and additional capital was needed that could be released quickly in the event of an adverse shock.

45. At that time, the FPC had judged that risks associated with domestic credit were no longer subdued, as they had been in the period following the financial crisis, and global risks were heightened. The Committee had raised the UK countercyclical capital buffer rate to 0.5% and signalled its expectation that it would increase it further, to 1%, if the risk level remained unchanged.

46. The Committee considered the appropriate setting of the UK countercyclical capital buffer rate, which it was required by statute to set quarterly. In its Policy Statement for applying this tool that it had published in April 2016, the FPC had emphasised its intention to release the buffer in situations where risks materialise, and to act pre-emptively before losses had crystallised in order to reduce banks' perceived need to preserve capital and restrict lending, with consequent negative impacts on the real economy.

47. The crystallisation of risks around the referendum had materially changed the risk outlook. Given that and consistent with its strategy, the Committee considered that there was a strong case

for cutting the buffer rate from 0.5% to 0% with immediate effect. This would reduce regulatory capital buffers by £5.7 billion, raising banks' capacity for lending to UK households and businesses by up to £150 billion. This would reduce pressure on banks to tighten credit conditions. In that environment, the growth rate in credit would depend on demand. This would provide banks with further headroom before mandatory restrictions on their distributions would occur. Reducing the buffer would also help to reinforce the FPC's view that all elements of the substantial capital and liquidity buffers that had been built up by banks were able to be drawn on, as necessary. A review of the Basel 'buffer guide' – a simple metric based on the gap between the ratio of credit to GDP and its long term trend which the FPC was required by legislation to consider when setting the countercyclical capital buffer rate – did not change this view.

48. The Committee discussed the possible drawbacks of reducing the buffer immediately. The most pressing concern was that banks could use the reduction to increase dividend payments or engage in other distributions of capital, rather than to absorb additional losses without constraining the supply of credit. Such an approach would be contrary to the purpose of the countercyclical capital buffer. But the Board of the PRA had indicated that it could set a clear supervisory expectation that firms should not use any reduction in the UK countercyclical capital buffer to increase dividends or other distributions. The FPC strongly expected that banks would continue to support the real economy, by drawing on buffers as necessary. This included the countercyclical capital buffer.

49. The Committee discussed reducing the UK countercyclical capital buffer rate from 0.5% to 0% of banks' UK exposures with immediate effect. There was consensus on this course of action. Absent any material change in the outlook, and given the need to give banks the clarity necessary to facilitate their capital planning, the FPC agreed that it expected to maintain a 0% UK countercyclical capital buffer rate until at least June 2017. Consistent with the FPC's leverage ratio framework, the countercyclical leverage ratio buffer rate would also fall.

50. The Committee reviewed how the decision should be implemented. The Committee's decision in March to raise the UK countercyclical capital buffer rate to 0.5% had been due to take effect formally from 29 March 2017. However, as the Committee had explained in March, there was an overlap between the risks captured by existing PRA supervisory capital buffers and a positive UK countercyclical capital buffer rate of 0.5%.

51. The PRA Board had concluded in March 2016 that, to ensure there was no duplication in capital required to cover the same risks, existing PRA supervisory buffers of PRA-regulated firms

should be reduced, as far as possible, to reflect a UK countercyclical capital buffer rate of 0.5%, when such a rate came into effect. This would be a one-off adjustment.

52. The FPC therefore accompanied its decision to reduce the UK countercyclical capital buffer rate with a Recommendation to the PRA that it bring forward this planned reduction in PRA supervisory capital buffers:

- *The FPC recommends to the PRA that, where existing PRA supervisory buffers of PRA-regulated firms reflect risks that would be captured by a UK countercyclical capital buffer rate, it reduce those buffers, as far as possible and as soon as practicable, by an amount of capital which is equivalent to the effect of a UK countercyclical capital buffer rate of 0.5%.*

53. Following the FPC's meeting, the Board of the PRA met to consider this Recommendation. The FPC was subsequently informed that the PRA Board had agreed to implement this recommendation. That meant that three quarters of banks, accounting for 90% of the stock of UK economy lending, would, with immediate effect, have greater flexibility to maintain their supply of credit to the real economy. Other banks would no longer see their regulatory capital buffers increase over the next nine months, increasing their capacity to lend to UK households and businesses too. The FPC supported the expectation of the PRA Board that firms would not increase dividends and other distributions as a result of this action.

54. The FPC considered whether to take any policy action on bank liquidity buffers. It noted that banks' extensive liquid asset buffers were there explicitly to be drawn upon where needed. And, as discussed earlier, the Bank of England was providing precautionary additional flexibility in its provision of liquidity insurance by continuing to offer indexed long-term repo operations on a weekly basis until end-September 2016. Against that background, the Committee agreed that no action was appropriate.

55. As the outlook evolved, the FPC stood ready to take any further actions deemed appropriate to support financial stability.

Regular reviews, including of existing Directions and Recommendations

56. The Committee reviewed the progress made on implementing its existing Recommendations and Directions since its previous policy meeting. It reviewed text previously deferred from publication. It also considered a request for reciprocation of a macroprudential

measure from the National Bank of Belgium. The full text of the outstanding Recommendations and Direction is the Annex of this Record (identifiers in brackets below refer to that Annex).

Developments in market liquidity and annual review of the leverage direction

57. In advance of the referendum, the FPC had reviewed developments in market liquidity. Over the past year, government and corporate bond markets, including in the United Kingdom, had shown signs of reduced liquidity, and activity in repo markets had fallen materially. Some measures of the compensation investors required for liquidity risk had picked up. These reductions in market liquidity probably, in part, reflected post-crisis regulations as firms adjusted their risk management and business models. The FPC had judged that these regulations remained materially beneficial because of their contribution to the resilience of these markets and to financial stability more broadly.

58. However, the FPC had judged that some market developments motivated careful review and consideration of whether there were possible refinements that would promote market effectiveness without compromising the resilience of the core system.

59. In that context, the FPC considered its first statutory annual review of its Direction to the PRA on the leverage ratio framework for major UK banks and building societies. The Direction was for the PRA to require each major UK bank and building society, on a consolidated basis, to satisfy a 3% minimum Tier 1 leverage ratio. It had also directed the PRA to secure that firms ordinarily satisfy leverage ratio buffers reflecting their countercyclical capital buffer rate and, for global systemically important institutions (G-SIIs), their G-SII buffer rate.

60. In response to the FPC's Direction, the PRA had in December 2015 published a policy statement, along with finalised rules and supervisory statements, to implement the UK leverage ratio framework. These rules were now in force. The PRA had also secured that UK G-SIIs satisfy an additional leverage ratio buffer by setting out its requirements of the relevant institutions pursuant to section 55M of the Financial Services and Markets Act (2000) (FSMA). The FPC therefore agreed that all rules and requirements needed to implement the Direction were now in force and it considered the Direction implemented.

61. As part of the review, the FPC considered the impact of the leverage ratio framework on the capital requirements of major UK banks and building societies, the incentives it had created

for banks to undertake different activities, and how the framework might affect bank behaviour in stressed circumstances.

62. On average, major UK banks had an overall leverage requirement (including buffers) of 3.1%; by 2019, a bank subject to a 2.5% systemic importance buffer and a 1% countercyclical capital buffer would be expected to meet a leverage ratio of 4.2%. However, in aggregate, risk-based requirements rather than leverage requirements remained the more proximate constraint on system-wide capital.

63. The FPC considered the impact of its leverage ratio framework on banks' incentives to undertake different intermediation activities. Since the end of 2012, when major UK banks and building societies had first been asked to disclose publicly their leverage ratios, there had been a shift away from some activities typically considered as low risk, such as trading inventory and repo activity, towards other activities that attracted higher risk weightings, such as certain types of mortgage lending. While these patterns had reflected a range of factors, there was some evidence of firms choosing to apply the leverage ratio framework to individual business lines rather than at the consolidated level. The Committee therefore restated its intention for its leverage ratio framework to be applied at the consolidated level.

64. In the process of finalising its international standard, the Basel Committee on Banking Supervision was currently consulting on two aspects of the leverage ratio framework that may have had unintended effects on banks' incentives to undertake certain activities. The FPC agreed that its views on these aspects should be fed into the Basel review.

65. The first issue was the treatment of outright sales and purchases of securities. Under the existing total exposure measure, pending cash receivables could not be offset against cash payables, which may have unnecessarily discouraged market-making activity in core financial markets. In the light of recent developments in market liquidity, the FPC judged that there would be merit in any internationally agreed leverage ratio standard permitting banks to net cash receivables relating to unsettled sales against cash payables relating to unsettled purchases, where trades are settled through a delivery-versus-payment or equivalent settlement system. In the view of the FPC, this change would increase dealers' incentives to make markets while maintaining the resilience of dealers.

66. The second issue was the treatment of client derivatives cleared through central counterparties. Under the existing total exposure measure, banks were not permitted to use the

initial margin posted by clients to reduce their potential future exposure. This could lead to clearing members raising their fees for client clearing of derivatives or even withdrawing from providing client clearing services altogether. For this reason, the FPC judged that there would be merit in any internationally agreed leverage ratio standard allowing initial margin posted by clients to reduce banks' potential exposures to a default of those clients in centrally-cleared derivative transactions, provided appropriate safeguards were in place. In the view of the FPC, this would support the availability and affordability of clearing services to real economy clients and other financial institutions and help them to hedge risks effectively, without compromising the resilience of dealers.

67. As the final part of its review, the Committee considered the impact that the leverage ratio might have in stressed conditions. In the FPC's view, there were two framework design issues that warranted further attention at the international level. The first concerned the importance of having material buffers in the framework that could be used to absorb losses and to support lending to the real economy. The second concerned the treatment of central bank reserves in the total exposures measure used in the framework.

68. Central bank reserves were a unique asset class because they were the ultimate settlement asset. If matched by liabilities in the same currency, they typically did not represent an exposure to risk. The Committee judged there to be no direct benefit, therefore, to funding reserve holdings with capital. There was, however, a potential macroeconomic cost, as the inclusion of reserves could affect the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities, as necessary, to maintain the supply of credit and support for market functioning. In circumstances where central bank balance sheets expanded, regulatory leverage requirements could effectively tighten.

69. The FPC therefore judged that it was appropriate to encourage the Basel Committee to review carefully any possible unintended effects of forthcoming international leverage ratio standards on the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities as necessary.

70. The FPC then discussed whether it would be appropriate to exclude central bank reserves from the exposures measure in the current UK leverage ratio framework. A motivation for this was to ensure that the leverage ratio would not act as a barrier to the effective implementation of any policy measure that may increase central bank reserves. This had become more relevant since the referendum. Central bank reserves could increase as a result of the Bank of England's indexed

long-term repo operations, for example, or if banks chose to use their pre-positioned collateral to take advantage of these additional liquidity facilities. Future decisions by the Monetary Policy Committee could also lead to an increase in reserves. Therefore, in the light of its view that there was no direct resilience benefit to funding reserves with capital, and given these near-term practical considerations, the FPC agreed in principle to exclude central bank reserves from the exposures measure in the current UK leverage ratio framework.

71. However, the FPC was concerned that announcing such a change might be taken as a signal about the future path of monetary policy. This was outside the FPC's remit and the Monetary Policy Committee had not yet met following the referendum. To avoid this, the Committee agreed to schedule an additional meeting ahead of publication of the Monetary Policy Committee's August *Inflation Report*. This would be in order to consider the action necessary to implement this change in practice and announce it alongside the publication of that Report. The next regular joint discussion meeting with the Monetary Policy Committee was due to take place on 6 July. The FPC was briefed that implementing the change might require revoking its current leverage Direction and replacing it with a Recommendation, given that amendments to the Direction were not possible.

72. The Committee noted excluding central bank reserves from the exposures measure would mean, other things equal, that a lower amount of capital would be needed to meet the current minimum 3% leverage ratio requirement. On the one hand, there were arguments for maintaining the existing calibration of the regime. If the existing calibration was appropriate, then amending the definition to exclude central bank reserves in the exposures measure should not affect capital required to fund genuinely risky assets. On the other hand, there was a case for grossing up the calibration in order to maintain the same overall level of capital required and avoid changing the leverage constraint at the aggregate level. The Committee agreed it would consider the implications of excluding central bank reserves for the calibration of the leverage ratio framework at its additional meeting. It would also consider whether to make the changes to the UK framework that it had discussed in the context of development of the international standard – ie on the treatment of outright sales and purchases of securities and the treatment of client derivatives cleared through central counterparties.

73. The Committee judged that it would be contrary to the public interest to publish details of such a decision at this stage because it could give an inadvertent signal on the future path of monetary policy. At this stage the Committee expected to be able to publish the text in August alongside the Monetary Policy Committee's *Inflation Report*.

74. Overall the Committee was clear that the leverage ratio remained an essential part of the framework on bank capital in the United Kingdom. Studies undertaken since the FPC had issued its Direction had supported its calibration and the FPC continued to judge that a leverage ratio framework had material net benefits for financial stability. The full results of the annual review would be published in the July *Financial Stability Report*.

75. In addition to these changes to the leverage ratio, and again in the context of market liquidity, the FPC also saw merit in further work being undertaken domestically and internationally to assess changes in the repo market and their economic consequences.

Existing recommendations

76. *Powers of Direction over housing instruments (14/Q3/1)*: The FPC had been granted powers of Direction over mortgage lending for owner-occupied properties in 2015. The outstanding part of the FPC's Recommendation to HM Treasury related to powers of Direction over buy-to-let mortgage lending. In December 2015, HM Treasury had published a consultation on granting the FPC powers of Direction over buy-to-let lending, along with a draft Statutory Instrument and an impact assessment. The consultation had closed on 11 March. HM Treasury was now in the process of bringing forward a response to the consultation, including final secondary legislation. The FPC would prepare a draft statement of its policy for the use of powers of Direction, to be published ahead of any such powers being approved by Parliament. The FPC agreed to review the Recommendation again in September, following any legislative action.

77. *CBEST vulnerability testing (15/Q2/3)*: Twenty three core firms had now completed CBEST cyber vulnerability tests (up from 20 at the time of the last meeting), with a further eight in the process of testing. Those firms which had completed CBEST tests had implemented individual cyber resilience action plans to address any vulnerabilities identified. Work by the UK authorities (the Bank of England, the FCA and HM Treasury) to develop proposals for embedding CBEST testing into the supervisory toolkit and firms' own regular risk management processes was also underway. Prior to its meeting, the FPC had received a progress update on the authorities' broader work programme designed to enhance financial system resilience; it asked for a further update in 2016 H2.

78. *Distribution of capital to meet 'fair shares' of systemic buffers (16/Q2/1)*: This Recommendation was made at the FPC's May 2016 meeting to agree the final systemic risk buffer

framework. The explanation for the Recommendation was set out in the Record of that meeting. The PRA would consult on its planned approach to implement the Recommendation later in the year. The FPC agreed to review progress after this date.

Deferred publication

79. The Committee agreed that it was no longer against the public interest to publish text from the Record of its March 2016 meeting on the briefing it had received on the Bank's contingency planning in the run up to the referendum. It therefore agreed that it would publish that text alongside the release of its Record of its current meeting on 12 July.

Request for reciprocity

80. Following a request from the National Bank of Belgium, the European Systemic Risk Board (ESRB) had agreed a recommendation dated 24 March 2016 to EU member states to reciprocate a macroprudential measure by the National Bank of Belgium on mortgage loans. The measure was to apply a five percentage point add-on to risk weights on mortgage loans secured on Belgian real estate for those banks using internal ratings-based (IRB) models to calculate capital requirements. The ESRB recommendation asked for member states to reciprocate this measure in the event that the member state had banks using IRB models with material exposures to the Belgian mortgage market.

81. UK banks' exposures to the Belgian mortgage market were very low, both in absolute terms and relative to the size of the mortgage market in Belgium. UK banks on the IRB approach reported retail mortgage exposures of around £13 million. And UK banks' mortgages were less than 0.01% of the Belgian mortgage market.

82. The FPC judged that these exposures were not material and therefore agreed, in line with the ESRB recommendation, it would not at this stage reciprocate the measure. However, it reiterated its previously stated general policy to reciprocate foreign macroprudential capital actions where appropriate, recognising both the likely benefit to UK financial stability and to ensure consistency with its approach to reciprocating foreign countercyclical capital buffer rates.

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

Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Andrew Bailey, Deputy Governor responsible for prudential regulation (28 June), Chief Executive of the Financial Conduct Authority (1 July)
Sam Woods, Deputy Governor responsible for prudential regulation (1 July), and as an observer at the meeting on 28 June
Ben Broadbent, Deputy Governor responsible for monetary policy
Alex Brazier
Clara Furse
Donald Kohn
Richard Sharp
Martin Taylor
Tracey McDermott, Acting Chief Executive of the Financial Conduct Authority (28 June)
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 on 28 June.

Apart from those decisions referred to in paragraphs 76 to 82 of this Record, the FPC formally took its decisions at its meeting on 1 July.

As permitted under the Bank of England Act 1998, Anthony Habgood was also present on 28 June as an observer in his role as member of the Oversight Committee of Court.

ANNEX: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

Identifier(*)	Recommendation/Direction
14/Q3/1	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; and (b) debt-to-income ratios, including interest coverage ratios in respect of buy-to-let lending.
15/Q2/3	The FPC recommends that the Bank, the PRA and the FCA work with firms at the core of the UK financial system to ensure that they complete CBEST tests and adopt individual cyber resilience action plans. The Bank, the PRA and the FCA should also establish arrangements for CBEST tests to become one component of regular cyber resilience assessment within the UK financial system.
16/Q2/1	The FPC recommends to the PRA that it should seek to ensure that, where systemic buffers apply at different levels of consolidation, there is sufficient capital within the consolidated group, and distributed appropriately across it, to address both global systemic risks and domestic systemic risks.
16/Q2/2	The FPC recommends to the PRA that, where existing PRA supervisory buffers of PRA-regulated firms reflect risks that would be captured by a UK countercyclical capital buffer rate, it reduce those buffers, as far as possible and as soon as practicable, by an amount of capital which is equivalent to the effect of a UK countercyclical capital buffer rate of 0.5%.

(*) Each Recommendation and Direction is listed with an identifier to allow tracking of progress. For example, ‘14/Q3/1’ refers to the first Recommendation made at the 2014 Q3 meeting.

Other FPC policy decisions which remain in place

The table below sets out previous FPC decisions, which remain in force, on the setting of its policy tools. The calibration of these tools is kept under review.

Topic	Calibration
Countercyclical capital buffer (CCyB)	In July 2016, the FPC reduced the UK CCyB rate from 0.5% to 0% of banks' UK exposures with immediate effect. Absent any material change in the outlook, and given the need to give banks the clarity necessary to facilitate their capital planning, the FPC expects to maintain a 0% UK CCyB rate until at least June 2017. This rate is reviewed on a quarterly basis. The United Kingdom has also reciprocated a number of foreign CCyB decisions — for more details see the Bank of England website.[2] Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Prevailing FPC Recommendation on mortgage affordability tests	When assessing affordability in respect of a potential borrower, UK mortgage lenders are required to have regard to any prevailing FPC Recommendation on appropriate interest rate stress tests. This requirement is set out in FCA rule MCOB 11.6.18(2).[3] In June 2014, the FPC made the following Recommendation (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).*
Recommendation on loan to income ratios	In June 2014, the FPC made the following Recommendation (14/Q2/2): *The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (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.* The PRA and the FCA have published their respective approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[4] and the FCA has issued general guidance.[5]

[2] http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx
[3] https://www.handbook.fca.org.uk/handbook/MCOB/11/6.html
[4] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[5] http://www.fca.org.uk/news/fg14-08

15/Q2/1(D)	*The FPC directs the PRA to implement in relation to each major UK bank and building society on a consolidated basis measures to:* • *require it to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3%;* • *secure that it ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific countercyclical capital buffer rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points;* • *secure that if it is a global systemically important institution (G-SII) it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate.* *The minimum proportion of common equity Tier 1 that shall be held is:* • *75% in respect of the minimum leverage ratio requirement;* • *100% in respect of the countercyclical leverage ratio buffer; and* • *100% in respect of the G-SII additional leverage ratio buffer.* *Common equity Tier 1 may include such elements that are eligible for grandfathering under Part 10, Title 1, Chapter 2 of Regulation (EU) 575/2013 as the PRA may determine.*