BANK OF ENGLAND

Record of the Financial Policy Committee Meeting on 20 September 2017

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This is the record of the Financial Policy Committee meeting held on 20 September 2017.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2017/record1710.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 a committee of the Bank of England.

The FPC's next policy meeting will be on 22 November 2017 and the record of that meeting will be published on 5 December.

Record of the Financial Policy Committee meeting held on 20 September 2017

At its meeting on 20 September 2017, the Financial Policy Committee (FPC):

- Maintained the UK countercyclical capital buffer (CCyB) rate at 0.5%, and reaffirmed that, absent a material change in the outlook, it expected to increase the rate to 1% at its November meeting, with binding effect a year after that. This was consistent with its judgements on the outlook, its stated policy of moving the CCyB rate gradually and its June 2017 guidance.

- Set out its view on the appropriate loss rate on consumer credit in the Bank's 2017 annual stress test of major UK banks. It judged that, in the first three years of that severe stress test scenario, the UK banking system would, in aggregate, incur UK consumer credit losses of around £30 billion, or 20% of UK consumer credit loans, representing 150 basis points of the aggregate common equity Tier 1 capital ratio of the UK banking system. Regulatory capital buffers for individual firms would be set following the full stress test results so that each bank could absorb its losses on consumer lending, alongside all the other effects of the stress scenario on its balance sheet. The FPC also expected that banks would begin to factor these market-wide levels of stressed losses on consumer credit into their overall lending and capital plans.

- Agreed that it would take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in a de facto increase in capital requirements. It would encourage firms to use any internationally agreed transitional arrangements as they adjust to the new IFRS9 regime, provided the arrangements are broadly similar to those currently being considered.

- Confirmed, following consultation over the summer, the following Recommendation to the Prudential Regulation Authority (PRA):

  The FPC recommends to the PRA that its rules on the leverage ratio:

  - exclude from the calculation of the total exposure measure those assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity; and
  - require a minimum leverage ratio of 3.25%.

1. The Committee met on 20 September 2017 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action.

2. The FPC discussed the risks faced by the UK financial system and the resilience of the system to those risks. Its aim is to ensure the financial system is able to provide essential services to the real economy, even in adverse circumstances.

The macroeconomic and financial environment

3. The Committee reviewed financial system and economic developments since its meeting in June, as summarised below.

Global economic and market risks

4. Global GDP (measured on a PPP-weighted basis) was estimated to have grown by 3.6% year on year in 2017 Q2, up from 3.3% the previous quarter. Within this, annual growth was 2.2% in the United States, 2.3% in the euro area, and 6.9% in China. This was the fastest rate of growth for almost two years in the United States, and for over six years in the euro area. Looking ahead, the MPC's expectation was for global GDP growth to remain strong relative to recent history, supported by a rotation of the composition of growth from consumption to investment in advanced economies.

5. Despite this improved global macroeconomic outlook, there was evidence of vulnerabilities in some financial systems and markets. Financial vulnerabilities in China continued to be pronounced. Chinese non-financial sector debt had grown by 50% over the three years to 2017 Q1 and stood at 258% of GDP. The expansion had been particularly rapid at domestic mid-sized and small banks, whose total assets had increased by 74% over the same period, and for non-bank sources of finance to the private non-financial sector, which had grown by 63%.

6. In the United States, while overall private non-financial sector debt was growing broadly in line with GDP, corporate sector leverage had risen to new highs. The costs of servicing this debt had also increased since 2014.

7. In the euro area, general government debt was now at around 90% of GDP. Low sovereign bond yields and improving primary balances in some periphery countries had led to a reduction in overall fiscal deficits, and there were signs of improvement in banking sector resilience. But debt levels remained high in Italy and Portugal.

8. Investors in some markets might be placing excessive weight on the recent experience of moderate growth, subdued inflation and low realised volatility. Asset markets reflected an expectation that monetary policy would be normalised only very gradually; they might also reflect the

belief that monetary policy had room to cushion the effects of any adverse shocks if they were to occur. So long-term interest rates remained very low and, despite the underlying material vulnerabilities from indebtedness in the global economy, valuations of some risky assets remained elevated, and market measures of uncertainty were close to record lows.

9. Spreads on corporate bonds were narrow when compared to long-run averages, especially in the high-yield segment. While these valuations appeared to have factored in the low level of long-term market interest rates, they may not be consistent with the pessimistic economic outlook embodied in these rates. These asset prices were therefore vulnerable to a repricing, whether through an increase in long-term interest rates or adjustment of growth expectations, or both.

10. Measures of uncertainty implied by options prices were extremely low, despite heightened levels of geopolitical uncertainty. In September, the VIX measure of implied equity market volatility, derived from option prices on the S&P 500 stock index, stood close to its historical lows. And in August, the MOVE index of implied bond market volatility reached an all-time low. Often in periods of low volatility, underlying risks can build up gradually.

11. There were signs that investors were searching for yield in the low interest rate environment. Global issuance volumes of leveraged loans had continued to increase. New money issuance, defined as gross lending less refinancing, was estimated to exceed $450bn by end-2017, getting close to pre-crisis levels. European and UK markets were smaller, but volumes in both had increased this year. This had been accompanied by a loosening in underwriting standards, with the share of so-called ‘cov-lite’ issuance – defined as loans with fewer financial covenants – increasing over the past year. In aggregate, major UK banks held £89bn of leverage loans, equivalent to around one-third of their CET1 capital, including via exposures to borrowers overseas.

12. The 2017 stress test scenario would assess banks’ ability to withstand global economic and financial markets risks crystallising. The stress scenario incorporated a synchronised global downturn, with world GDP falling by 2.4% at its trough. Output growth in China, Hong Kong and Singapore was particularly adversely affected. The stress featured substantial increases in risk premia and volatility in financial markets, with US equities falling by 46% and spreads on US high yield corporate bonds increasing by 1,150 basis points.

Domestic risks

13. Domestic private non-financial credit had grown broadly in line with nominal GDP over the past two years. Bank lending to UK households and companies grew by 3.7% in the twelve months to 2017 Q2, closely in line with nominal GDP growth of 3.6%. Within that, borrowing by households grew by 3.9%, while borrowing by companies grew by 3.1%.

14. The household sector's debt to income ratio was 137% in 2017 Q1; it had risen by 2.2 percentage points on the quarter, partly reflecting an increase in household debt and partly a fall in disposable income caused by a sharp increase in taxes paid by households. The ratio was now 60% higher than in 1988. Servicing costs on this stock of debt remained low, however, reflecting continued low interest rates. The aggregate debt service ratio – defined as interest payments plus regular mortgage principal repayments as a share of household disposable income – was 8% in 2017 Q1, below its average since 1988 of 8.8%. The share of households with mortgage debt-servicing costs exceeding 40% of their income (the percentage beyond which historical evidence suggests that households are materially more likely to experience repayment difficulties) remained small, at just 1%.

15. Housing market activity had been relatively weak in the first half of the year, with mortgage approvals for new home purchases falling by 3.3% relative to 2016 H1. Residential mortgage lending grew by 3.1% in the twelve months to 2017 Q2. Lending spreads on new owner-occupier mortgages were 167 basis points, in line with their average since 1997. There were some signs, however, that strong competition among lenders in the mortgage market was feeding through into increased risk appetite over non-price terms. In the buy to let market, there was some evidence of a firming in underwriting standards, following the implementation of the PRA's supervisory statement in September 2016.

16. In the corporate sector, the leverage of UK private non-financial sector companies had increased in recent years. In 2017 Q1, the ratio of gross debt to corporate profits stood at 294%, close to pre-crisis levels. But the ratio of debt net of cash holdings to profits remained significantly below pre-crisis levels. And the aggregate debt-servicing ratio for UK non-financial corporations was below its average since 1999. Within overall corporate debt, leveraged finance accounted for only a small proportion of funding for UK companies: high-yield bonds issued by UK companies were only 15% of the UK corporate bond market; leveraged loans were only 9% of domestic corporate lending by UK banks.

17. The current account deficit at the time of the Committee's meeting was 3.4% of GDP for 2017 Q1, 2 percentage points lower than it was at the same time in 2016. The improvement was mainly due to an increase in foreign direct investment income, reflecting in part the depreciation in sterling and the structure of the United Kingdom's assets and liabilities. The United Kingdom's net foreign asset position had also improved and was close to a record high. The Committee was mindful of the potential for revisions to these data, and other indicators, for example in the ONS's *Blue Book 2017*.

18. Within the aggregate domestic credit environment, the rapid growth of consumer credit remained a pocket of risk. Growth in UK consumer credit had slowed a little in recent months but

remained rapid at 9.8% in the year to July 2017. This reflected strong growth of dealership car finance, credit card debt and other borrowing, such as personal loans. Growth of consumer credit remained well above the rate of growth in household disposable income.

19. In addition, valuations in some segments of the UK property market appeared stretched, such as London commercial property. As the FPC had discussed in relation to other asset classes globally, valuations appeared to factor in the low level of long-term market interest rates but not necessarily the cash flows associated with the economic outlook embodied in these rates.

20. Banks' ability to withstand losses associated with a severe domestic downturn was also being tested in the 2017 annual stress test. The stress scenario featured a sharp fall in UK residential and commercial property prices of 33% and 40% respectively. The unemployment rate increased by 4.7 percentage points. Following a UK-specific risk premium shock, there was a large depreciation of sterling, which fed through into higher inflation and higher short-term and longer-term interest rates.

Overall assessment and CCyB decision

21. Putting these developments together, the FPC judged that overall risks to UK financial stability from the domestic environment were broadly unchanged at a standard level. However, there were signs in some markets, globally and domestically, of excessive weight being placed on recent benign conditions as an indicator of future risks. This behaviour encouraged greater risk taking, potentially building up greater vulnerabilities.

22. While there were pockets of risk domestically, most notably in the consumer credit sector, the balance of indicators monitored by the Committee were neither particularly elevated nor subdued when judged by historical standards.

23. The UK's credit-to-GDP gap, defined as the difference between the ratio of credit to GDP and a simple statistical estimate of its long-term trend, was -14% in 2017 Q1. This indicator had increased by 5.5 percentage points over the past four quarters, 2.1 percentage points of which reflected reductions in the estimated trend. As the FPC had observed at previous meetings, it was required in legislation to consider this indicator; but the long-run trend on which it was based gave undue weight to the rapid build-up in credit prior to the global financial crisis.

24. Based on these judgements, the FPC agreed to maintain the UK countercyclical capital buffer (CCyB) rate at 0.5%, and reaffirmed that, absent a material change in the outlook, it expected to increase the rate to 1% at its November meeting, with binding effect a year after that. This was consistent with its June 2017 guidance. It was also consistent with the Committee's strategy for setting the CCyB, as published in December 2015: that it expected to set a CCyB in the region of 1% in a standard risk environment, and that it expected to vary the CCyB rate gradually.

Consumer credit

25. The FPC had previously concluded that the primary channel through which consumer credit could affect financial stability was from the potential for direct losses to lenders. The FPC had set out its reasoning for this in the Record of its March meeting. Although banks' outstanding stock of consumer credit, at £145 billion, was only 1/8th of mortgage debt, this asset class had generated losses in the 2016 stress test of major banks that had been around 60% greater than those on mortgages. That was because defaults on consumer credit tended to rise substantially during recessions.

26. In that respect, it was different from the way in which high owner-occupier mortgage debt could pose a threat to financial stability, which was mainly through the impact on consumption in downturns as households cut back on spending to continue to service their mortgage obligations. In the FPC's view, the rapid growth of consumer credit was not, in itself, a material risk to economic growth through its effect on household spending. The overall level of consumer debt relative to household incomes was in line with historical averages. New consumer borrowing was equivalent to 1.4% of consumer spending and had made almost no contribution to the growth in aggregate consumer spending in the past year.

27. In June, given the continued rapid growth in consumer credit portfolios, the FPC had requested that the consumer credit element of the Bank's 2017 annual stress test of major UK banks be accelerated, to inform its assessment of whether any additional resilience was required in aggregate against this lending. This was also in the context of a review by the PRA, covering a wide range of lenders, which had found evidence of weaknesses in some aspects of underwriting and a reduction in resilience to losses in a downturn. By accelerating this assessment, the FPC was aiming to support timely corrective action and a more prudent assessment of risk in an environment of rapid consumer credit growth.

28. The FPC's concern in June had been that lenders might be placing excessive weight on recent good performance and a relatively benign economic environment when assessing potential loss rates on their consumer credit portfolios. Defaults on consumer debt had fallen in recent years, with write-off rates falling from 5% to 2% between 2011 and 2016. This might reflect an improvement in credit quality. But it also reflected the macroeconomic environment of sustained employment growth and low interest rates. When assessing the possible performance of consumer credit portfolios in a stress, current macroeconomic performance should be discounted.

29. The FPC considered evidence on the extent of any underlying improvement in credit quality since the financial crisis. This included evidence from credit scores, levels and distribution of debt relative to income and historical relationships between loan losses and macroeconomic factors.

30. Estimates suggested that there had been a greater improvement in credit quality in personal loans than in credit cards. The ratio of the stock of personal loans to income had broadly halved since the crisis; the stock of credit card debt relative to income was broadly unchanged. There was evidence that the fall in write-offs for credit cards (6.0% to 3.1%) had been smaller than for non-credit card consumer credit (3.9% to 1.2%). And some caution was needed when considering the quality of credit card portfolios, given the shift into 0% interest rate offers. Although the risk profile of those customers was typically above average, there was greater uncertainty around how they would behave in a stress; if borrowers were relying on being able to roll over these 0% offers, removal of them could result in borrower financial distress.

31. The recent PRA review had provided additional scrutiny on the quality of lenders' consumer credit portfolios. The review had examined PRA regulated firms' asset quality and underwriting practices. It had identified some weaknesses but provided assurance that some of the practices that had been in place during the expansion in consumer credit prior to the crisis were no longer present.

32. On the basis of the available evidence, the FPC judged that there had been an improvement in credit quality of consumer credit portfolios since the financial crisis – with a greater improvement in personal loans than credit cards. That was consistent with the sharp fall since the crisis in the level of consumer debt relative to income. It was also consistent with a shift in the distribution of consumer lending towards borrowers with lower credit risk, as evidenced by borrower credit scores. These improvements implied that borrowers would be 30% less likely to default on personal loans under stress and 20% less likely to default on credit cards than during the financial crisis.

33. The FPC judged that, in the first three years of the 2017 stress test scenario, the UK banking system would, in aggregate, incur credit losses on UK consumer loans of around £30 billion, or 20% of UK consumer credit loans. This comprised impairment rates of around 25% on credit cards, 15% on personal loans and 10% on car finance. These overall credit impairments on consumer credit represented 150 basis points of the aggregate capital ratio of the UK banking system. In reaching this judgement, the FPC had been informed too by views from the Prudential Regulation Committee (PRC), who had also been reviewing the firms' submissions.

34. This loss rate was consistent with the average historical relationship between unemployment and credit losses. It embodied some improvement in consumer credit quality since the financial crisis, but not to the extent implied by banks' own judgements. So although the 2017 stress test scenario was, in important respects, a tougher macroeconomic scenario than the financial crisis, with the unemployment rate rising to 9.5% and Bank Rate rising to 4%, the losses the FPC judged it would generate were broadly the same as those incurred in the financial crisis.

35. The FPC judged that submissions by major banks in this year's stress test process confirmed banks had been underestimating losses in a severe stress. It judged that lenders overall had been attributing too much of the improvement in consumer credit performance in recent years to underlying improvement in credit quality and too little to the macroeconomic environment. This was also consistent with the recent review by the PRA, which had concluded that lenders' assessment and pricing for risk appeared to be overly-influenced by the current benign macroeconomic environment and historically low arrears rates; lenders were reducing interest margins and risk weights associated with consumer loans while, at the same time, beginning to increase lending to higher-risk segments of the market.

36. The FPC's judgement about the loss rate in the 2017 stress test was significantly higher than the loss rate of 13% of consumer loans in the 2016 stress test for the major UK banks. At the system level, this upward revision was equivalent to £10 billion of additional losses in the first three years of the stress scenario. This revision in part reflected the change to the stress scenario in 2017, with interest rates increasing; in the 2016 exercise, Bank Rate was cut to zero. It also reflected the more rigorous assessment of underlying consumer credit quality undertaken in recent months by the PRC and FPC. The increase in the loss rate relative to the 2016 test was equivalent, other things equal, to around 50 basis points of the aggregate capital ratio of the UK banking system.

37. Regulatory capital buffers for individual firms would be set following the full stress test results so that each bank could absorb its losses on consumer lending, alongside all the other effects of the stress scenario on its balance sheet. However, the implications for bank capital of this higher loss rate on consumer credit under stress were not yet clear. First, some banks already held capital in excess of their regulatory requirements. Second, any change in banks' regulatory capital buffers would reflect the full stress test results, covering their whole balance sheet. The loss rate on consumer credit was just one element of the broader 2017 stress test, the full results of which would be published as planned in November. The assessment of consumer credit losses would feed into the overall assessment of banks' losses and resilience under stress. It should not be used as a guide to banks' full stress test results, which would reflect, amongst other things, the losses they would incur on all other assets, their income and costs in the stress scenario and the management actions they would take.

38. Smaller banks, which had increased consumer lending by 14% in the past year, were not part of the annual stress testing exercise. But the judgment about the losses the system would incur included those firms. Those with material exposures to consumer credit would be assessed against the 2017 stress scenario, including the system-wide losses on consumer credit that it had been judged would result in that scenario. Results for these banks would not be published but would form part of their next capital assessment.

39. The Committee discussed potential alternative policy responses on consumer credit to ensure the banking system was able to absorb, and continue lending through, such a stress.

40. One potential approach was to set the UK CCyB rate at a higher level relative to what would be implied by the Committee's judgement on the aggregate risk outlook, because of its assessment on the risk from consumer credit. This approach would increase the capital banks were required to maintain in proportion to all their UK exposures. Given the substantial variation in lenders' exposures to the consumer credit sector, the FPC judged that such a policy response would be inefficient. It could result in increased requirements for lenders with no exposure to consumer credit. Such a response could also result in too much capital against sectors of the economy where risks were judged to be around standard. As a result, the Committee judged that a targeted response was preferable.

41. One potential targeted response was to recommend that the PRA implement a sector-wide increase in capital buffers in proportion to each bank's exposures to the sector. This approach would have the advantage that it would send a clear signal about risks of continuing to expand lending to the consumer credit sector. Depending on its design, it would also directly increase capital buffers against the flow of new lending in the sector. And it should be more robust to uncertainty around the risk characteristics of individual lenders' books, as it delivers extra capital for all lenders exposed to the sector.

42. There were also drawbacks to a potential sector-wide approach. Importantly, it did not fully take into account differences in the quality of individual firms' books – and again in that way might not be efficient. And it could mean that some firms would be required to maintain more capital than required by the overall stress test results, given the level of risk in other parts of their balance sheets.

43. On balance, the FPC therefore judged that it would be appropriate at this time for any increases in resilience to be met within the current framework of the PRC setting regulatory capital buffers for individual firms ('PRA buffers') following the full stress test results.

44. The FPC expected that banks would begin to factor these market-wide levels of stressed losses on consumer credit into their overall lending and capital plans. To avoid diminishing their ability to meet the standard demanded by future stress tests, they would need to accompany any expansion of consumer lending with sufficient resilience to the losses it would add in the stress scenario. That resilience to credit losses could be generated in a range of ways, including with net interest income, reduction in risks in other areas, or additional capital.

45. In addition, the PRA had requested all PRA-regulated lenders with material consumer credit exposures to provide, by September, details of the safeguards they had against placing too much

weight on recent performance. These details would inform firm-specific supervisory actions by the PRA to ensure underwriting standards on consumer credit were maintained over time. In addition, the Financial Conduct Authority (FCA) was consulting on proposals to clarify what is expected of firms in assessing creditworthiness; their aim was to publish final rules and guidance in the first half of 2018.

EU withdrawal

46. The FPC continued to assess the risks of disruption to financial services arising from Brexit so that preparations could be made and action taken to mitigate them. Consistent with its remit, the FPC is focused on outcomes that, even if they may be the least likely to occur, could have most impact on UK financial stability. This includes a scenario in which there is no agreement in place at the point of exit.

47. The FPC was considering risks arising from: discontinuity of cross-border contracts, in particular insurance and derivatives; restrictions on sharing of personal data between the European Union and United Kingdom; and restrictions after Brexit on cross-border banking, central clearing and asset management service provision. Many of these issues pose risks to the provision of financial services in the European Union and United Kingdom. The FPC had reviewed the state of contingency planning across the financial sector, informed by responses to the PRA request for firms to detail their contingency plans.

48. The FPC judged that it would be difficult for firms themselves to mitigate fully risks to the continued servicing of derivative contracts between UK and EU27 counterparties. In particular, after Brexit, firms may lose the permissions required to perform regular 'life cycle' events in these contracts, such as trade compression or exercising options. Tens of thousands of counterparties could be affected, representing around a quarter of both UK and EU client uncleared derivative contracts and notional value potentially totalling around £20 trillion.

49. Impairment to the servicing of these contracts could disrupt market functioning and make it more expensive for firms and households to insure against risks. To continue to service their contracts firms would need to replace cross-border business by novating contracts to new entities with the necessary regulatory permissions. For each of the large dealers, this would require the agreement of 2,000-4,000 counterparties who may themselves need to secure agreement with other involved parties. There were no precedents for these types of multiple large scale novations within an 18-month period.

50. A fully effective mitigant to these risks would require some form of bilateral agreement between the European Union and United Kingdom. The Bank was working with industry, and had

consulted the International Swaps and Derivatives Association, to clarify the scope of potentially affected 'life cycle' events across key trading jurisdictions to identify legal mechanisms that might fix this issue. The two-way nature of derivatives meant that both UK and EU firms doing cross-border business may require appropriate permissions. A comprehensive solution was therefore likely to require the development and passage of legislation in both jurisdictions in order to protect the long-term validity of existing contracts.

51. There were also operational impediments to firms' plans to mitigate risks to the continuity of insurance contracts. Loss of authorisation could affect firms' ability to continue to collect premiums and pay out on claims on outstanding insurance contracts, which in some cases extend for several years.

52. Early estimates suggested that at least £20 billion of insurance liabilities of EEA firms to around 6 million UK policyholders, and £40 billion of liabilities of UK incorporated firms to around 30 million EEA policyholders, could potentially be affected. To mitigate these risks, firms were planning either to secure new authorisations for existing entities or transfer contracts to a new entity with the correct permissions. The UK process of transferring retail contracts relied on a court procedure that could take 12-18 months; given the volume of these applications was expected to be three to five times the normal level, there was a risk that transfers would not be completed in time. The PRA and FCA were working to ensure that firms' plans were as robust as possible, and the Bank had written to the High Court to alert them to the potential for increased applications. The Bank had also discussed the risks in this area with HM Treasury. HM Treasury, the PRA and the FCA were drawing up options to protect UK policyholders, some of which may require legislation and in some cases cooperation with the EU.[1]

53. Firms also lacked robust contingency plans to mitigate risks to financial service provision from possible barriers to the flow of personal data between the UK and EU27. Many firms currently relied on data centres located in the United Kingdom to provide financial services across Europe. Contingency plans were reliant on firms replacing contracts with new ones that included clauses permitting data transfer, but this could be difficult in the time available and such contracts may be subject to legal challenge. The continued free flow of personal data would require the United Kingdom and EU27 to recognise each other's data protection regimes as 'adequate', as recognised by the Government's recent position paper.

54. The risk of disruption to wholesale UK banking services appeared to be slightly higher than previously thought, given that a number of EEA firms branching into the UK were not sufficiently

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[1] The text in this paragraph was omitted from the version of the Record that was initially published on 3 October 2017. The Committee agreed at its 22 November 2017 meeting to publish this text, for the reasons set out in the Record of that meeting.

focused on addressing this issue. Absent an appropriate agreement in place at the point of exit, EEA firms branching into the UK would need to apply for new authorisations from the PRA in order to continue to carry out regulated activities here. These branches accounted for around a tenth of lending to UK companies. Firms would need to start seeking authorisations in 2018 Q1. Their plans were also reliant on a greater degree of cooperation between the UK and EU. The PRA was engaging firms to improve the state of their contingency planning.

55. The United Kingdom was an important global hub for central clearing activity and there remained significant risks from disruption to cross-border clearing activity between the UK and EU. Central counterparties (CCPs) located in the United Kingdom provided important services to EU clients across a range of markets. The European Commission had published a legislative proposal on the supervision of CCPs, which included draft provisions that could be used to deny EU firms access to 'substantially systemically important CCPs' unless they were located within the EU.

56. CCPs and firms were therefore examining contingency options, including the potential to relocate some clearing activity from the UK in order to continue to provide services to EU clients. But such mitigants did not appear to be available in all markets, for example where the complexity and cost of any migration was significant. In the event of access restrictions in those markets, EU firms would therefore have to move their activity to another CCP, which was likely to be difficult to achieve before the point of EU withdrawal. So there remained a substantial risk of disruption of cross-border clearing activity. The Bank was continuing to engage financial market infrastructure and firms on their contingency planning.

57. The risk of disruption to cross-border asset management services had increased. UK-located asset managers accounted for over 35% of assets managed in Europe. Fragmentation of asset management activity between the United Kingdom and the EU could reduce material economies of scale and scope that were currently achieved by pooling of funds. The European Securities and Markets Authority had published an Opinion setting out a more restrictive approach to delegation arrangements involving third countries. At the margin, this increased the risk that UK-located asset managers would be restricted in their ability to provide delegated portfolio management services to EU-domiciled funds. Firms' contingency planning appeared to be at a relatively early stage, increasing the risk of disruption to the provision of these services. The FCA was engaging with firms to improve efforts on contingency plans.[2]

58. The Committee noted that the various issues it had identified posed risks to the provision of financial services in both the European Union and the United Kingdom. This suggested benefits of

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information sharing and a coordinated approach between the European Union and the United Kingdom in managing these risks, and a suitable transition period agreed in a timely fashion.

59. As the FPC had set out in its Financial Stability Report in June, without contingency plans that could be executed in the available time, effects on financial stability could also arise through macroeconomic shocks that could test the resilience of the financial system. On 5 July 2017, the FPC had met with the Monetary Policy Committee (MPC) to discuss the risks of adverse economic shocks as the United Kingdom withdrew from the European Union. The macroeconomic projections set out in the MPC's Inflation Report had been conditioned on the average of a range of possible outcomes for the United Kingdom's new relationship with the European Union and the assumption of a smooth adjustment to that new relationship. The Committees were presented with initial analysis of the potential impact on these projections if the UK instead left the EU in 2019 Q2 on WTO terms, without an agreed transition period. The FPC would meet with the MPC again on 4 October to assess further the scale of these risks to the macroeconomic outlook.

60. The FPC discussed whether it was in the public interest to publish all of the details of its discussion on EU withdrawal at this meeting. There were benefits to disclosure, where it could inform and catalyse contingency planning and therefore mitigate possible financial stability risks. But in some cases, publishing the details of the FPC's discussion at this stage could precipitate action that contingency planning was seeking to avoid. A clear example of this was the risk of a discontinuity in insurance contracts. Work was underway, but not yet finalised, by HM Treasury, the PRA and FCA on options to provide a solution to protect UK policyholders, where this could be achieved by unilateral action from UK authorities; the FPC would receive an update on this work at its meeting in November. Additional disclosures at this stage could prompt policyholders to take costly and potentially unnecessary actions to safeguard the future continuity of their contracts. In some areas, there continued to be a risk that publishing further material could undermine negotiations between the UK and EU – which, given the benefit of an orderly transition, would be at odds with financial stability.

61. The FPC therefore agreed that, on balance, publication of some details of its discussion on EU withdrawal risks was currently against the public interest. It therefore decided to defer publication of those details, under Section 9U of the Bank of England Act 1998. It did not expect to be able to publish much of this text until after the United Kingdom had exited from the European Union. However, it would keep this under review.[3]

[3] The text in this and the two preceding paragraphs was omitted from the version of the Record that was initially published on 3 October 2017. The Committee agreed at its 20 November 2018 meeting to publish this text, for the reasons set out in the Record of that meeting.

Bank capital

62. Major UK banks had continued to build their resilience. In aggregate they had a capital ratio that was more than three times higher than it had been ten years ago. The aggregate common equity Tier 1 capital ratio of major banks had increased to 14.3% of risk-weighted assets in June 2017, and the aggregate Tier 1 ratio was at 16.3%. The leverage ratio of the major UK banks in aggregate was 5.5% in June 2017.

IFRS9

63. On 1 January 2018, most banks in the United Kingdom[4] would need to adhere to the new accounting standard – International Financial Reporting Standard 9 (IFRS 9). The FPC considered the implications of this for its capital framework and bank resilience.

64. Under the new accounting standard, banks would set aside provisions for expected credit losses on all loans, not just where a loan was past due or had already fallen into default. Banks would therefore set aside provisions to cover potential losses in a more timely way than under the current approach to accounting, in which credit losses were recognised only once a loss event had actually happened (known as an 'incurred loss' basis).

65. 'Expected loss' accounting meant that provisions for potential credit losses would be made in a timely way. As identified by the G20, banks' provisions during the financial crisis had lagged market expectations of likely credit losses, causing investors to question banks' true underlying strength.

66. The FPC judged that by enhancing transparency and market confidence in book measures of capital, IFRS9 accounting would support financial stability.

67. The change in accounting standard would not change the cumulative losses banks incur during any given stress episode. The losses would, however, be provided for at an earlier point in the stress. Other things equal, bank capital, as measured under IFRS 9, would fall more sharply in the early part of a stress, before recovering more rapidly.

68. The FPC observed that its 2015 judgement of the necessary level of loss absorbing capacity for the banking system was invariant to accounting standards. Its judgement of the appropriate level

[4] More than 70% of UK banks, including the major UK banks, will be affected by IFRS 9. Other UK banks will continue to report on an incurred loss basis under the UK GAAP accounting standard. IFRS 9 will also apply to all of the largest UK insurers, though all EU insurers have an option to defer application until 2021.

of capital for the banking system had been calibrated such that banks could absorb the cumulative losses in historical stress episodes and continue to provide essential services to the real economy, regardless of the timing of when those losses were actually measured.

69. The FPC then considered how IFRS9 would affect the Bank's annual stress test of major UK banks. The annual stress test examined the potential impact of a hypothetical adverse scenario on the capital of the banking system and individual institutions within it. The severity of the scenario reflected the FPC's and PRC's risk appetite and would not change in response to the new accounting standard. But the effect of IFRS 9 on the timing of losses during a stress period would be seen in the results of future tests. Banks' capital ratios would fall more sharply at the beginning of the stress. Without adjustments to the stress testing framework and / or associated prudential capital requirements, this would imply banks needed to maintain higher capital ratios to meet the standard demanded by the test.

70. The FPC would therefore take steps to ensure that the interaction of IFRS 9 accounting with the annual stress test did not result in a *de facto* increase in capital requirements.

71. Lenders were still finalising their approaches to IFRS 9 and it would take time for the precise magnitude of impacts to be fully understood. The United Kingdom had supported EU authorities' proposals that transitional arrangements should be used to smooth the impact of introducing IFRS 9. Final arrangements were expected to be decided later this year.

72. Given the uncertainty about the precise magnitude of effects and the need to make accompanying adjustments to stress tests and / or prudential requirements, the FPC and PRC would encourage firms to use any internationally agreed transitional arrangements as they adjusted to the new regime, provided the arrangements were broadly similar to those currently being considered. The FPC and PRC would respect firms' choices in future capital assessments and stress tests. Observing how IFRS 9 was applied during the transitional period would inform the precise calibration of the necessary adjustments to the stress testing and / or prudential capital frameworks to accommodate IFRS 9.

Leverage

73. In July 2016, the FPC had decided to exclude central bank reserves from the measure of banks' exposures used to assess their leverage. This change reflected the special nature of central bank reserves and had been designed to avoid a situation in which the Committee's leverage ratio framework impeded the transmission of monetary policy. In doing so, the FPC had not intended a permanent loosening of the leverage framework. It had made clear at the time that it would make an offsetting adjustment to ensure that the amount of capital needed to meet the UK leverage ratio

requirement would not decline. It had planned to make this change as part of its broader review in 2017 of the UK leverage ratio framework.

74. In June, the FPC had agreed that its preferred method of adjustment was to raise the minimum ratio to 3.25%. As set out in its June Record, in arriving at this view members had put weight on maintaining the simplicity of the leverage ratio framework.

75. Over the summer, the Committee had consulted on this proposed adjustment. In the consultation, the FPC had also proposed to recommend to the PRA that it make the exclusion of central bank reserves from the total leverage exposure measure formally part of the PRA's Rulebook.

76. The FPC had received four responses to the consultation paper. Responses had supported the exclusion of central bank reserves, but had questions on the timing or other aspects of the proposed recalibration.

77. On timing, a consideration had been to allow the Bank to reflect the new minimum leverage ratio in its 2017 stress test hurdle rate framework, as announced in the Bank's 2017 stress test scenario publication that had been published in March. Even though, because of the recent delays, this was ahead of the international timetable, the proposal had been designed in the context of the current UK, EU and international regulatory frameworks. And, as set out in its June Record, the FPC would continue to be briefed on ongoing international discussions in the Basel Committee on Banking Supervision.

78. Some respondents argued that the FPC consultation understated the costs of the recalibration of the minimum requirement to 3.25%. Three responses raised concerns around the potential implications for MREL (minimum requirement for own funds and eligible liabilities). The Committee had considered these factors at its June 2017 meeting, and had acknowledged them in its consultation paper. Firms had not provided any evidence that materially changed the FPC's assessment of the costs of the recalibration.

79. Some respondents had questioned how the change would affect banks not currently in scope of the UK leverage ratio framework. The FPC confirmed that it related only to the UK banks and building societies within the scope of application of the Leverage Ratio part of the PRA Rulebook (ie those with retail deposits equal to or greater than £50 billion on an individual or consolidated basis).

80. Respondents had also asked for other technical clarifications, some of which were related to the way in which the PRA would implement the change. These included questions on the claims eligible for exclusion, the definition of 'deposits', and the interaction between the recalibration of the

leverage ratio and MREL. The FPC agreed to set out its responses in more detail in a box that would be included in its existing leverage ratio policy statement.

81. In light of the feedback to its consultation, the FPC confirmed its Recommendation to the PRA to set the minimum leverage requirement at 3.25%, with central bank reserves removed from the leverage exposure measure:

The FPC recommends to the PRA that its rules on the leverage ratio:

(i) exclude from the calculation of the total exposure measure those assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity; and

(ii) require a minimum leverage ratio of 3.25%.

82. The FPC was informed after its meeting that the PRA would comply with this Recommendation. The PRA planned to publish its rules on how this change would be implemented alongside publication of the Record of the FPC's meeting.

83. The FPC had originally planned to conduct a wider review of its leverage ratio framework in 2017, in light of progress towards an international standard for a minimum leverage ratio requirement. The delays in finalising the international leverage standard had led the FPC to postpone its planned fuller review of the UK leverage ratio framework, including its scope and level of application. The FPC intended to undertake this review in 2018.

Regular reviews

Mortgage affordability Recommendation

84. In June 2017, the FPC had replaced its June 2014 affordability test Recommendation for owner-occupied mortgage lending. This had been done to promote consistency in its application across lenders, by clarifying lenders should apply the interest rate stress test in the Recommendation to the reversion rate specified in the mortgage contract. The affordability test Recommendation had been part of the FPC's June 2014 policy package designed to prevent a significant increase in the number of highly indebted households and a marked loosening in underwriting standards in the owner-occupied mortgage market.

85. Since then, market participants had asked whether the FPC's affordability test Recommendation applied to remortgaging activity. Given the aim of the policy, the FPC confirmed that it should not apply to any remortgaging where there is no increase in the amount of borrowing,

whether done by the same or a different lender. This was consistent with the application of the other part of the FPC's mortgage policy package – its mortgage loan to income flow limit.

86. Lenders should continue to read the FPC affordability test Recommendation together with FCA requirements around affordability assessments as set out in the FCA's Mortgages and Home Finance: Conduct of Business sourcebook (MCOB). As part of an affordability assessment, MCOB required lenders to have regard to the FPC's affordability test Recommendation. This did not require lenders to conduct an affordability assessment for remortgaging by their existing borrowers, if there was no increase in the amount of borrowing (other than to finance any product fee or arrangement fee for the proposed new or varied contract) and no change to the contract terms which was likely to be material to affordability. Lenders were required to carry out an affordability assessment where they take on existing borrowers from other lenders, even if there was no increase in the amount of borrowing. However, the FPC Recommendation part of that affordability assessment was not intended to apply in these cases.

87. Lenders were required to have regard to the FPC's June 2017 revision to the affordability Recommendation immediately, by virtue of the existing FCA MCOB rule. The FPC therefore considered that the revision it had made at its June meeting had been implemented.

ESRB recommendation on reciprocity and spillovers of macroprudential policy action

88. The European Systemic Risk Board (ESRB) had asked relevant authorities to report on their implementation of relevant parts of an ESRB Recommendation issued in 2015. These related to: assessing the possible cross border effects of macroprudential policy measures; and the voluntary reciprocity of others' macroprudential policy measures where requested.

89. Analysis on the scope for FPC policy measures to have cross border effects – for example the FPC's previous action on the CCyB – had found the potential effects to be small. On reciprocity, so far there had been a limited number of requests from ESRB member countries and the exposures of UK banks in each case had been small. But the FPC would continue to consider requests, as part of its previously stated general policy to reciprocate foreign macroprudential capital actions where appropriate, recognising the likely benefit to UK financial stability and to ensure consistency with its approach to countercyclical capital buffer rates. The Committee therefore judged that its policy actions were consistent with the relevant parts of the Recommendation.

Review of redacted text

90. In March 2017, the FPC had been briefed on the progress of reforms to interest rate benchmarks. It had previously discussed this in 2013 and 2014, when it had been concerned by the

risks to financial stability associated with Libor or other interest-rate benchmarks becoming unavailable. Subsequently, in 2014, the Financial Stability Board had published a report on *Reforming Major Interest Rate Benchmarks,* and there had been significant improvements to the methodology and governance of Libor.

91. Nonetheless, in March it had become increasingly apparent that the scarcity of term unsecured deposit transactions posed a risk to the medium-term sustainability of term Libor benchmarks. As the FPC had observed in 2013, 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 became unavailable. The Committee had agreed that market reliance on the Libor benchmark created a financial stability risk.

92. The FPC had been updated on the continued work being done internationally to address those risks in the jurisdictions in which Libor was widely used as a reference rate. There were three parts to the work: encouraging the development and usage of near risk-free transactions-based interest-rate benchmarks as alternatives to Libor; developing robust contractual fallback provisions for new and existing Libor contracts; and maintaining Libor in the interim. This latter had included work by the FCA to prepare a consultation on the use of its powers to compel Libor panel banks to continue to make submissions, should that prove necessary.

93. At that stage, the Committee had been concerned that publication of its discussion could precipitate the risks that the action underway was seeking to avoid, and that it was therefore against the public interest to publish the discussion in the Record of its meeting. It had decided to defer publication, under Section 9U of the Bank of England Act 1998, and reaffirmed that decision in June.

94. Subsequently, there had been progress across each of the three areas of work designed to address the financial stability risk:

- In April, the market-led Working Group on Sterling Risk-Free Reference Rates had recommended SONIA, the Sterling Overnight Index Average, as its preferred alternative to sterling Libor. Similarly, market participant groups convened by relevant central banks had identified preferred near risk-free alternatives to Libor in USD, JPY and CHF, while European authorities viewed EONIA as the leading available alternative to EURIBOR.

- The International Swaps and Derivatives Association was coordinating work, at the request of the FSB Official Sector Steering Group, to develop and implement robust fallbacks for Libor within standard derivatives documentation.

- The FCA was seeking to ensure the continued availability of Libor for a period sufficient to enable an orderly transition to alternative benchmarks. The FCA's plans on this had been set out in a speech by Mr Bailey on 27 July. This had highlighted the FCA's concerns about the sustainability of Libor and the consequent need for market participants to transition to using alternative benchmarks. To facilitate this, the FCA had requested voluntary support for Libor from panel banks for the period until end-2021. The response had been positive from the majority of panel banks, although final agreement had yet to be reached. While voluntary arrangements were preferable, the FCA had also taken a number of steps to prepare for use of its powers to compel continued submission to Libor, if required. Mr Bailey had also outlined that markets could not rely on Libor's continued availability after 2021, and should plan accordingly, to ensure a smooth transition to alternative reference rates where appropriate.

95. Given the FCA's plans now in place and powers prepared, the FPC judged that publication of its discussion on the financial stability risk from market reliance on the Libor benchmark was no longer against the public interest. The Records of its meetings in March and June would be updated to include the previously deferred text at the same time as the Record of this meeting was published. That text is included in Annex 2 of this Record. The FPC would receive further briefings on work to address risks related to Libor and other similar benchmarks as relevant.

The following members of the Committee were present:

Mark Carney, Governor

Jon Cunliffe, Deputy Governor responsible for financial stability

Ben Broadbent, Deputy Governor responsible for monetary policy

Dave Ramsden, Deputy Governor responsible for markets and banking

Sam Woods, Deputy Governor responsible for prudential regulation

Alex Brazier

Anil Kashyap

Donald Kohn

Richard Sharp

Martin Taylor

Andrew Bailey, Chief Executive of the Financial Conduct Authority

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

ANNEX 1: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

Identifier(*)	Recommendation/Direction
17/Q3/1	The FPC recommends to the PRA that its rules on the leverage ratio: (i) exclude from the calculation of the total exposure measure those assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity; and (ii) require a minimum leverage ratio of 3.25%.

(*) 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 rate	At its meeting in September 2017, the FPC maintained the UK CCyB rate at 0.5%. Absent a material change in the outlook, and consistent with its stated policy for a standard risk environment and of moving gradually, the FPC reaffirmed that it expected to increase the rate to 1% at its November meeting. 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.[5] Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Mortgage 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,[6] and the FCA has issued general guidance.[7]
Mortgage affordability	At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates: 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, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of

[5] http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx
[6] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[7] http://www.fca.org.uk/news/fg14-08

	origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product 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). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.

ANNEX 2: PREVIOUSLY DEFERRED 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. As set out in paragraph 95 of this Record, the FPC has decided to publish now the following text from the Record of its meetings on 22 March 2017 and 21 June 2017. Those Records have been updated on the Bank's website.

Meeting date	Previously deferred text
March 2017	*Interest-rate benchmark reforms and contingency planning* 56. The FPC was briefed on the progress of reforms to interest rate benchmarks. It had previously discussed this in 2013 and 2014, when it had been concerned by the risks to financial stability associated with Libor or other interest-rate benchmark quotes becoming unavailable. It had issued at that time a recommendation to the Bank and FCA to promote the development of credible contingency plans, working with other authorities and bodies. Subsequently, the Financial Stability Board (FSB) in July 2014 had published a report on *Reforming Major Interest Rate Benchmarks*. 57. Since the FSB's report, and despite significant improvements to the methodology and governance of Libor, it had become increasingly apparent that the scarcity of term unsecured deposit transactions posed a risk to the medium-term sustainability of term Libor benchmarks. As the FPC had observed in 2013, 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. The Committee agreed that market reliance on the Libor benchmark created a financial stability risk. 58. Mr Bailey updated the Committee on the continued work being done internationally to address these risks in the jurisdictions in which Libor was widely used as a reference rate. There were three parts to the work: encouraging the development and usage of near risk-free transactions-based interest-rate benchmarks as alternatives to Libor; developing robust contractual fallback provisions for new and existing Libor contracts; and maintaining Libor in the interim. This latter included work by the FCA to prepare a consultation on the use of its powers to compel Libor panel banks to continue to make submissions, should that prove necessary. 59. Given the risks to financial stability of Libor and similar interest-rate benchmarks becoming unavailable before any alternatives had been implemented, the FPC asked for a further update on progress following planned international discussions later in the spring. 60. The Committee agreed that publication of its discussion at this point was against the public interest, because there was a possibility that publication could precipitate the risks that the action underway was seeking to avoid. It therefore decided to defer publication, under Section 9U of the Bank of England Act 1998. It was not possible to agree now the date at which this text would be published, but the Committee would keep this under review.

June 2017	*Redacted text on interest-rate benchmark reforms and contingency planning* 89. The FPC discussed whether it was still against the public interest to publish text from the Record of its March 2017 meeting on the risks to financial stability of Libor and similar interest-rate benchmarks becoming unavailable before any alternatives had been implemented, and on the work being done internationally to address these risks. At its March meeting, it had agreed that publication was against the public interest at that point, because there was a possibility that publication could precipitate the risks that the action underway was seeking to avoid. 90. Since the FPC's meeting in March, the FCA had published a consultation on its powers to compel Libor banks to continue to make submissions on Libor, should that prove necessary. It was doing further work to put Libor on a stable footing for a transitional period, and staff would provide an update on that in Q3. The FPC would review whether it was appropriate to publish its discussion after that update.