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# News release

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## Financial Policy Committee statement from its policy meeting, 24 March 2015

At its meeting on 24 March 2015, the Bank of England's Financial Policy Committee (FPC) reviewed its assessment of risks to financial stability. Credit growth in the United Kingdom remains moderate and UK banks continue to build their resilience. Nonetheless, the Committee has identified a number of risks to financial stability and has commissioned work in relation to them.

*Global risks*

International and geopolitical risks to financial stability in the United Kingdom persist. Despite recent encouraging signs, the risk of low nominal growth in the euro area remains. There are also risks associated with a further slowdown in China and to some emerging economies as the stance of monetary policy begins to diverge globally. There also remain significant risks in relation to Greece and its financing needs, including in the near term.

Any of these risks could trigger abrupt shifts in global risk appetite that in turn might lead to a sudden reappraisal of underlying vulnerabilities in highly indebted economies, or sharp adjustments in financial markets.

The Committee has reflected international and other risks in the scenario it is developing with the PRA Board for the 2015 stress test of the largest UK banks. This scenario is being finalised and will be published on 30 March, alongside the hurdle rates that will be used.

*Market liquidity risks*

The Committee remains concerned that investment allocations and pricing of some securities may presume that asset sales can be performed in an environment of continuous market liquidity, although liquidity in some markets may have become more fragile. Trading volumes in fixed income markets have fallen relative to market size and recent events in financial markets, including in US Treasury markets in October 2014, appear to suggest that sudden changes in market conditions can occur in response to modest news.

This could lead to heightened volatility and undermine financial stability. The Committee judges that there is a need for market participants to be alert to these risks, price liquidity appropriately and manage liquidity prudently.

The Committee asked the Bank and FCA to work together to:

- Encourage and contribute to international work to address data gaps and build a common understanding of vulnerabilities in capital market and asset management activities.

- Deepen understanding of the channels through which UK financial stability could be affected by any market correction and reduction in market liquidity. This will include analysis of the reliance of UK corporate financing and economic activity on market-based sources of finance.
- Gather information from asset managers in the United Kingdom about their strategies for managing the liquidity of their funds in normal and stressed scenarios. This would inform assessment of the extent to which markets are reliant on investment funds offering redemptions at short notice.
- Assess how and why liquidity in relevant markets might have become more fragile drawing on evidence from recent episodes of heightened market volatility.

This information should clarify the extent of any macroprudential risks associated with market liquidity and allow the Committee to assess potential policy mitigants. The Committee asked for a full report at its meeting in September and for an interim report in June.

*Cyber risk*

In an environment of geopolitical tension, the Committee remains concerned about the need for core firms and financial market infrastructures to address their resilience to cyber attack. The Committee will receive an update on the programme of vulnerability testing of systemic firms at its meeting in June.

*Domestic risks*

The Committee continues to monitor the UK current account deficit, which widened to 6% of GDP in Q3 2014. The Committee set out its analysis in the December 2014 *FSR,* including the extent to which the risks here depend on the nature of the flows of funds that lay behind the deficit. The Committee will keep that assessment under review.

The Committee judges that risks stemming from the housing market and household indebtedness have not increased. However, UK household indebtedness remains high and the insurance provided by the Committee’s June 2014 housing related recommendations remains warranted.

Following recent market intelligence on loosening underwriting standards in some UK corporate lending markets, the Committee reviewed surveys of underwriting standards in UK commercial real estate (CRE) and leveraged loan markets.

Commercial property prices have risen significantly in the past two years. However, yields on commercial property are not unusually low, increased values of commercial property transactions have not been financed primarily by debt and UK banks have contributed a smaller share of lending to finance CRE transactions than in the past. Major UK banks were subjected to a severe stress in commercial property markets in the 2014 stress test and more recent calculations suggest they remain resilient to such stress. As such, the Committee's judgement is that at present no action is necessary to mitigate risks in this market.

Underwriting standards, though not out of line with historical averages, have loosened recently, as measured by loan-to-value and interest coverage ratios. Were that trend to continue, UK banks could quickly become less resilient to stress in these markets. In addition, the evolution of CRE markets will affect the wider economy through the ability of businesses to borrow because commercial property is commonly used as collateral for their borrowing. Mindful of the past cyclicality of these markets, the Committee would consider appropriate action if underwriting standards threatened to evolve in an unsustainable way. It will continue to monitor developments carefully and supports the development of data sources on individual CRE loans.

In the UK leveraged loan market, loan spreads have fallen, debt-to-EBITDA ratios have increased and covenants have loosened. Although the UK leveraged loan market accounts for less than 10% of gross financing for UK businesses, some major UK banks have additional exposures to global leveraged loan markets, including in the United States which is materially larger and where US regulators have acted to tighten underwriting standards.

Based on the historical experience of losses, the UK banking system currently appears resilient to stress in the leveraged loan market. The Committee's judgement is that at present no action is necessary to mitigate risks in this market. However, were the recent loosening in underwriting standards to continue, major banks could face increased risks in stressed and illiquid market conditions, particularly if forced to retain loans intended for distribution to investors. The Committee therefore intends to repeat surveys of standards in this market on a regular basis.

In light of its assessment of the outlook for financial stability, and the progress by UK banks in meeting new capital standards in advance of regulatory requirements, the Committee is maintaining the countercyclical capital buffer (CCB) rate for UK exposures at 0%. Hong Kong's recently announced CCB rate of 0.625% on its banks' domestic exposures will be reciprocated automatically from 27 January 2016.

The Committee's response to the Chancellor's letter and annex setting out the Government's economic policy and a series of recommendations has been published today.

The Record of the Committee's meeting will be published on 7 April.

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