



**BANK OF ENGLAND**

# News release

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## **Financial Policy Committee statement from its policy meeting, 23 March 2016**

1. 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 them against the resilience of the system. In doing so, its aim is to ensure the financial system can continue to provide essential services to the real economy, even in adverse circumstances.
2. The FPC judges that the outlook for financial stability in the United Kingdom has deteriorated since it last met in November 2015. Some pre-existing risks have crystallised, drawing on the resilience of the system. Other risks stemming from the global environment have increased. Domestic risks have been supplemented by risks around the EU referendum. Weighed against these developments, the resilience of the core banking system has improved further since November 2015, though investor expectations of future profitability have weakened, with possible implications for banks' ability to build resilience in the future. In some financial markets, underlying liquidity conditions have continued to deteriorate.
3. In December, the Committee signalled its intention to set the UK countercyclical capital buffer rate in the region of 1% in a standard risk environment. Consistent with the Committee's assessment of the current risk environment, and its intention to move gradually, the Committee has decided to increase the UK countercyclical capital buffer rate from 0% to 0.5% of risk-weighted assets. This new setting will become binding with effect from 29 March 2017, at which time the overlapping aspects of Pillar 2 supervisory capital buffers will be lifted. This will increase transparency and sharpen the incentives of the buffer system.
4. The FPC judges that continuing developments in financial market liquidity motivate a careful review of the implementation and precise design of internationally agreed post-crisis regulations. The objective is to determine whether there are opportunities to enhance

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sustainable liquidity without compromising underlying resilience. It intends to publish its assessment later in 2016.

5. The FPC welcomes and supports the Supervisory Statement issued by the Board of the Prudential Regulation Authority (PRA) to clarify its expectations for underwriting standards in the buy-to-let market. The FPC will continue to monitor developments, including the impacts of this initiative and forthcoming tax changes, and to assess the implications for financial stability of the buy-to-let mortgage market.

### **Global & market risks**

6. The Committee recognises that some risks have crystallised since November. Banks have remained resilient and markets have continued to function against a backdrop of monetary policy tightening in the United States, capital outflows from emerging market economies (EMEs) and widespread falls in the prices of risky assets. In recent weeks, earlier declines in risky asset prices have partly reversed as China's exchange rate policy has been clarified, authorities have taken further actions and commodity prices have stabilised.
7. In an environment of low inflation and continued weakness in investment and productivity growth, prospects for global nominal growth are subdued. This raises questions about resilience to future adverse shocks, particularly for EMEs where debt levels continue to rise and terms of trade have deteriorated. In this environment, the re-acceleration of credit growth in China is concerning. In some advanced economies, lower nominal interest rates associated with weak growth prospects are restraining profitability in banking systems that are still in post-crisis repair and pose challenges for some banking business models. Globally, bank equity prices have fallen significantly and a material proportion of banks are now trading below book value.
8. These global risks, alongside domestic risks, are reflected in the 2016 stress test scenario for major UK banks, published alongside this Statement. This is the first annual stress test scenario to be designed under the Bank's new 'Annual Cyclical Scenario' framework. The test will examine banks' resilience to a macroeconomic and traded risk stress linked to the FPC's assessment of the risk outlook, along with a misconduct stress.

### **Domestic risks**

*EU referendum*

9. The FPC has considered the channels through which uncertainty associated with the 23 June referendum on the United Kingdom's membership of the European Union, and any period of extended uncertainty following the vote, could increase risks to financial stability.
10. The Committee noted that the effect of uncertainty has been most marked in sterling spot and options markets. Looking ahead, heightened and prolonged uncertainty has the potential to increase the risk premia investors require on a wider range of UK assets, which could lead to a further depreciation of sterling and affect the cost and availability of financing for a broad range of UK borrowers.
11. These pressures have the potential to reinforce existing vulnerabilities for financial stability. The UK current account deficit remains high by historical and international standards. The financing of that deficit is reliant on continuing material inflows of portfolio and foreign direct investment. Those flows have contributed to the financing of the public sector financial deficit and corporate investment, including in commercial real estate. Heightened uncertainty could test the capacity of core funding markets at a time when the liquidity of these markets has shown signs of fragility across advanced economies. In addition, the impact of a decision of the United Kingdom to withdraw from the European Union could spill over to the euro area, driving up risk premia and further diminishing the prospects for growth there.
12. The Committee assesses the risks around the referendum to be the most significant near-term domestic risks to financial stability. It will continue to monitor the channels of risk closely and support mitigating actions where possible. In that regard, the FPC has considered the results of the 2014 stress test of major UK banks, which incorporated an abrupt change in capital flows, a sharp depreciation of sterling, a marked increase in unemployment and a prolonged recession. The results of that test, when combined with revised bank capital plans, suggested that the banking system was strong enough to continue to serve households and businesses during the severe shock.<sup>1</sup> Since then, UK banks' resilience has increased further.
13. The Committee welcomes the Bank's announcement on 7 March that it will offer three additional indexed long-term repo operations and will continue to offer dollar liquidity in weeks around the referendum, to provide banks, building societies and broker dealers with an opportunity to obtain liquidity against the full range of collateral eligible in the Bank's Sterling Monetary Framework.

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<sup>1</sup> *Stress testing the UK banking system: 2014 results* and the December 2014 *Financial Stability Report*:  
<http://www.bankofengland.co.uk/financialstability/Documents/fpc/results161214.pdf> and  
<http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr36.aspx>

*Credit conditions and buy-to-let mortgage lending*

14. Overall, risks stemming from domestic credit have risen beyond their subdued levels during the immediate post-crisis period. However, the FPC judges that they are not yet elevated. Supported by low interest rates, debt servicing costs remain below historic averages and the proportion of highly indebted households has not increased.
15. Nevertheless, the FPC remains vigilant to risks in this area. With a relatively high level of household indebtedness, debt serviceability remains vulnerable to shocks to interest rates, employment or growth. Growth of the stock of credit extended to the private sector has been driven by pockets of strength in consumer credit and buy-to-let mortgage lending. It is now broadly in line with the growth rate of nominal GDP, which itself is weak by historical standards.
16. Strong growth of consumer credit, which reached 9% in the year to January 2016, in part reflects increased use of finance secured on the purchase of vehicles. The FPC will continue to monitor the composition of new consumer credit, and the implications this has for the debt-servicing ability of the most vulnerable households and the resilience of lenders.
17. The FPC remains alert to potential threats to financial stability from rapid growth in buy-to-let mortgage lending. The outstanding stock of buy-to-let mortgages has risen by 11.5% in the year to 2015 Q4. The macroprudential risks centre on the possibility that buy-to-let investors could behave pro-cyclically, amplifying cycles in the housing market, as well as affecting the resilience of the banking system and its capacity to sustain lending to the wider real economy in a stress.
18. The FPC welcomes and supports the Supervisory Statement issued by the Board of the PRA to clarify its expectations for underwriting standards in this market, including guidelines for testing the affordability of interest payments.<sup>2</sup>
19. The PRA's review of lenders' plans revealed that some lenders are applying standards that are somewhat weaker than those prevailing in the market as a whole. The PRA's action is a prudent supervisory measure intended to bring all lenders up to prevailing market standards. It will guard against any slipping of underwriting standards during a period in which rapid growth plans could be challenged by the impact of forthcoming tax changes.

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<sup>2</sup> *Consultation Paper 11/16: Underwriting standards for buy-to-let mortgage contracts, March 2016* - <http://www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp1116.aspx>

20. The Committee notes that growth of buy-to-let mortgage lending is likely to slow in Q2 as changes to stamp duty take effect. Looking ahead, the combination of forthcoming changes to mortgage interest tax relief and the implementation of the PRA Supervisory Statement will probably dampen growth of buy-to-let mortgage lending relative to lenders' plans. The FPC will continue to monitor closely these developments and potential threats to financial stability from the buy-to-let mortgage market.
21. HM Treasury has consulted on giving powers of direction to the FPC on buy-to-let mortgage lending, and will respond to that consultation, including with final secondary legislation, in due course. The FPC will prepare a statement of its policy for the use of powers of direction ahead of any such powers being approved by Parliament.

### **Resilience of the banking system and UK countercyclical capital buffer rate decision**

22. Overall, the Committee judges that, although measures of bank resilience have improved since November 2015, investors expect weaker future profitability.
23. Measures of bank resilience have continued to strengthen. Major UK banks' aggregate common equity Tier 1 (CET1) ratio has increased further, to 12.6% at end-2015. The aggregate Tier 1 capital ratio of major UK banks reached 13.8% and the Tier 1 leverage ratio reached 4.8% – both a little higher than the FPC's view of the steady state capital requirements for the major UK banks as currently measured.<sup>3</sup>
24. At the same time, investors expect future bank profitability to be weaker. UK bank share prices have fallen by around 15% since November 2015, though there are significant differences in expectations of performance across bank business models. If expectations of weaker earnings were to materialise, the future capacity of the system to withstand shocks through internal capital generation would be reduced.

#### *UK countercyclical capital buffer rate decision*

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<sup>3</sup> As set out in the December 2015 *Financial Stability Report* and the *Supplement to the December 2015 Financial Stability Report: The framework of capital requirements for UK banks*:

<http://www.bankofengland.co.uk/publications/Documents/fsr/2015/dec.pdf> and  
<http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf>

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25. The FPC detailed its strategy for setting the UK countercyclical capital buffer rate in the December 2015 *Financial Stability Report*. Its primary objective is to ensure that the UK banking system is able to withstand stress without restricting essential services, including the supply of credit, to the real economy. To achieve this, the Committee intends to vary the buffer in line with the risk, at the system level, that banks will incur losses on their UK exposures in the future.
26. The FPC judges that the overall threat to banks' UK exposures is currently at a relatively standard level: risks associated with domestic credit are no longer subdued, as they were in the period following the financial crisis; and global risks, which can also affect UK exposures indirectly, are heightened. As the Committee set out in December 2015, in such an environment it expects that the UK countercyclical capital buffer rate would be in the region of 1%.
27. At this stage, the FPC has decided to increase the UK countercyclical capital buffer rate from 0% to 0.5% of risk-weighted assets. Consistent with the FPC's powers, the new setting will become binding with effect from 29 March 2017. In reaching its decision, the FPC took account of the current risk environment and balanced the importance of acting gradually with the desirability of a buffer in the region of 1% in the standard risk environment.
28. The FPC also took account of the review by the PRA Board of the overlap between the risks captured by current supervisory capital buffers and a positive UK countercyclical capital buffer. Following its review, the PRA Board has concluded that existing Pillar 2 supervisory capital buffers should be reduced, where possible, by the full 0.5% UK countercyclical capital buffer. This is a one-off adjustment reflecting the transition to the new capital framework and will take place when the new setting of the UK countercyclical capital buffer rate comes into force in March 2017.
29. The removal of any overlap means that banks accounting for around three quarters of the outstanding stock of UK lending will not see their overall regulatory capital buffers increase as a result of the UK countercyclical capital buffer rate being increased to 0.5%. Other banks will effectively have the period over which they must meet new requirements extended. This will be documented in a forthcoming statement by the PRA Board. The FPC's action will raise the future regulatory capital buffer of some banks, including many smaller banks that have contributed around half of the increase in net lending to the real economy over the past year. Almost all of these banks currently carry capital in excess of the 2019 Basel III requirements

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and the 0.5% UK countercyclical capital buffer. The FPC recognises that these banks may wish to build capital over time in order to retain some excess over regulatory capital buffers, but their current position means that any such action will be able to take place gradually.

30. The UK countercyclical capital buffer rate will apply to all UK banks and building societies and to investment firms that have not been exempted by the Financial Conduct Authority. Under European Systemic Risk Board rules, it will apply to branches of EU banks lending into the United Kingdom. The FPC will work with other authorities to achieve reciprocity, consistent with its own policy on reciprocity.
31. The total countercyclical capital buffer of each firm will be a weighted average of the countercyclical capital buffer rates that apply in the jurisdictions where the credit exposures of the institution are located.
32. In line with the approach set out in the FPC's policy statement for using its powers over leverage ratio tools, the countercyclical leverage ratio buffer will be set at 35% of countercyclical capital buffers, rounded to the nearest 10 basis points. This requirement applies only to major UK banks and building societies.
33. As required by statute, the FPC will keep the setting of the UK countercyclical capital buffer rate under review each quarter.

#### **Resilience of market-based finance and market liquidity**

34. The FPC has continued to review the level of market liquidity – the ease with which securities can be exchanged for cash at predictable prices – in dealer-intermediated markets such as gilt and UK corporate funding markets.
35. Some measures of liquidity, such as bid-ask spreads, do not suggest deteriorating conditions. However, the Committee also places weight on indications of lower market depth, smaller trade sizes on average and greater price impact of asset sales. It further notes the increasing size and persistence of pricing anomalies between related cash and derivative instruments, such as spreads between government yields and swap rates and differences between corporate bond yields and credit default swap spreads.

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36. Market intelligence suggests that broker dealers, which are central to supporting trading activity in government and corporate bond markets, are less willing to expand their inventories of securities in response to sales by other investors and to provide financing to other leveraged investors. Moreover, there has been a reduction in the volume of, and increase in the price of, the provision of financing through reverse repo arrangements secured against gilts.<sup>4</sup> This increase in the cost incurred by leveraged investors to obtain financing using gilt collateral could reduce activity in financial markets going forward, with potentially adverse implications for market liquidity.
37. These developments have taken place during a period of structural change in markets when many post-crisis regulations have been implemented or planned and market participants are in the process of adjusting to the post-crisis economic and financial environment. The FPC considers the regulations to be an important part of the post-crisis reform agenda to build the resilience of the core of the global financial system. While these regulations may reduce the normal level of market-making services provided by core intermediaries, they should also enhance the resilience of that provision in times of stress, promoting the effectiveness of markets. The Committee continues to emphasise the importance of market participants managing their liquidity prudently, in the light of evolving market conditions, and pricing risks accordingly.
38. However, the FPC judges that some market developments motivate careful review and consideration of whether there are any possible refinements to internationally agreed post-crisis regulations that could further promote market effectiveness without compromising the resilience of the core of the financial system. The FPC is undertaking such a review and intends to publish its assessment later in 2016.
39. The Record of the Committee's meeting will be published on Tuesday 5 April.

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<sup>4</sup> Repo markets are the core secured financing market that allow intermediaries with finance to make markets and other market participants (and hence sources of market liquidity), such as hedge funds, with the finance they need to take advantage of arbitrage opportunities. They also provide financial institutions, including the Central Counterparties (CCPs), with the means to re-deploy cash and make it available to others.