BANK OF ENGLAND

Record of the Financial Policy Committee Meeting on 12 March 2018

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This is the record of the Financial Policy Committee meeting held on 12 March 2018.

It is also available on the Internet: https://www.bankofengland.co.uk/-/media/BoE/Files/record/2018/financial-policy-committee-meeting-march-2018.

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 19 June 2018 and the record of that meeting will be published on 3 July.

Record of the Financial Policy Committee meeting held on 12 March 2018

At its meeting on 12 March 2018, the Financial Policy Committee (FPC):

- Set the UK countercyclical capital buffer (CCyB) rate at 1%, unchanged from November. The FPC will reconsider the adequacy of the 1% CCyB rate in June with a particular focus on the evolution of domestic risk appetite.

- Reviewed progress on the checklist that it published in November, of actions that would mitigate risks of disruption associated with Brexit to important financial services used by households and businesses. It judged that since November, in the United Kingdom, progress had been made. Nonetheless, material risks remained, particularly in areas where actions would be needed by both the UK and EU authorities. The FPC re-emphasised the importance that preparations continue to be made and actions taken by relevant authorities to tackle these risks.

- Reviewed the financial stability risks from crypto-assets. It recognised the potential benefits of the technologies underlying crypto-assets and of their potential to create a more distributed and diverse payments system. It judged that existing crypto-assets did not currently pose a material risk to UK financial stability. The FPC made clear that it would act to ensure the core of the UK financial system remained resilient if linkages between crypto-assets and systemically important financial institutions or markets were to grow significantly.

- Agreed to the 2018 stress test scenario being the same as that used in 2017, which would allow the Bank to isolate, as far as possible, the impact on the stress test results of the new accounting standard which came into effect on 1 January 2018 (International Financial Reporting Standard 9, or IFRS 9). This recognised the deployment of resources both within the Bank and at private institutions in 2018 to prepare for Brexit and the introduction of ring-fencing requirements on 1 January 2019. In the FPC's view, the calibration of the stress scenario remained appropriate given the current risk environment. In 2019 the stress test scenario would be updated in line with the Bank's usual approach.

- Agreed to the hurdle rates for the 2018 stress test evolving from those used in earlier years. The Bank would hold banks of greater systemic importance to higher standards: each participating bank would now be assessed against single risk-weighted capital and leverage hurdle rates that incorporated any buffers to reflect their systemic importance. These would now include, for the first time, capital buffers for domestic, as well as global, systemic importance. In addition, adjustments would be made to hurdle rates to reflect the increased loss absorbency that would result from higher provisions in stress under the new IFRS 9 accounting standard.

1. The Committee met on 12 March 2018 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. To do so, the FPC discussed the risks faced by the UK financial system and assessed the resilience of the system to those risks. It aims to ensure the UK financial system is resilient to, and prepared for, the wide range of risks it could face – so that the system could support the real economy, even in difficult conditions.

Risks to UK financial stability

2. The Committee reviewed financial system and economic developments since its previous meeting in November.

Global vulnerabilities

3. The outlook for global growth had strengthened further. The pick-up in global growth over the past year had been notably broad-based: growth in 2017 Q4 was estimated to be 0.6% in both the euro area and the United States. The Monetary Policy Committee's (MPC's) expectation was for global GDP growth to remain strong in 2018.

4. Despite this continued strength, there were material risks associated with interest rate volatility. Volatility in global equity markets had spiked in early February, triggered by concerns about US inflation risks and the potential for a faster-than-expected tightening in US monetary policy as US fiscal policy turned more expansionary. The VIX measure of implied US equity market volatility had experienced its largest recorded one-day move, reaching its highest level since 2015, though it subsequently fell back. The Bank's market contacts had reported that the initial shock had been amplified by financial instruments designed to provide investors with leveraged exposure or inverted exposure to the VIX, which required instrument issuers to act pro-cyclically in response to market moves.

5. The principal risks were in debt markets. Global long-term real interest rates had risen on the quarter. But yields remained close to historical lows, with estimated term premia remaining compressed. Across major markets, spreads between corporate and sovereign bond yields remained compressed, particularly for high-yield corporate bonds. It was likely that valuations were conditioned on the expectation that robust global growth and subdued inflation would continue.

6. Against that market backdrop, risks stemming from corporate debt in the United States had continued to build, with lending to non-investment grade companies increasing sharply in 2017. Issuance of high-yield bonds, leveraged loans and collateralised loan obligations were all significantly higher than a year earlier. Underwriting standards had deteriorated, with the proportion of so-called

'cov-lite' loans high by historical standards. Yields on US commercial real estate investments had also fallen, and were now below their pre-crisis troughs.

7. Whilst US corporate earnings were likely to be boosted by recent tax reforms, the resulting increase in government debt-to-GDP could, in the medium term, reduce the policy space available to cushion future shocks to growth. Moreover, the potential for an increase in trade barriers represented a significant downside risk to growth, both in the United States and globally.

8. Financial vulnerabilities in China remained elevated. Private non-financial sector debt remained at very high levels. Credit growth in Hong Kong had also remained strong. The FPC had discussed, along with the MPC, the transmission channels via which a sharp slowdown in China and Hong Kong could adversely affect UK GDP growth. Given the strength of financial interlinkages, as well as the UK's indirect links with China through its main trading partners, there was the potential for significant spillovers to UK growth and hence financial stability in such a scenario.

9. In the euro-area, bank lending had picked up during 2017, but credit growth remained well below both pre-crisis averages and GDP growth. The key vulnerabilities in the euro area continued to be driven by the high levels of public debt accumulated by periphery economies during the crisis.

UK external financing

10. The United Kingdom's current account deficit had narrowed in recent quarters. At 4.5% of GDP in 2017 Q3, however, it remained large by international standards. Over recent quarters this deficit had been increasingly funded by capital inflows (rather than sales of foreign assets by UK residents), thus increasing the UK's reliance on the confidence of foreign investors.

Domestic credit environment

11. Aggregate private (non-financial sector) debt had increased only a little faster than GDP over the past couple of years, and relative to incomes, remained well below pre-crisis levels. In the four quarters to 2017 Q3, outstanding borrowing by households and non-financial businesses had increased by 5.5%. In the four quarters to 2017 Q4, outstanding borrowing by households and non-financial businesses from banks (a subset of total credit) had increased by 3.7%. Annual nominal GDP growth was estimated to have been 3.2% in 2017 Q4.

12. The United Kingdom's credit-to-GDP gap, which measured the difference between the ratio of credit to GDP and a mechanical statistical estimate of its long-term trend, remained significantly negative in 2017 Q3 at -16 percentage points. This suggested that risks from credit growth were very subdued. However, as the FPC had observed at previous meetings, the long-term trend on which it

was based gave undue weight to the rapid build-up in credit prior to the global financial crisis and was at present, therefore, a less reliable indicator.

13. In the household sector, aggregate debt (excluding student debt) as a share of income had fallen by almost 20 percentage points since its peak before the crisis. The low level of interest rates meant that the cost of servicing this debt had remained low. The total debt service ratio – defined as interest payments plus regular mortgage principal repayments as a share of household disposable income – was 7.6% in 2017 Q3, below its pre-crisis average of 9%. Moreover, the share of households with a debt service ratio above 40% (the percentage beyond which historical evidence suggested that households were materially more likely to experience repayment difficulties) remained small at 1.4% in 2017 Q3. The average share of households in this situation prior to the crisis was 1.9%. Mortgage interest rates would need to increase by around 150 basis points with no change in household income for this ratio to return to its pre-crisis average – though as the Committee had discussed previously, it was important not to draw too much comfort from comparisons to the pre-crisis era given the scale of vulnerabilities that had built up then.

14. There had been a gradual loosening in credit conditions in the mortgage market in recent years. Spreads on new fixed-rate owner-occupier mortgages had fallen, particularly for loans with riskier characteristics: for instance, the spread between 90% loan-to-value (LTV) and 75% LTV mortgage products had fallen by 34 basis points since 2016 Q1. This was unlikely to reflect an improvement in underlying credit quality: the share of lending at high loan-to-income (LTI) ratios had increased, and average amortisation periods had lengthened. And, although the share of lending at very high LTV ratios (>95%) remained significantly below pre-crisis levels, the share of lending at LTV ratios just below that had recovered from its crisis troughs.

15. There was little evidence, however, of easier credit conditions driving a stronger uptake in mortgage borrowing by households in aggregate. A pick-up in owner-occupier mortgage lending had been offset by the softness in demand in the buy-to-let market, which likely reflected factors such as recent changes in the level of stamp duty applicable to buy-to-let investors and the Prudential Regulation Authority's (PRA's) September 2016 Supervisory Statement. In the owner-occupier market, the FPC's Recommendations on prudent affordability criteria and limits on the proportion of mortgages that lenders could extend at or in excess of 4.5 times borrowers' incomes were preventing a marked increase in the number of highly-indebted households. But there had been increased lending at LTIs just below 4.5.

16. Turning to developments in the consumer credit sector, growth had slowed in recent months, but remained elevated: in the twelve months to January 2018, it had grown by 9.3%, down from the peak of 10.9% in November 2016. This had predominantly reflected a reduction in the growth rate of

car finance. The recent actions by the FPC and Prudential Regulation Committee (PRC) were expected to result in some further tightening in consumer credit conditions over the coming months. This was corroborated by the latest Credit Conditions Survey, where lenders expected a decrease in the availability of consumer credit. Smaller lenders remained a source of growth in the consumer credit market, and were expanding their portfolios at a faster rate than major UK banks.

17. Credit had become more readily available for non-financial companies over the past two years – especially for large companies with access to capital markets. Gross issuance of high-yield bonds and leveraged loans by UK companies had reached record levels in 2017, though estimates suggested that this type of credit accounted for only around 10% of gross issuance of bonds and bank loans. About 60% of the leveraged loan issuance was for refinancing purposes, much higher than pre-crisis levels. But leveraged loans that were classified as 'cov-lite' had accounted for 60% of total gross issuance in 2017. Leveraged loan issuance in 2018 had been higher than in the corresponding months of 2017. Within that aggregate picture, there had been some tightening in the availability of credit for sectors experiencing difficult trading conditions, such as retail, healthcare, outsourcing, and construction sectors.

18. Valuations in some segments of the UK commercial real estate (CRE) sector continued to appear stretched. Current prices were at the top end of estimated sustainable values. Valuations were particularly stretched in the central London office market. That was the case even under the benign assumption that historically low discount rates persisted and that rental growth returned to historically average levels. Overseas investors continued to invest heavily in the UK CRE market. In 2017 overseas buyers were responsible for 47% of UK transactions in total, and 73% of London transactions.

Risk overview and UK CCyB rate decision

19. In light of these developments, the FPC turned to its UK CCyB rate decision.

20. In November, the FPC had agreed to increase the UK CCyB rate from 0.5% to 1% with binding effect from 28 November 2018. It had judged that, apart from those related to Brexit, domestic risks remained at a standard level overall – and so its decision was consistent with its published strategy for setting the CCyB in the region of 1% in a standard risk environment. That decision had also been supported by the results of the 2017 Annual Cyclical Scenario (ACS) stress test of the UK banking system.

21. In November, the FPC had also considered how particularly adverse – and therefore highly unlikely – combinations of risks that could arise as the United Kingdom withdrew from the European

Union compared to the macroeconomic outcomes embodied in the ACS stress test scenario for 2017. As it had set out in November, it had judged that even particularly adverse combinations of the risks that could be associated with Brexit would be encompassed by this scenario. At its meeting, the FPC reviewed its assessment and continued to judge that the 2017 stress test encompassed a wide range of UK macroeconomic outcomes that could be associated with Brexit – and therefore that the UK banking system could continue to support the real economy through a disorderly Brexit.

22. As the FPC had noted in November 2017, the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could, however, result in more severe conditions than in the stress test. In such circumstances, capital buffers would be drawn down substantially more than in the stress test and, as a result, banks would be more likely to restrict lending to the real economy.

23. At the time, the FPC had judged that the likelihood of this combination occurring simultaneously could be seen as extremely remote. Reflecting the resilience of major UK banks, which had an aggregate Tier 1 capital ratio of 16.8%, the FPC had judged that Brexit risks did not warrant additional capital buffers for banks.

24. Developments since November had not changed this assessment.

25. The FPC turned to the evolution of the overall risk environment. In its assessment of non-Brexit risks, the Committee took into account developments both on the quarter and since 2016 Q1 when it had first judged the risk environment to be at a relatively standard level. This approach helped guard against the possibility of a slow build-up of risks being masked when only looking at incremental quarterly developments.

26. The FPC continued to judge that, apart from those related to Brexit, domestic risks remained standard overall. Aggregate domestic indicators were, on balance, close to historical norms and were evolving at a modest rate.

27. However, the Committee had noted some signs of rising domestic risk appetite in recent quarters which could be a signal of a more generalised pick up in the risk-taking environment. There were some particular pockets of risk. These included risks stemming from rapid consumer credit growth and risks relating to household indebtedness and mortgage underwriting standards. The FPC noted that its previous targeted policy actions had so far contained these risks – its September 2017 judgement on the appropriate loss rate for the UK consumer credit sector that had been used in the 2017 stress test, and its 2014 housing market actions, which guarded against significant growth in the number of highly indebted households. If the signs of rising domestic risk appetite became

persistent and more generalised, the FPC would consider further how to balance targeted policy action with decisions on the UK CCyB rate.

28. Looking at the global environment, the Committee continued to judge that, while the outlook for global growth had strengthened further, risks from global vulnerabilities remained material. The Committee recognised that global risks were relevant when considering the adequacy of the UK CCyB rate only to the extent that they had spillover effects for the UK economy – and so UK credit exposures – via global trade and financial and asset price linkages. Some estimates suggested that the additional spillovers that could arise from above-standard global risks could be non-negligible for risks to UK credit exposures and so to the UK CCyB rate.

29. In light of this overall risk environment, the Committee considered the adequacy of a 1% UK CCyB rate. Its strategy was to set a UK CCyB rate in the region of 1% when risks were in a standard range.

30. On the one hand, there were arguments for setting the UK CCyB rate a little above 1%. Risks had increased since the Committee first judged that a 1% UK CCyB rate was appropriate, in 2016 Q1 – and the Committee's published strategy was to match banks' resilience to the evolving risk level. The one year implementation lag when the CCyB rate was increased meant that the Committee's risk assessment had to be forward-looking. And waiting for a more marked evolution in domestic risks before acting could result in a need to consider sharper adjustments to the UK CCyB rate, which would likely carry larger economic costs. A measured increase this quarter could be accommodated by banks without a need to tighten credit conditions – and would not be unexpected for banks and market participants, relative to the case in November, given the Committee's previous communications.

31. On the other hand, there were also arguments for maintaining a 1% UK CCyB rate at this meeting. First, given the relatively modest growth that had been observed in aggregate credit quantities, it might be appropriate to put less weight on signs of intensifying risk appetite in some sectors at this stage; some members thought that these signs would need to persist in order to consider acting. Second, if risks grew in particular areas, the Committee might judge that further, more targeted, policy responses could be appropriate. There were likely to be benefits therefore to waiting to see whether risk-taking continued to grow over the coming months. Third, the Committee re-emphasised its preference to vary the UK CCyB rate in a gradual manner, in part to allow banks to factor it into their capital planning appropriately. At this stage, it might be beneficial to note the probable direction for the UK CCyB rate, given how risk-taking had developed, and to observe the evolution of risks over the coming months in considering whether a rise was warranted.

32. Balancing all these factors, the FPC decided to set the UK CCyB rate at 1%, unchanged from November. It would reconsider the adequacy of the 1% CCyB rate in June with a particular focus on the evolution of domestic risk appetite.

Risks of disruption to UK financial services arising from Brexit

33. Consistent with its statutory duties, the FPC continued to identify and monitor UK financial stability risks associated with Brexit so that preparations could be made and actions taken to mitigate them. Through this, the FPC was aiming to promote an orderly adjustment to the new relationship between the United Kingdom and the European Union.

34. In November, the Committee had outlined a checklist of actions that would mitigate risks of disruption associated with Brexit to important financial services used by households and businesses to support their economic activity. This had covered the main cross-cutting issues that could affect the degree of potential disruption. There were a range of possible outcomes for the future UK-EU relationship. Given its remit, the FPC was focused on outcomes that could have most impact on financial stability. That included outcomes in which there were barriers to providing financial services across the UK-EU border in the same way as they were provided today.

35. At its meeting, it reviewed progress against those actions. Its judgements on the scale of risks reflected the underlying scale of disruption to end users and probability of that materialising, taking account of progress made in mitigating actions. Although focused on the availability of financial services to end users in the United Kingdom, where appropriate the FPC also considered risks of disruption to services available to end users in the European Union because the impact of that could spill back to the UK economy.

36. The checklist was not a comprehensive assessment of risks to economic activity arising from Brexit. It covered only the risks identified to date that could stem from disruption to the availability of financial services. There were also other risks to economic activity that could arise as a result of, for example, restrictions on exports of goods and services or a reduction in the appetite of foreign investors to provide finance to the United Kingdom. The FPC had considered these as part of its assessment that the 2017 stress test encompassed a wide range of UK macroeconomic outcomes that could be associated with Brexit.

Legal frameworks

- <u>Ensure the legal and regulatory framework is in place</u>. Much of the UK's legal and regulatory framework for financial services is derived from EU law. Directly applicable EU law would need to be brought into UK law. Changes would need to be made to the resulting legal framework to make it workable when the UK was no longer a member of the EU. The Government planned to achieve this with the EU Withdrawal Bill and related secondary legislation. The Bill continued to progress through Parliament and was now under scrutiny in the House of Lords. HM Treasury had begun drafting the secondary legislation, including the highest priority for early progress (eg those delivering the temporary permissions regimes). The FPC judged that the risk to the UK was at a medium level, and that there had been a reduction in risk since November.

- <u>Implementation period to allow mitigating actions by firms</u>. Financial institutions would need time to complete any necessary restructuring of their operations, re-papering of contracts and obtain necessary regulatory permissions. Timely agreement on an implementation period would significantly reduce all of the risks set out below. In December, the European Council had agreed that "sufficient progress" had been made in the first phase of negotiations, such that they could move on to transitional arrangements and the framework on the future relationship. Negotiations between the UK and EU were ongoing. The FPC judged that the risks to the UK and to the EU were at a medium level, and that there had been a reduction in risk to both the UK and the EU since November.

Preserving the continuity of outstanding cross-border contracts

- <u>Insurance contracts</u>. Insurers in the UK and the European Economic Area (EEA) might not be able to pay claims to, or receive premiums from, policyholders in the other jurisdiction. Based on latest data, this could affect around £27 billion of insurance liabilities and 10 million UK policyholders. Around £55 billion of insurance liabilities and 38 million EEA policyholders could also be affected. On 20 December 2017 the UK Government had committed to legislate, if necessary, to allow EEA insurance companies to continue to service insurance policies held by UK-based customers (through a temporary permissions regime and additional legislation). EEA customers were currently reliant on their UK insurance company transferring existing contracts to legal entities located in the EU. The FPC judged that the risk to the UK and to the EU was at a medium level, and that there had been a reduction in risk to the UK since November.

- <u>Derivative contracts (uncleared)</u>: UK and EEA parties might no longer have the necessary permissions to service over-the-counter (OTC) derivative contracts with parties in the other jurisdiction. Around a quarter of contracts entered into by parties in both the UK and EEA, with a notional value of £26 trillion, could be affected. The UK Government had committed on

20 December to legislate, if necessary, to allow EEA counterparties to service contracts with UK entities (through a temporary permissions regime and additional legislation if required). However, the majority of contracts also required the UK counterparty to have permission from the EEA. EU authorities had not announced their intention to grant such permissions. The FPC judged that the risk to the UK and to the EU was at a high level, and that there had been a reduction in risk to the UK since November.

- Derivative contracts (cleared). Many major UK and EEA counterparties were obliged to clear contracts in certain products using central counterparties (CCPs) that were authorised or recognised under EU legislation. EEA banks and their clients currently relied heavily on CCPs based in the UK. The ECB had estimated that UK CCPs cleared approximately 90% of euro denominated interest rate swaps used by euro-area banks. A loss of recognition could interfere with EEA clearing members' ability to meet existing contractual obligations to the CCP. Migration of existing contracts to address this would be complex and difficult to achieve. The notional amount of outstanding cleared OTC derivative contracts that could be affected was over £70 trillion (around £27 trillion of which matured after 2019 Q1). The Bank of England was in active discussions with UK CCPs on options to address these risks. The FPC judged that the risk to the UK was at a medium level and the risk to the EU was at a high level.

Avoiding disruption to availability of new financial services

- Clearing services. In the absence of an agreement or recognition by the European Securities and Markets Authority (ESMA) of UK CCPs (see above), EEA banks and their clients would need new arrangements for future clearing services with other CCPs. Given their current heavy reliance on UK CCPs, this could disrupt the availability of services to EEA end-users. UK banks used EU-based CCPs for some clearing activities. The UK Government had committed to legislate regarding the recognition of non-UK CCPs so that they would continue to be able to provide clearing services to UK banks if necessary to avoid disruption. The FPC judged that the risk to the UK was at a medium level and that there had been a reduction in risk since November. It judged that the risk to the EU was at a high level.

- Banking services. EEA businesses relied on UK-based banks for certain services. UK-incorporated banks provided around half of wholesale banking services used by EEA customers. Disruption to this would create risks to the availability of services to end users in the EEA. To continue providing these services, some UK-based banks were in the process of undertaking restructuring and obtaining necessary regulatory permissions for EU subsidiaries.

There were 77 branches of EEA banks operating in the UK under the current 'passporting' regime. These provided services to both UK and EEA end users. These firms would require new regulatory permissions from the PRA after Brexit. The PRA had announced that it intended to permit branch structures for banks that were not conducting material retail business and where sufficient supervisory cooperation and assurance on resolution existed. The UK Government had committed to legislate, if necessary, for a temporary permissions regime that would enable EEA banks to continue to operate pending authorisation should a fallback be required. The FPC judged that the risk to the UK and to the EU was at a medium level, and that there had been a reduction in risk since November.

- <u>Asset management</u>. Delegation of fund management across borders was a global practice. It was estimated that the management of around 10% of funds domiciled in non-UK EEA countries was undertaken in the UK. The management of at least an additional estimated 20% of funds domiciled in these countries was delegated to countries outside the EEA and UK. Restrictions on this delegation could require disruptive changes to asset managers' business models. Both EU and UK investors used funds domiciled in the EU. Further, asset managers required authorisation to market funds across borders. To enable funds domiciled in the EU to continue to be marketed to investors in the UK, the UK government had committed to legislating for a temporary permissions regime if necessary. The FPC judged that the risk to the UK and to the EU was at a medium level.

- <u>Personal data</u>. Even with the necessary regulatory permissions, the ability of financial companies to carry out both new and existing financial services might be impaired by barriers to the cross-border flow of personal data between the UK and EEA. These barriers could disrupt firms' ability to service EEA clients from their data centres, which were typically located in the UK. This risk could be mitigated if the UK and EU were to recognise each other's data protection regimes as 'adequate'. The UK Government had indicated it was pursuing such an EU-UK agreement. Companies could also take steps to mitigate this risk by, for example, introducing new clauses into contracts that permitted data transfer, but this solution may not be comprehensive or completely effective. The FPC judged that the risk to the UK and to the EU was at a medium level.

37. In the FPC's view, overall since November, in the United Kingdom, progress had been made towards mitigating risks of disruption to the availability of financial services. Nonetheless, material risks remained, particularly in areas where actions would be needed by both the UK and EU authorities.

38. The FPC re-emphasised the importance that preparations continued to be made and actions taken by relevant authorities to tackle these risks.

39. The FPC agreed that it would publish with its Statement following this meeting a table summarising these judgements on progress against its checklist, and that it intended to update and publish that quarterly from this point.

40. The FPC had set out in earlier meetings that, irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, it would remain committed to the implementation of robust prudential standards in the United Kingdom. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international baseline standards.

41. Ahead of its meeting, the FPC considered possible forms for the future relationship between the United Kingdom and European Union in financial services.

Crypto-assets

42. The Committee discussed whether there were financial stability risks arising from the use and development of crypto-assets.

43. The Committee recognised the potential benefits of the technologies underlying crypto-assets and of their potential to create a more distributed and diverse payments system. It was important to distinguish the crypto-assets themselves from the distributed ledger and cryptographic technologies upon which many of them relied. These underlying technologies had significant potential and, over time, could have material benefits, including for the efficiency and resilience of the financial system.

44. Banks were already working to apply new technologies to wholesale markets and banks and payment providers were innovating to improve the speed and efficiency of payments. The FPC welcomed the work of the Bank and other authorities to explore ways of achieving these benefits in a robust and efficient manner.

45. The FPC judged that existing crypto-assets did not currently pose a material risk to UK financial stability. In contrast to the underlying technologies, crypto-assets that used them might have limited utility. Their values were currently too volatile to be widely used as a currency or a store of value and, with transaction costs high and settlement times slow, they were an inefficient media of exchange. Their use in payments was minimal in the United Kingdom. They should be considered as assets rather than currencies. However, as assets, they established no claim on any future

income streams or collateral. They had no intrinsic value beyond their currently limited potential to be adopted as money in the future, and hence could prove worthless. Nevertheless, the UK financial system was resilient to this risk. The total stock of crypto-assets was small relative to the financial system. Even at their recent peak, the combined global market capitalisation of crypto-assets was less than 0.3% of global financial assets. Systemically important UK financial institutions currently had negligible exposures to these assets and to the system around them.

46. The FPC would aim to ensure the core of the UK financial system remained protected if linkages between crypto-assets and systemically important financial institutions or markets were to grow significantly. The FPC would continue to monitor exposures – both direct and indirect – of UK banks and insurers, including any arising through derivatives or through exposure via counterparties. The FPC welcomed the intention of the PRA to assess how existing requirements – including those for capital – would apply to crypto-asset exposures.

47. In the event that one or more crypto-assets were likely to become widely used for payments, or as an asset intended to store value, the FPC would require current financial stability standards to be applied to relevant payments and exchanges. In this event, financial stability could be affected both directly – if payments or asset markets were to be disrupted – and indirectly – through confidence effects on the wider financial system. Financial stability standards should address both of these channels. If needed, the FPC would consider recommending to HM Treasury that the regulatory perimeter be expanded. Material improvements in the integrity of the crypto-asset ecosystem, including a strengthening in cyber defences of exchanges, and systems and controls more generally, would be required to meet the standards to which payments and trading infrastructure was currently held.

48. Crypto-assets also raised a number of other public policy concerns, many outside the purview of the Committee. These included consumer and investor protection, market integrity, and the potential to facilitate money laundering and terrorism financing. It was possible, if the use of crypto-assets were to increase substantially, that these issues could also pose risks to confidence in the financial system. Given the international nature of the market, the Committee welcomed forthcoming discussions at the FSB and G20 on these issues.

Stress testing, including IFRS9

49. The Committee discussed the key elements of the Bank's 2018 ACS test. The Bank would publish plans for the 2018 test alongside the Statement from the FPC's meeting.

50. The Committee discussed a proposal to keep the stresses applied to the economic and financial market prices and measures of activity in the 2018 ACS the same as in the 2017 test. This would mean that the scenario would remain more severe than the global financial crisis and, as the FPC had discussed earlier, would mean that it encompassed a wide range of UK macroeconomic outcomes that could be associated with Brexit.

51. An important benefit of running the same scenario would be that it would allow the Bank to isolate, as far as possible, the impact on the stress-test results of the new IFRS 9 accounting standard that had come into effect on 1 January 2018. This was important because, as the FPC had discussed previously, the introduction of IFRS 9 would mean that provisions against loan losses would typically be made earlier in an economic downturn. As a result, banks' capital ratios were likely to fall more sharply than they had in previous tests. Without adjustments to the stress testing framework and / or associated prudential capital requirements, this could lead to an increase in the capital ratios necessary to meet the standard demanded by the tests. But the change in accounting standard did not, other things equal, change the total amount of losses a bank would incur through a given stress.

52. Maintaining the scenario also recognised the deployment of resources both within the Bank and at private institutions in 2018 to prepare for Brexit and the introduction of ring-fencing requirements on 1 January 2019.

53. The FPC noted that keeping the scenario the same was a decision for 2018 only. In 2019 the stress test scenario would be updated in line with the Bank's usual approach. This would emphasise the Bank's approach that the ACS reflected changes in the macroeconomic cycle and financial conditions. Members observed that updating last year's scenario to reflect the evolution of data, as would normally have been done, would have resulted in a scenario that would have been quantitatively similar to 2017. In light of this, the Committee agreed that the calibration of the stress scenario remained appropriate given the current risk environment, and keeping it the same would allow the Bank to realise the benefits outlined above.

Ring-fenced banks

54. UK firms were making progress towards setting up ring-fenced banks (RFBs). Given their significance to the UK economy, the FPC agreed that it was appropriate to include the RFB subgroups of existing stress-test participants in future stress tests. In its 2015 approach document, the Bank had said it would give new participants 12 months' notice before changing its approach to participation in the stress tests. RFBs would only become operational in 2019, and their stressed capital need had been assessed by the PRA as part of the Court transfer scheme process. Taking these considerations together, the FPC was minded to include the RFB sub-groups of the existing

stress-test participants separately in the annual stress test from 2020. It noted that the tests would continue to cover the consolidated groups of existing participants, which would incorporate both ring-fenced and non-ring-fenced entities.

Hurdle rate framework

55. The FPC discussed the hurdle rate framework for the 2018 test. This could evolve from previous years in four important ways.

i) Standards for systemically important banks

56. In previous years banks had been assessed against two different benchmarks – the 'hurdle rate' reflecting minimum capital requirements, and, for systemically important banks, a 'systemic reference point' standard that incorporated the additional systemic buffers applied to those banks. The regulatory capital buffers that had been calibrated on the back of the annual stress test were driven by the higher of the two benchmarks. Systemic banks that did not meet the higher standards expected of them, but that remained above the minimum capital requirements in the stress test, were permitted to take less intensive actions to improve their capital position than banks that fell below their hurdle rate.

57. An alternative was to have just one benchmark / hurdle rate, and to include systemic buffers within it. Systemically important banks falling below their hurdle rate in the stress test would be required to take action to improve their capital position that was as intensive as that expected of non-systemic banks that fell below their minimum capital requirements in stress tests. The Committee judged that this would reinforce the higher standards demanded from systemic banks. This was appropriate, given the additional costs their failure would impose on the wider economy. Having one benchmark would have the additional benefit of further simplifying the stress-testing framework.

58. The Committee observed that in a real stress, capital buffers to reflect systemic importance were, like all other capital buffers, useable to absorb losses. Their inclusion in the stress test hurdle rate ensured that systemic banks could withstand a real stress that was even more severe than that against which they are assessed in the test.

ii) Adding the SRB to the hurdle rate

59. In the description of the 2017 ACS scenario, the Bank had noted its intention to take account in the 2018 stress test of the systemic risk buffer (SRB), which reflected banks' domestic systemic importance. The Committee discussed whether to include the uplift to group capital arising from the application of the SRB to ring-fenced sub-groups in the risk-weighted capital hurdle rates. In previous years, only buffers that reflected global systemic importance had been included. Including

domestic systemic importance buffers in the hurdle rate would reflect the importance of the relevant groups for the provision of financial services to the UK economy. The FPC agreed hurdle rates should incorporate buffers to capture domestic systemic importance as well as global systemic importance.

60. Similarly, on a Tier 1 leverage basis, the hurdle rate should incorporate the 3.25% minimum leverage ratio and additional leverage ratio buffers that reflected banks' systemic importance. The FPC had previously indicated its intention to apply a supplementary leverage ratio buffer for firms subject to a SRB (to reflect their domestic systemic importance). The Bank expected that leverage hurdle rates would reflect this intention, in parallel with the risk-weighted hurdle rate.

iii) Adjustments to the treatment of P2A in the stress test

61. In previous tests, the 'Pillar 2A' element of minimum capital requirements had been expressed as a constant share of risk-weighted assets. However, many of the risks reflected in Pillar 2A, such as pension risks, were not related to the size of a bank's risk-weighted assets. Pillar 2A capital requirements should therefore be expected to fall as a fraction of risk-weighted assets as risk-weighted assets increase in a stress. Because risk weights typically increased under the stress scenario, this fall should be reflected in the hurdle rate for the stress test.

62. The FPC welcomed the fact that the PRC intended to refine the approach to specifying Pillar 2A requirements in the stress test to reflect more closely the probable impact of the stress on the risks captured in Pillar 2A.

iv) IFRS 9 impact

63. As the FPC had discussed earlier, the introduction of IFRS 9 could have an impact on the 2018 stress test results. As well as keeping the 2018 scenario the same in order to isolate the impact, the FPC discussed the possible ways in which the hurdle rate in the 2018 stress test could change to reflect this introduction.

64. In September 2017, the FPC had agreed that it would be appropriate to take steps to avoid an unwarranted *de facto* increase in capital requirements, which could result from the interaction between IFRS 9 and the stress-testing framework. The FPC agreed to reflect the fact that lower capital ratios in the early part of the stress should be assessed in the light of the increased loss absorbency that would result from higher provisions in stress under IFRS 9.

65. To achieve this, the FPC (and PRC) intended to use the information provided by the 2018 stress test to make adjustments to the hurdle rates against which banks' performance in this year's

test was assessed. Applying the same stress scenario as in the 2017 ACS would allow the Bank to estimate the impact of this accounting change.

66. The Committee agreed that any adjustments to hurdle rates should be subject to the constraints that: the effect of adjustments on system-wide capital requirements would be no bigger than the impact in aggregate of changing the accounting standard; and no bank should have a hurdle rate after any adjustment that was below its minimum risk-weighted (Pillar 1 plus Pillar 2A) capital and leverage ratio requirements.

67. An important consideration in determining the scale of adjustments would be the degree to which provisions made early in a stress, in anticipation of future losses, provided loss absorbing capacity for banks comparable to that of capital. This would be a focus of analysis in the 2018 stress test.

68. It would be necessary to assess whether to take firm-specific factors into account when making the adjustments, given that the impact of IFRS 9 was likely to vary significantly across banks depending on their asset mix, business models and previous provisioning practices. Any adjustment would be subject to the constraints outlined above.

69. Given the uncertainty about the precise magnitude of effects, the FPC and PRC had, in September 2017, encouraged firms to use transitional arrangements as they adjusted to the new regime, and had agreed to respect firms' choices in future stress tests. Transitional capital arrangements were now in place, which allowed banks to 'add back in' a portion of the increase in expected credit loss provisions resulting from the introduction of IFRS 9 to their CET1 capital. These arrangements would be phased out by 2023. In the 2018 stress test, firms would be asked to submit results based both on a transitional basis and on a fully-phased in basis.

70. The Bank would judge the adequacy of participating banks' capital using the results submitted on a transitional basis. But the Bank also intended to publish the 2018 stress test results without these transitional arrangements. The results without transitional arrangements would be compared to the results of the 2017 stress test results and used to help calculate the size of any adjustments to hurdle rates in response to the new accounting standard. The publication of results without transitional arrangements meant this judgement – and the information behind it – would be transparent.

71. The Bank would phase in any adjustments to hurdle rates between the 2018 and 2023 stress tests as transitional arrangements were gradually removed.

Regular reviews

Systemic risk buffer

72. There was a statutory obligation for the FPC to review at least every second year its framework for calibrating the SRB, which would apply to ring-fenced banks and large building societies that hold more than £25bn in deposits and shares, excluding deferred shares, (SRB institutions) from 2019. The FPC had initially set the framework in May 2016, and so was required to review it at this meeting.

73. There had been limited new evidence since the FPC had agreed its SRB framework, given that the framework had not yet been implemented. Under the FPC's framework, systemic importance was measured using the total assets of each SRB institution, with higher SRB rates applicable at different thresholds. In its 2016 SRB framework publication, the FPC had noted that the thresholds could be adjusted as part of its two-yearly reviews – for example in line with nominal GDP or inflation. The Committee agreed that it was likely to need to see a sustained and significant impact of nominal GDP growth or inflation before revising the calibration of the thresholds.

74. More generally, the FPC judged that at this stage, there was no evidence that warranted any changes to its SRB framework.

Reciprocity

75. The FPC had agreed at its March 2015 meeting to return to the general issue of its framework for reciprocating the non-CCyB macroprudential policy actions of overseas regulators. It did so at this meeting, in light of the experience of a small number of reciprocity requests since then.

76. Reciprocity involved a regulator in one country replicating the effect of a macroprudential policy imposed in another country, typically with the aim that firms lending cross-border into a country are subject to the same rules as local firms. A cross-border framework existed for regulators to reciprocate CCyB decisions. For non-CCyB macroprudential actions, the FPC had previously set out its general intention to reciprocate foreign macroprudential capital actions where appropriate. This recognised both the likely benefit to UK financial stability and for consistency with its approach to reciprocating foreign CCyB rates. Given the benefits to global financial stability of a coordinated approach across national boundaries, the Committee had also previously noted the desirability of other jurisdictions taking a similar approach to reciprocation of macroprudential decisions.

77. The Committee reiterated its previously stated policy to reciprocate foreign macroprudential actions where appropriate. It also agreed to take non-CCyB macroprudential measures imposed by

overseas authorities into account when designing the ACS in the future, to the extent that those measures provided new information about material risks to UK financial stability from overseas.

78. The FPC welcomed a recent Recommendation from the European Systemic Risk Board (ESRB, Recommendation ESRB/2017/4), which provided guidance on the thresholds to be used by relevant authorities in determining the materiality of cross-border exposures when requesting reciprocity of macroprudential measures. It would be minded to set a materiality threshold in any future requests for reciprocation of its policies.

79. The FPC considered an ESRB Recommendation for relevant authorities to reciprocate a risk weight increase imposed by the Finnish Financial Supervisory Authority (FIN-FSA). The FPC decided no action was necessary as no UK credit institution had exposures exceeding the materiality threshold proposed by FIN-FSA.

Review of redacted text

80. Under Section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of the Records of its meetings, if it decides that publication at that point would be against the public interest. Where it defers publication of text, it sets a date for publication or keeps that decision under review.

81. The FPC discussed whether it was appropriate to publish now parts of its previous Records where it had deferred publication of some of its discussions on the implications of the United Kingdom's withdrawal from the European Union. This text was predominantly on potential scenarios of macroeconomic impacts of leaving the EU without a deal. It had not expected to be able to publish this text until after the United Kingdom had exited from the European Union. But it had decided to keep this publication under review. In the FPC's view, there continued to be a risk that publishing this material could undermine negotiations between the United Kingdom and the European Union – which, given the benefit of an orderly transition, would be at odds with financial stability. Given the uncertainty around the estimates, a suggestion of apparently precise scenarios could be misleading and liable to misinterpretation. The FPC therefore agreed that it remained, at this stage, against the public interest to publish details of its discussions in previous meetings.[1]

[1] The text in this and the preceding paragraph was omitted from the version of the Record that was initially published on 27 March 2018. The Committee agreed at its 20 November 2018 meeting to publish this text, for the reasons set out in the Record of that meeting.

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
Elisabeth Stheeman
Martin Taylor
Andrew Bailey, Chief Executive of the Financial Conduct Authority
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

As permitted under the Bank of England Act 1998, Anthony Habgood was present at the meeting as observer in his role as Chairman of Court.

ANNEX: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

The FPC has no Recommendations or Directions that have not already been implemented.

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 March 2018, the FPC set the UK CCyB at 1%, unchanged from November. It said it would reconsider the adequacy of the 1% CCyB rate in June, with a particular focus on the evolution of domestic risk appetite. 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%.
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,[3] and the FCA has issued general guidance.[4]
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 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.

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