



News release

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Financial Policy Committee Statement from its policy meeting, 20 September 2016

1. At its meeting on 20 September, the Financial Policy Committee (FPC) reviewed developments since its meeting on 1 July and since the 23 June referendum on the United Kingdom's membership of the European Union.
2. The financial system has demonstrated resilience to spikes in uncertainty and risk aversion. Core financial markets functioned effectively despite initial sharp price moves and particularly high volumes of transactions relative to normal levels in some markets. Bank funding conditions remained broadly stable.
3. That reflected the consistent building of resilience in the financial system over recent years, extensive contingency planning undertaken by the Bank of England and financial institutions in the run up to the referendum, and the co-ordinated actions taken by the Bank after the referendum.
4. Although financial stability has been maintained in the United Kingdom through a period of volatility, and a number of economic indicators have picked up from their post-referendum low points, the United Kingdom faces a challenging period of uncertainty and adjustment.
5. The FPC continues to assess the financial stability implications of the United Kingdom's withdrawal from the EU. These will be driven in part by the nature of, and the transition to, the United Kingdom's new relationship with the EU. The Committee will develop its assessment over the coming months.

The FPC's approach following the referendum

6. The United Kingdom's position as the leading internationally active financial centre, with a financial system that is, by asset size, around ten times GDP, means that the FPC's statutory responsibility of protecting and enhancing the resilience of the UK financial system is particularly important for both the domestic and global economies.
7. Irrespective of the particular form of the United Kingdom's future relationship with the EU, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK financial system. This will require a level of resilience to be maintained that is at least as great as that currently planned, which itself exceeds that required by international baseline standards.
8. The FPC will need to ensure that the regulatory framework continues to evolve alongside international standards and the risk environment. It notes the importance to achieving its statutory objectives of having the macroprudential flexibility to align the resilience of the financial system to the risks that the system faces.

Current outlook for financial stability: risks

9. The 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.
10. The FPC judges that the current outlook for financial stability in the United Kingdom remains challenging.
11. Heightened uncertainty about the near-term macroeconomic outlook and the United Kingdom's future relationship with the EU is reinforcing domestic risks. In the UK commercial real estate market, the risks of a sharp adjustment are crystallising. Prices have fallen and transactions are at their lowest level since 2009.
12. Although the sharp fall in the sterling exchange rate will help to smooth the adjustment of the current account over time, the risk remains of a fall in overseas investors' appetite to invest in the United Kingdom. Any disorderly adjustment in capital flows would be associated with tighter funding conditions for the UK real economy.

13. The FPC remains concerned that the ability of some households to service their debts would be challenged by a period of weaker employment and income growth. These vulnerable households could affect broader economic activity by cutting back sharply on expenditure in order to service debts.
14. The FPC intends in November to set out its regular review of the policy measures¹ that it put in place in June 2014 to insure against the risk of a marked loosening in underwriting standards and a significant rise in the number of vulnerable households.
15. The FPC judges that risks to UK financial stability from the global economy remain elevated. There remains a high degree of political and policy uncertainty in many advanced economies. European bank equity prices reflect continued concerns over banks' profitability and, particularly in Italy and Portugal, high levels of non-performing loans.
16. Capital inflows into emerging market economies have resumed in recent months, loosening credit conditions and risking a further build-up of vulnerabilities, which could leave some countries at risk of a tightening in financial conditions. Credit growth in China continues to materially outpace GDP growth, and the level and growth of credit relative to GDP in China are very high by international standards. A crystallisation of these risks is an important element of the 2016 stress test of major UK banks; the results will be published alongside the *Financial Stability Report* in November.
17. The actions of the Bank's Monetary Policy Committee in August have supported financial stability by reducing downside risks to the near-term economic outlook. Partly driven by these actions, but also by investor perceptions of unusually low volatility, a range of fixed income asset prices appear elevated. Term and risk premia in bond markets are compressed despite heightened domestic and global uncertainty. This creates a vulnerability to a sharp adjustment that could prove disorderly – for example, if asset price falls triggered fund outflows and dealers were unable or unwilling to hold additional bonds as inventory.
18. The FPC welcomes the announcement that the Financial Stability Board and its members will undertake further monitoring and analysis on market depth and funding liquidity conditions. This will include a cross-jurisdiction study of developments in repo markets by the Committee on the Global Financial System, given the importance of these financing markets for overall market liquidity and market functioning.

¹ In June 2014, the FPC made two Recommendations on owner-occupier mortgage underwriting standards: on mortgage affordability tests and on loan to income ratios. For details of these Recommendations, see the June 2014 *Financial Stability Report*: <http://www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf>

Current outlook for financial stability: resilience

19. Set against the above risks, the resilience of the UK financial system is grounded on substantial capital and liquidity held by the major UK banks. The aggregate Tier 1 capital position of major UK banks in June 2016 was 13.8% of risk-weighted assets, and 4.8% of total assets. These include buffers that have been shown in the Bank's stress tests to enable banks to absorb severe economic and market shocks.
20. Market valuations of major UK banks remain, in aggregate, well below their book value. These appear in particular to reflect challenges to future profitability, largely arising from redress costs for past misconduct and weak investment banking profitability. Underscoring banks' current resilience, bank funding costs remain significantly lower than during previous episodes in which market valuations have been well below book value.
21. Net interest margins of major UK banks have been maintained since the financial crisis. Reductions in deposit rates and, following the introduction of the Term Funding Scheme, in wholesale funding costs, have in the main offset the impact of the pass-through to lending rates of the recent reduction in Bank Rate.
22. Banks' substantial capital and liquidity buffers are intended to be drawn on as needed, to allow the banking system to withstand economic and financial shocks without restricting the provision of financial services. This promotes a system that dampens, rather than amplifies, the impact of uncertainty and adjustment on the real economy. To support that, in July, the FPC cut the UK countercyclical capital buffer (CCyB) rate from 0.5% to 0% of banks' UK exposures with immediate effect.
23. The FPC is today reaffirming that it expects to maintain a UK CCyB rate at 0% until at least June 2017, absent any material change in the outlook. It continues to expect that all elements of the substantial capital and liquidity buffers that have been built up by banks are able to be drawn on, as necessary. It also continues to support the clear supervisory expectation of the PRA Board that firms should not increase dividends and other distributions as a result of the UK CCyB rate being maintained at 0%.

Annual review of Help to Buy: Mortgage Guarantee scheme

24. The FPC has also conducted its third annual assessment of the impact on financial stability of the Help to Buy: Mortgage Guarantee scheme. The Committee judges that, given the

parameters used in the scheme, the scheme has not posed risks to financial stability and that, in current market conditions, its closure as planned at the end of the year would be unlikely to affect significantly the provision of finance. The Committee's full assessment is being published in a letter to the Chancellor alongside this statement.

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