



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

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Financial Policy Committee Statement from its policy meeting, 20 September 2017

- **At its meeting on 20 September, the Financial Policy Committee (FPC) reviewed developments since its meeting on 21 June.** The FPC assessed the outlook for UK financial stability by identifying the risks faced by the UK financial system and assessing the resilience of the system to them. In doing so, its aim is that the financial system can continue to provide essential services to the real economy, even in adverse circumstances.
- **The FPC judges that overall risks to UK financial stability from the domestic environment are broadly unchanged at a standard level.** However, there are signs in some markets, globally and domestically, of excessive weight being placed on recent benign conditions as an indicator of future risks. This behaviour encourages greater risk taking, potentially building up greater vulnerabilities.

Global economic and market risks

- **In the global economy, risks from indebtedness remain material and geopolitical tensions have risen.** Financial vulnerabilities in China remain pronounced. Corporate leverage in the United States has risen to new highs.
- **Near-term global growth prospects have continued to improve and broaden, and expectations of inflation are subdued. Against that backdrop, long-term interest rates remain very low and market measures of volatility and uncertainty are at historic lows.**
- **Often in periods of low volatility, underlying risks can build up gradually.** In recent years, financial covenants in riskier corporate lending markets have loosened materially. And global corporate bond spreads have narrowed to unusually low levels.
- **Some asset valuations appear to factor in the low level of long-term market interest rates but may not be consistent with the pessimistic and uncertain economic outlook embodied in these rates.** These asset prices are therefore vulnerable to a repricing, whether through an increase in long-term interest rates or adjustment of growth expectations, or both.

- **The FPC is assessing the resilience of major banks to severe global and market shocks as part of the Bank's 2017 annual cyclical stress test.**

Domestic risks

- **In domestic credit markets, risk-taking is currently judged to be at a standard level overall.** Domestic credit has grown broadly in line with nominal GDP over the past two years. Lending spreads on new owner-occupier mortgages are in line with their average since 1997. The share of households with mortgage debt-servicing costs exceeding 40% of their income (the percentage beyond which historical evidence suggests that households are materially more likely to experience repayment difficulties) is just 1%. And the aggregate debt-servicing ratio for UK non-financial corporations is below its average since 1999.
- **In segments of the UK commercial property market, valuations appear to factor in the low level of long-term market interest rates but not necessarily the cash flows associated with the economic outlook embodied in these rates.**
- **Consistent with these judgements, its stated policy of moving gradually, and its June 2017 guidance; the FPC is maintaining the UK countercyclical capital buffer (CCyB) rate at 0.5%.** Absent a material change in the outlook, the FPC expects to increase the rate to 1% at its November meeting, with binding effect a year after that.

Consumer credit

- **Within a benign overall domestic credit environment, there is a pocket of risk in the rapid growth of consumer credit.** This is not a material risk to economic growth, as consumer credit represents only 11% of overall household debt. It is a risk to banks' ability to withstand severe economic downturns, because this asset class is disproportionately more likely to default. Although the overall credit quality of consumer credit has improved significantly since the financial crisis, the FPC judges that lenders overall are placing too much weight on the recent performance of consumer lending in benign conditions as an indicator of underlying credit quality. As a result, they have been underestimating the losses they could incur in a downturn.
- **The FPC has responded to this risk by accelerating its analysis of credit losses that banks could incur in the very deep recession encapsulated in the 2017 annual stress test scenario.** The FPC and PRC judge that, in the first three years of that severe stress test scenario, the UK banking system would, in aggregate, incur UK consumer credit losses of around £30 billion, or 20% of UK consumer credit loans, representing 150 basis points of the aggregate common equity Tier 1 capital ratio of the UK banking system. This is just one

element of the overall stress test and should not be used as a guide to lenders' overall results, which will be published as planned on 28 November.

- **Regulatory capital buffers for individual firms will be set following the full stress test results so that each bank can absorb its losses on consumer lending, alongside all the other effects of the stress scenario on its balance sheet. The FPC also expects that banks will begin to factor these market-wide levels of stressed losses on consumer credit into their overall lending and capital plans.**

Brexit

- **The FPC continues to assess the risks of disruption to financial services arising from Brexit so that preparations can be made and action taken to mitigate them.** The FPC is considering in particular risks arising from: discontinuity of cross-border contracts, in particular insurance and derivatives; restrictions on sharing of personal data between the European Union and United Kingdom; and restrictions after Brexit on cross-border banking, central clearing and asset management service provision.
- **In areas where it would be complex and difficult for firms themselves to mitigate risks fully, such as the continuity of contracts between UK and EU27 counterparties, the FPC is exploring other mitigating actions.** This applies most notably to uncleared derivative contracts between UK and EU27 counterparties, which account for around a quarter of outstanding contracts and involve tens of thousands of counterparties. It also applies to the cross-border sharing of personal data.

Bank capital

- **Major UK banks have continued to build their resilience. The aggregate common equity Tier 1 capital ratio of major banks has increased to 14.3% of risk-weighted assets.** In aggregate they have a capital ratio that is more than three times higher than it was ten years ago.
- **On 1 January 2018, most banks in the United Kingdom will need to adhere to a new accounting standard called International Financial Reporting Standard 9 (IFRS 9).** Under the new accounting standard, banks will set aside provisions for expected credit losses on all loans, not just where a loan is past due or has already fallen into default. Because provisions will be made in a more timely way, **IFRS 9 accounting will support financial stability.**
- **The FPC's judgement of the necessary level of loss absorbing capacity for the banking system is invariant to accounting standards.** The change in accounting standard will not, by itself, change the cumulative losses banks incur during any given stress episode. The

Committee's judgement of the appropriate level of capital for the banking system was calibrated such that banks could absorb the cumulative losses in historical stress episodes and continue to provide essential services to the real economy, regardless of the timing of when those losses were actually measured.

- **The FPC will take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in a *de facto* increase in capital requirements. The FPC and Prudential Regulation Committee (PRC) encourage firms to use any internationally agreed transitional arrangements as they adjust to the new regime, provided the arrangements are broadly similar to those currently being considered. The FPC and PRC will respect firms' choices in future capital assessments and stress tests.**
- Following consultation, **the FPC is confirming its recommendation to the Prudential Regulation Authority (PRA) to set the minimum leverage requirement at 3.25%**, with central bank reserves removed from the leverage exposure measure. The PRA will shortly be publishing its rules on how this change will be implemented, alongside publication of the Record of the FPC's meeting.

Consumer credit

1. **Growth in UK consumer credit has slowed a little in recent months but remained rapid at 9.8% in the year to July 2017.** This reflects strong growth of dealership car finance, credit card debt and other borrowing, such as personal loans. Growth of consumer credit remains well above the rate of growth in household disposable income.
2. **Consumer credit is an important determinant of banks' ability to withstand severe economic downturns.** Although banks' outstanding stock of consumer credit (£145 billion) is only 1/8th that of mortgage debt, this asset class generated losses in the 2016 stress test of major banks that were around 60% greater than those on mortgages. That is because defaults on consumer credit tend to rise substantially during recessions. This is different from the way in which high owner-occupier mortgage debt can pose a threat to financial stability, which is mainly through the impact on consumption in downturns as households cut back on spending to continue to service their mortgage obligations.
3. **Consumer credit can therefore pose a risk to financial stability through losses to banks in a downturn. The rapid growth of consumer credit is not, in itself, a material risk to economic growth through its effect on household spending.** The overall level of consumer

debt relative to household incomes is in line with historical averages. New consumer borrowing is equivalent to 1.4% of consumer spending and has made almost no contribution to the growth in aggregate consumer spending in the past year.

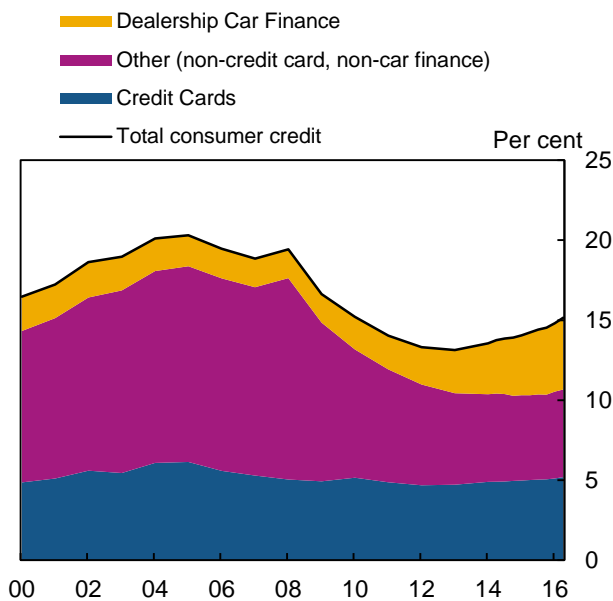
4. **Defaults on consumer debt have fallen in recent years, with write-off rates falling from 5% to 2% between 2011 and 2016. In part that reflects an improvement in underlying credit quality since the financial crisis.** That is consistent with the sharp fall since the crisis in the level of consumer debt relative to income (Chart 1). It is also consistent with a shift in the distribution of consumer lending towards borrowers with lower credit risk, as evidenced by borrower credit scores.
5. **The fall in defaults also reflects factors that should be discounted when assessing how loans would perform under stress.** These include the macroeconomic environment of sustained employment growth and low interest rates, as well as growth of interest-free credit card balance transfer offers.
6. **The FPC judges that lenders overall have been attributing too much of the improvement in consumer credit performance in recent years to underlying improvement in credit quality and too little to the macroeconomic environment. As a result, they have been underestimating the losses they could incur in a downturn.**
7. This judgement was supported by the recent review by the PRA of consumer lending, which found that lenders were reducing interest margins and risk weights associated with consumer loans while, at the same time, beginning to increase lending to higher-risk segments of the market. **Submissions by major banks in this year's stress test process confirm banks have been underestimating losses in a severe stress.**
8. **The PRA has requested all PRA-regulated lenders with material consumer credit exposures to provide, by September, details of the safeguards they have against placing too much weight on recent performance.** These details will inform firm-specific supervisory actions by the PRA to ensure underwriting standards on consumer credit are maintained over time. In addition, the Financial Conduct Authority is currently consulting on proposals to clarify what is expected of firms in assessing creditworthiness; they aim to publish final rules and guidance in the first half of 2018.
9. **The FPC supplemented these actions by bringing forward its assessment of the losses the banking system would incur on consumer credit in the 2017 stress test scenario.** The stress scenario (which was published in March) incorporates a UK economic downturn that is, in important aspects, worse than the financial crisis, with the unemployment rate rising to 9.5%, and Bank Rate rising to 4%. By accelerating this assessment, the FPC was aiming to

support timely corrective action and a more prudent assessment of risk in an environment of rapid consumer credit growth.

10. **The FPC and PRC have now completed that assessment. It is just one element of the broader 2017 stress test, the full results of which will be published as planned in November.** The assessment of consumer credit losses will feed into the overall assessment of banks' losses and resilience under stress. It is not therefore a guide to banks' full stress test results, which will reflect, amongst other things, the losses they would incur on all other assets, their income and costs in the stress scenario and the management actions they would take.
11. **The FPC and PRC judge that, in the first three years of the 2017 stress test scenario, the UK banking system would, in aggregate, incur credit losses on UK consumer loans of around £30 billion, or 20% of UK consumer credit loans.** This comprises impairment rates of around 25% on credit cards, 15% on personal loans and 10% on car finance. These overall credit impairments on consumer credit represent 150 basis points of the aggregate capital ratio of the UK banking system.
12. **The loss rate in the 2017 stress test scenario is significantly higher than the loss rate of 13% of consumer loans in the 2016 stress test for the major UK banks.** This revision in part reflects a change to the stress scenario in 2017, with interest rates increasing. In the 2016 exercise, Bank Rate was cut to zero. It also reflects the more rigorous assessment of underlying consumer credit quality undertaken in recent months by the PRC and FPC. The increase in the loss rate relative to the 2016 test is equivalent, other things equal, to around 50 basis points of the aggregate capital ratio of the UK banking system.
13. **The loss rate in the stress test is consistent with the average historical relationship between unemployment and credit losses (Chart 2). It embodies some improvement in consumer credit quality since the financial crisis, but not to the extent implied by banks' own judgements.** Detailed assessment of the current credit quality of loan books suggests that, overall, borrowers are 30% less likely to default on personal loans under stress and 20% less likely to default on credit cards than in the run-up to the financial crisis. So although the stress test scenario is, in important respects, a tougher macroeconomic scenario than the financial crisis, the losses it is judged to generate are broadly the same as those incurred in the financial crisis.
14. **Stress tests are used to ensure that the banking system and individual banks within it are able to absorb, and continue lending to support the real economy through, a severe and synchronised UK and global recession.** Regulatory capital buffers for individual firms will be set following the full stress test results so that each bank can absorb its losses on consumer lending, alongside all the other effects of the stress scenario on its balance sheet.

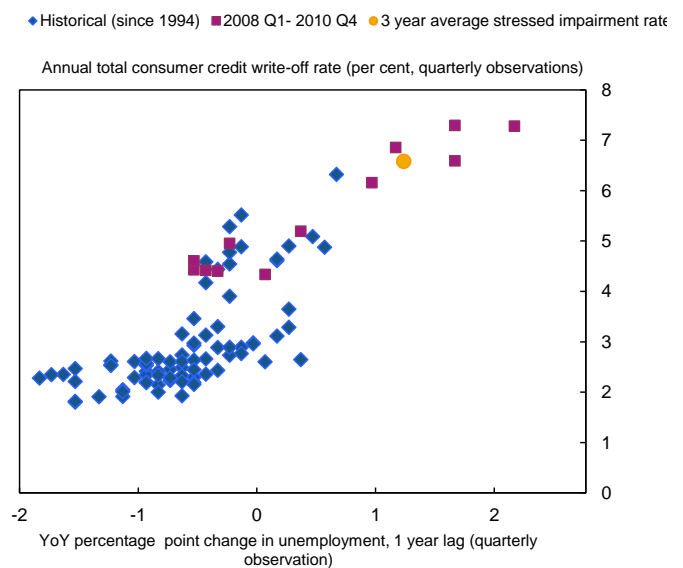
15. **The FPC also expects that banks will begin to factor these market-wide levels of stressed losses on consumer credit into their overall lending and capital plans.** To avoid diminishing their ability to meet the standard demanded by future stress tests they will need to accompany any expansion of consumer lending with sufficient resilience to the losses it would add in the stress scenario. That resilience to credit losses could be generated in a range of ways, including with net interest income, reduction in risks in other areas, or additional capital.
16. **Smaller banks have increased consumer lending by 14% in the past year.** These are not part of the annual stress testing exercise. But the judgment about the losses the system would incur includes those firms. Those with material exposures to consumer credit will be assessed against the 2017 stress scenario, including the system-wide losses on consumer credit that it is judged would result in that scenario. Results for these banks will not be published but will form part of their next capital assessment.

Chart 1: Stock of consumer credit debt by type relative to household income^{(a)(b)(c)}



Sources: Bank of England, Finance & Leasing Association, ONS & Bank calculations.
 (a) Annual data from 2000 to 2014, quarterly from 2015 onwards.
 (b) Other includes unsecured personal loans, overdrafts and other consumer credit (such as store credit, high-cost short-term credit etc).
 (c) Dealership car finance data are not seasonally adjusted.

Chart 2: Relationship between consumer credit write-offs and changes in unemployment



Sources: Bank of England, ONS and Bank calculations.

Brexit

17. **The FPC continues to assess the risks of disruption to financial services arising from Brexit so that preparations can be made and action taken to mitigate them.** Consistent with its remit, the FPC is focused on outcomes that, even if they may be the least likely to occur, could have most impact on UK financial stability. This includes a scenario in which there is no agreement in place at the point of exit.
18. **The FPC is considering risks arising from:** discontinuity of cross-border contracts, in particular insurance and derivatives; restrictions on sharing of personal data between the European Union and United Kingdom; and restrictions after Brexit on cross-border banking, central clearing and asset management service provision. Many of these issues pose risks to the provision of financial services in the European Union and United Kingdom. The FPC has reviewed the state of contingency planning across the financial sector, informed by responses to the PRA request for firms to detail their contingency plans.
19. **The FPC judges that it will be difficult for firms themselves to mitigate fully risks to the continued servicing of derivative contracts between UK and EU27 counterparties.** In particular, after Brexit, firms may lose the permissions required to perform regular 'life cycle' events in these contracts, such as trade compression or exercising options. Tens of thousands of counterparties could be affected, representing around a quarter of both UK and EU client uncleared derivative contracts.
20. **Impairment to the servicing of these contracts could disrupt market functioning and make it more expensive for firms and households to insure against risks.** To continue to service their contracts firms would need to replace cross-border business by novating contracts to new entities with the necessary regulatory permissions. For each of the large dealers, this would require the agreement of 2,000-4,000 counterparties who may themselves need to secure agreement with other involved parties. There are no precedents for these types of multiple large scale novations within an 18-month period.
21. **A fully effective mitigant to these risks will require some form of bilateral agreement between the European Union and United Kingdom.** The Bank is working with industry, and has consulted the International Swaps and Derivatives Association, to clarify the scope of potentially affected 'life cycle' events across key trading jurisdictions to identify legal mechanisms that might fix this issue. The two-way nature of derivatives means both UK and EU firms doing cross-border business may require appropriate permissions. A comprehensive solution is therefore likely to require the development and passage of legislation in both

jurisdictions in order to protect the long-term validity of existing contracts.

- 22. There are also operational impediments to firms' plans to mitigate risks to the continuity of insurance contracts.** Loss of authorisation could affect firms' ability to continue to collect premiums and pay out on claims on outstanding insurance contracts, which in some cases extend for several years.
- 23. Firms also lack robust contingency plans to mitigate risks to financial service provision from possible barriers to the flow of personal data between the UK and EU27.** Many firms currently rely on data centres located in the United Kingdom to provide financial services across Europe. Contingency plans are reliant on firms replacing contracts with new ones that include clauses permitting data transfer, but this could be difficult in the time available and such contracts may be subject to legal challenge. **The continued free flow of personal data will require the United Kingdom and EU27 to recognise each other's data protection regimes as 'adequate', as recognised by the Government's recent position paper.**

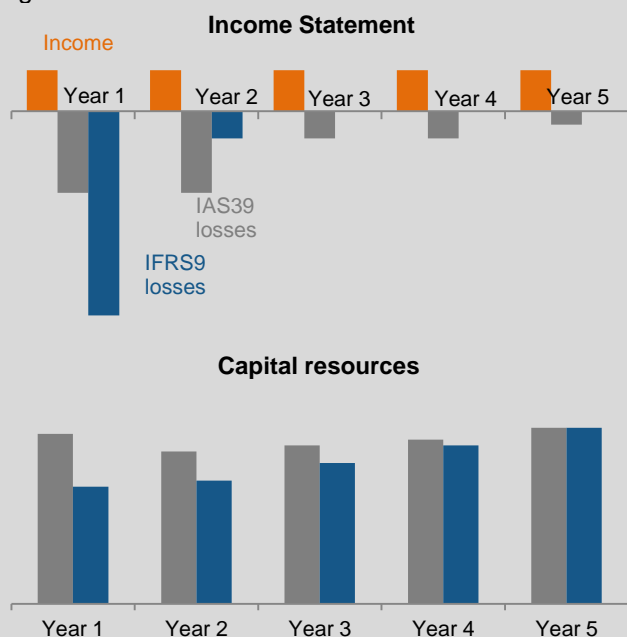
IFRS 9

- 24. On 1 January 2018, most banks in the United Kingdom¹ will need to adhere to a new accounting standard called International Financial Reporting Standard 9 (IFRS 9).**
- 25. Under the new accounting standard, banks will set aside provisions for expected credit losses on all loans,** not just where a loan is past due or has already fallen into default. Banks will therefore set aside provisions to cover potential losses in a more timely way than under the current approach to accounting, in which credit losses are recognised only once a loss event has actually happened (known as an 'incurred loss' basis).
- 26. IFRS 9 accounting will support financial stability.** 'Expected loss' accounting means that provisions for potential credit losses will be made in a timely way. As identified by the G20, banks' provisions during the financial crisis lagged market expectations of likely credit losses, causing investors to question banks' true underlying strength.
- 27. The change in accounting standard will not change the cumulative losses banks incur during any given stress episode.** The losses will, however, be provided for at an earlier point in the stress. Other things equal, bank capital, as measured under IFRS 9, will fall more sharply in the early part of a stress, before recovering more rapidly.

¹ More than 70% of UK banks, including the major UK banks, will be affected by IFRS 9. Other UK banks will continue to report on an incurred loss basis under the UK GAAP accounting standard. IFRS 9 will also apply to all of the largest UK insurers, though all EU insurers have an option to defer application until 2021.

An illustration of the impact of IFRS 9 on a bank's capital resources during a stress scenario

Figure 1



This illustration shows the same bank conducting the same activities under two different accounting standards.

Under IFRS 9, losses will be recognised at an earlier stage than under the existing IAS 39 accounting regime (see top panel to the left). The cumulative losses over the entire stress period are the same under both accounting standards. The blue bars in Figure 1 show the credit losses under IFRS 9, the grey bars show how the same total credit losses would be recorded under current (IAS 39) accounting.

The time at which *income*, e.g. from performing loans, is recognised is unchanged by the move to the new accounting standard.

It is the net profit - the difference between losses and income - that drives the *change in a bank's capital resources*, shown in the bottom panel to the left.

As both *income* and *cumulative losses* over the stress period are unaffected by the move to the new accounting standard, a bank will eventually end up with the same capital resources as it would have under IAS 39. But its capital will fall more sharply and then recover more rapidly.

28. **The FPC's judgement of the necessary level of loss absorbing capacity for the banking system is invariant to accounting standards.** The Committee's judgement of the appropriate level of capital for the banking system was calibrated such that banks could absorb the cumulative losses in historical stress episodes and continue to provide essential services to the real economy, regardless of the timing of when those losses were actually measured.
29. The Bank's annual stress test of major banks examines the potential impact of a hypothetical adverse scenario on the capital of the banking system and individual institutions within it. **The severity of the stress test scenario reflects the FPC's and PRC's risk appetite and will not change in response to the new accounting standard.** But the effect of IFRS 9 on the timing of losses during a stress period will be seen in the results of future tests. Banks' capital ratios will fall more sharply at the beginning of the stress.
30. Without adjustments to the stress testing framework and/or associated prudential capital requirements, this would imply banks need to maintain higher capital ratios to meet the standard demanded by the tests. **The FPC will take steps to ensure that the interaction of**

IFRS 9 accounting with its annual stress test does not result in a *de facto* increase in capital requirements.

31. Lenders are still finalising their approaches to IFRS 9 and it will take time for the precise magnitude of impacts to be understood fully. The United Kingdom has supported EU authorities' proposals that transitional arrangements should be used to smooth the impact of introducing IFRS 9. Final arrangements are expected to be decided later this year.
32. Given the uncertainty about the precise magnitude of effects and the need to make accompanying adjustments to stress tests and/or prudential requirements, **the FPC and PRC encourage firms to use any internationally agreed transitional arrangements as they adjust to the new regime, provided the arrangements are broadly similar to those currently being considered.** The FPC and PRC will respect firms' choices in future capital assessments and stress tests. Observing how IFRS 9 is applied during the transitional period will inform the precise calibration of the necessary adjustments to the stress testing and/or prudential capital frameworks to accommodate IFRS 9.

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