BANK OF ENGLAND

News release

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Financial Policy Committee statement from its policy meeting, 23 September 2015

The Bank of England's Financial Policy Committee (FPC) assesses the outlook for financial stability by identifying the risks faced by the financial system and weighing these against the resilience of the system.

Overall, the FPC judges that the outlook remains challenging. While the resilience of the financial system has continued to improve, downside risks have risen.

The immediate risks in relation to Greece and the euro area have fallen somewhat from their acute level at the time of publication of the July 2015 *Financial Stability Report* (*FSR*). However, other downside risks to UK financial stability stemming from the global environment, and to which the United Kingdom as a global financial centre is exposed, have increased. These risks come from both China and emerging market economies more broadly.

Increased volatility in financial markets since the July *FSR* reflects heightened perceptions of risk, but also highlights changes in the way those markets function that may have the potential to disrupt financing conditions in the real economy, although they have not done so to date. Market participants should be alert to these risks, price liquidity appropriately and manage it prudently.

In the United Kingdom, credit growth to the private non-financial sector has picked up a little. Household debt to income has fallen slightly but remains elevated, and some households continue to have high debt servicing ratios. The Committee considered the rapid growth rate of buy-to-let mortgage lending. It does not consider action to be warranted at present but will monitor underwriting standards and other conditions closely.

The Committee also reviewed the other risks highlighted in its July *FSR*. The UK current account deficit remains close to a record high. Although the capital flows financing the deficit remain mostly long-term in nature and do not give rise to material mismatches, the Committee will continue to monitor closely risks associated with the current account. In response to risks posed by cyber

attack, the Committee maintained its June 2015 recommendation to the Bank, the PRA and the FCA to ensure firms at the core of the financial system complete cyber risk testing and adopt individual action plans.

Weighing against these risks, there has been continuing improvement in the resilience of the banking sector. Major UK banks' core equity Tier 1 (CET1) capital ratios have increased by 1.1 percentage points over the past year to 11.9%. UK bank funding spreads rose only a little in response to market volatility in recent months. The Committee is assessing the vulnerability of the UK banking system to global economic and financial market developments as part of the 2015 stress test.

In the light of its assessment of the outlook for financial stability, the Committee is maintaining the countercyclical capital buffer (CCB) rate for UK exposures at 0%. This setting will be reviewed in 2015 Q4 in the light of the 2015 stress test results. The Committee will also consider the appropriate level of the CCB for all stages of the cycle, taking into account lags in implementation, its impact on credit availability and how it should interact with other existing microprudential capital buffers already in place.

Global risks to UK financial stability

Prospects in China and other emerging market economies (EMEs) have softened since July 2015 and downside risks have risen. Spreads on EME sovereign and corporate dollar bond indices have risen and EME currencies have fallen by around 4% since August and 11% over the past year. Currencies of some commodity-exporting economies have seen much steeper falls.

China is making the transition to a slower-growth, more liberalised and consumption-driven economy. These transitions are made more challenging by some underlying vulnerabilities arising from a rapid build-up of debt since the crisis: the ratio of credit to GDP in China has more than doubled since 2008, to 195%. Non-performing loan rates are starting to rise.

Other EMEs face a set of challenges and downside risks that could be self-reinforcing.

First, the broad slowing of EME growth has been one factor behind lower commodity prices, which have reduced export earnings and further damaged the ability of commodity producers to service debts. Second, slowing growth and divergent monetary policy prospects between some major advanced economies and some emerging market economies have encouraged capital outflows, further tightening domestic financing conditions in EMEs. Capital outflows, including redemptions from EME-focused bond and equity funds, have accumulated to over $90 billion over the past year. Third, where EME exchange rates have depreciated, the burden of debt denominated in foreign

currency has increased. Dollar-denominated borrowing by EMEs has more than doubled since 2008.

These risks in both China and EMEs more broadly affect UK financial stability through the direct exposures of UK banks, whose claims on China and other EMEs are around 3.5 times CET1 capital. The Committee is assessing the capacity of UK banks to withstand these risks in the 2015 stress test. Further, UK asset managers have material holdings of emerging market debt securities. UK financial stability could also be affected more indirectly through markets if reallocation of capital in the global economy tests market functioning, or if capital inflows into advanced economies, including the United Kingdom, encourage looser underwriting standards or stretch asset prices.

Market functioning

The Committee's July 2015 *FSR* documented a number of episodes of very high financial market volatility exposing the fragility of market liquidity. In particular, on 24 August, currency markets and US equity markets for a period traded in a disorderly way: over 1,000 temporary suspensions were placed on individual equities on the New York Stock Exchange.

In March, the Committee asked the Bank and the FCA to assess how and why liquidity in relevant markets might have become more fragile and to investigate the possibility that persistent disruptions to market liquidity could affect issuance conditions for real economy borrowers, with systemic consequences. The Committee reviewed provisional findings of that work and has asked for further analysis in the light of the latest developments, which will be published in due course.

A number of the episodes of high volatility share common characteristics of originating in largely electronic markets that are often exchange-traded and experience sudden reductions in market depth, as measured by the volume of offers to buy and sell at prevailing market prices. In these markets, automated trading and the use of passive and other pro-cyclical trading strategies that in aggregate can amplify price moves, may be growing in importance.

To date, the episodes have been short-lived and without systemic consequences. However, there is evidence that disorderly conditions in one market can spill over to others. For example, the suspension of trading in cash equities on 24 August affected associated derivatives markets, with large discounts emerging between exchange-traded funds and the underlying equities on which they were based. In derivatives markets, option-implied measures of uncertainty around future equity prices increased intraday to their highest level since 2009.

The Committee is alert to the possibility that future heightened volatility and reductions in market depth could have more widespread and persistent effects, including on the provision of credit to the real economy. It has asked the Bank and the FCA for further analysis of common causes of recent episodes and whether factors that have stabilised markets in the past can be relied upon and the channels by which there has been contagion between markets.

The Committee has also reviewed changes in market functioning in largely over-the-counter markets such as corporate bond markets. There is evidence that turnover in some of these markets has fallen and average trade size reduced. Transaction data suggest that market-making dealers account for more than half of gross trading volumes in sterling-denominated corporate bonds, facilitating sales and purchases of such bonds by end investors. Since the crisis, however, the role of dealers has changed: with transaction volumes unaffected, inventories have been worked harder; at the same time, inventories appear to have become less responsive, and prices more responsive, to sales of securities by other investors.

The Committee has asked the Bank for an updated assessment of changes in dealers' ability to act as intermediaries in markets and how these may have affected market liquidity. This work will draw on the Bank's forthcoming Open Forum which will take stock, among other things, of the impact of regulatory reforms on financial markets.

In the context of potentially more fragile market liquidity, the Committee had asked the Bank and the FCA to analyse the risks associated with a range of market participants, starting with open-ended funds offering short-notice redemption. These funds have grown in importance since the financial crisis, one part of a broader shift of financial intermediation from banks to market-based finance.

The Bank and the FCA have surveyed 17 asset management firms covering 143 investment funds and conducted follow-up interviews with eight firms. That work suggests funds operating under UCITS[1] ensure that remaining investors are not disadvantaged when redemptions occur. This reduces incentives for investors to redeem if they suspect others will do the same. These funds also operate with minimal amounts of borrowing.

The Committee has asked for further work on the potential impact of correlated investment behaviour by investment funds and of the measures those funds could deploy under stress. It will report on its conclusions in the December 2015 *FSR*.

[1] Undertakings for collective investment in transferable securities (UCITS) – Directive 2014/91/EU, amending Directive 2009/65/EC.

Recognising the global nature of financial markets, the Bank and the FCA continue to work at an international level, through the European Systemic Risk Board and the Financial Stability Board, on market liquidity issues.

UK housing market risks

In the United Kingdom, house prices continue to rise faster than incomes, with forward-looking indicators suggesting that house price inflation will pick up further in the near term. Transaction volumes have also risen and spreads on mortgage rates have fallen to their lowest level since 2008. However, the proportion of owner-occupier mortgagors with high debt servicing ratios has been broadly stable at 5% since 2011 and, more recently, the share of new mortgage lending with loan to income ratios above 4.5 has fallen slightly to 8%. The Committee judges that the insurance provided by its June 2014 housing recommendations for the owner-occupier market remains warranted.

The buy-to-let sector of the mortgage market has continued to grow rapidly, consistent with a structural trend towards a larger private rental sector, driven by demographic changes and higher house prices relative to incomes. The outstanding stock of buy-to-let mortgage lending has increased by over 40% since 2008. Over the same period, the stock of owner-occupier mortgage lending rose by only 2%. The share of buy-to-let in the stock of outstanding mortgage lending has risen to 16% from 12% in 2008.

Overall, risks from buy-to-let mortgage lending are contained when house prices fall moderately, given that only a small share of buy-to-let is extended at high loan to value ratios. However, the stock of buy-to-let lending might be disproportionately vulnerable to very large falls in house prices. Buy-to-let mortgages are typically extended on interest-only terms and therefore do not amortise. As a result, loan to value ratios on older vintages of buy-to-let loans fall more slowly over time. Indications of this vulnerability to larger falls in house prices were seen in the 2014 stress test of the UK banking system, which featured a 35% fall in house prices. The results of the test confirmed the resilience of the core banking system to losses on buy-to-let mortgage lending.

Buy-to-let mortgage lending has the potential to amplify the housing and credit cycles, though the extent of the amplification is hard to judge because the market has only recently grown to significant levels. Any increase in buy-to-let activity in an upswing could add further pressure to house prices. This could prompt owner-occupier buyers to take on even larger loans, thereby increasing overall risks to financial stability. Demand for buy-to-let lending is itself likely to be cyclical, as in an upswing demand may increase from landlords seeking not only rental return but also capital gains. Buy-to-let investors may further exacerbate a downturn if they expect rental

incomes to fall below their interest payments, and consequently add to selling pressure. Survey evidence suggests that around 40% of buy-to-let investors would respond to a fall in their rental income below their interest payments by seeking to sell their property. Large falls in house prices may in turn directly affect consumer spending, as households have less collateral against which to borrow. Credit risk on UK lenders' balance sheets would also rise.

Changes to mortgage interest tax relief announced in the July Budget are likely to reduce the incentives of some investors to take on increased leverage. And there is little evidence that underwriting standards of major lenders have fallen. Less than 12% of buy-to-let lending in Q2 2015 had an LTV greater than 75%, compared to almost 40% of owner-occupier mortgage lending. The majority of buy-to-let lending further appears to be extended at interest coverage ratios of greater than 125%, evaluated at a stress interest rate of 5%.

The FPC judges that there is, at present, no immediate case for action in the buy-to-let mortgage market. However, the FPC is alert to the rapid growth of the market and potential developments in underwriting standards. As the market continues to grow, particularly if driven by loosening of underwriting standards, the sector could pose risks to broader financial stability, both through credit risk to banks and the amplification of movements in the housing market. Intensified competition among lenders could lead to loosening underwriting standards in future. The FPC supports the intention of the Bank and the PRA to develop datasets needed for systematic monitoring of those standards and other terms and conditions on buy-to-let mortgage lending.

The rapid growth of the market also underscores the importance of FPC powers of direction for use in future. HM Treasury has said it will consult on powers of direction for the FPC related to buy-to-let lending later in 2015.

The Committee is publishing a letter to the Chancellor giving its annual assessment, as requested, of the impact on financial stability of the Help-to-Buy: Mortgage Guarantee Scheme, including whether the parameters of the scheme remain appropriate. As set out in the letter, under current market conditions, the Committee assesses that the scheme does not pose material risks to financial stability. Further, the Committee does not see a case for changing the fee or the current setting of the house price cap on financial stability grounds at this point.

Resilience of the financial system

The major UK banks increased their aggregate CET1 ratio by 0.5pp in 2015 Q2 to 11.9%, and their aggregate leverage ratio rose by 0.3 percentage points to 4.7%. Major UK banks' CET1 ratios

have risen by 1.1 percentage points over the past year and by 4.6 percentage points since 2011. Capital ratios were improved mostly through banks reducing their non-core assets including trading assets and international exposures, rather than by cutting domestic lending.

That increase in resilience has supported credit expansion to the UK economy, with annual UK private sector non-financial credit rising by 3% in the year to 2015 Q1. Intelligence from the Bank's Agents and its latest *Credit Conditions Survey* suggests that credit availability for companies, including small enterprises, has generally improved throughout 2015.

Potential headwinds to banks' resilience remain, however. The scale of future misconduct and redress costs for the UK banking sector is highly uncertain and banks should hold sufficient resources to pay these costs without affecting their ability to continue to lend to the real economy. The Committee will review potential future costs as part of the 2015 stress test of the UK banking system.

Against the backdrop of credit growth that is still modest but picking up a little, domestic risks beginning to re-emerge from a low post-crisis base, the global risk environment, and a level of resilience in the banking system that is around the end-point Basel III requirements, the Committee considered the appropriate setting of the countercyclical capital buffer (CCB) rate for UK exposures. It is maintaining the rate at 0%. This setting will be reviewed in 2015 Q4 in the light of the 2015 stress test results. The Committee will also consider the appropriate level of the CCB for all stages of the cycle, taking into account lags in implementation, its impact on credit availability and how it should interact with other existing microprudential capital buffers already in place.

The Record of the Committee's meeting will be published on Thursday 1 October.

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