

# Financial Policy Summary

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The Financial Policy Committee (FPC) aims to ensure the UK financial system is resilient to, and prepared for, the wide range of risks it could face — so that the system can serve UK households and businesses in bad times as well as good.

At its meeting on 13 December the FPC reviewed developments since its meeting on 2 October.

## 2019 annual cyclical scenario stress test

The 2019 annual cyclical scenario stress test (ACS) shows the UK banking system would be resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. It would therefore be able to continue to meet credit demand from UK households and businesses even in the unlikely event of these highly adverse conditions.

- In the 2019 stress-test scenario, world GDP falls by 2.6%, UK GDP falls by 4.7%, Bank Rate rises to 4% and the UK unemployment rate rises to 9.2%.
- Losses on corporate exposures are higher than in previous tests, reflecting some deterioration in asset quality and a more severe global scenario. Despite this and weakness in banks' underlying profitability (which reduces their ability to offset losses with earnings), all seven participating banks and building societies (together 'banks') remain above their hurdle rates.
- The major UK banks' aggregate common equity Tier 1 (CET1) capital ratios after the 2019 stress scenario would still be more than twice their level before the crisis.
- Banks' resilience relies in part on their ability in stress to cut dividend payments, employee variable remuneration, and coupon payments on additional Tier 1 instruments. If banks had not cut their distributions during the stress, in aggregate they would not have met the 2019 ACS hurdle rate. Investors should be aware that banks would make such cuts as necessary if a stress were to materialise.

Major UK banks' capital ratios have remained stable since year-end 2018 (the starting point of the 2019 stress test). At the end of 2019 Q3, their CET1 ratios were over three times higher than at the start of the global financial crisis. Major UK banks also continue to hold sizable liquid asset buffers.

## Global developments

The global economy has continued to slow, reflecting in part the broad effects of the trade war between the United States and China. In Hong Kong, rising political tensions have contributed to the sharpest fall in economic activity since the global financial crisis.

The FPC judges that the 2019 stress-test scenario for the global economy was sufficiently severe to encompass economic risks from both a broader trade war and tensions in Hong Kong. Major UK banks were resilient to the stress scenario, and so will be able to continue to lend to UK households and businesses, even if these risks play out further.

The Committee continues to judge that underlying global vulnerabilities remain material, and that there are risks of further deterioration.

- A broadening of the trade war beyond tariff measures to restrictions on technology and capital would further fragment the global economy and slow its rate of potential growth.

- While lower risk-free interest rates will support global growth, monetary authorities have correspondingly less room to respond in the event of further shocks to the global outlook.
- Although overall debt levels in advanced economies are rising no faster than incomes, debt vulnerabilities remain in China and in the US corporate sector. Risks remain in the euro-area banking sector. Flows of capital to emerging markets remain vulnerable to changes in risk sentiment. And political tensions in Hong Kong pose risks due to its position as a major financial centre.

### **Domestic vulnerabilities and Brexit**

**In the UK, against a backdrop of Brexit-related uncertainty, growth has slowed and international investor demand for UK assets, notably commercial real estate, has fallen.**

**The core of the UK financial system — including banks, dealers and insurance companies — is resilient to, and prepared for, the wide range of UK economic and financial shocks that could be associated with a worst-case disorderly Brexit.**

- The 2019 stress-test scenario for the UK economy was severe enough to encompass the range of economic shocks that could be associated with a disorderly Brexit. The core UK banking system demonstrated its resilience to — and capacity to keep lending in — that stress scenario.
- Even if a protectionist-driven global slowdown were to spill over to the UK at the same time as a worst-case disorderly Brexit, the FPC judges that the core UK banking system would be strong enough to absorb, rather than amplify, the resulting economic shocks.

**Reflecting extensive preparations made by authorities and the private sector, most risks to UK financial stability that could arise from disruption to cross-border financial services in a worst-case disorderly Brexit have been mitigated.**

- A range of measures have been put in place by financial services firms and authorities, including in the European Union (EU), to address these risks. Since November 2017, the FPC has regularly published a checklist of actions to avoid disruption to end-users of financial services during Brexit. The FPC updated this checklist at its most recent meeting.
- With over £1 trillion of high-quality liquid assets, major UK banks can meet their maturing obligations without any need to access wholesale funding for many months. They can also withstand an unprecedented loss of access to foreign currency markets. As a further precaution, the Bank is maintaining operations to lend in all major currencies on a weekly basis.
- The FPC welcomes the recent proposal from the European Commission to extend the temporary equivalence arrangements relating to UK central counterparties (CCPs). It expects confirmation of this and extended recognition of UK CCPs to be provided by end-December.
- Financial stability is not the same as market stability. Significant further volatility and asset price changes would be expected in a disorderly Brexit.

**The FPC judges that domestic vulnerabilities (excluding Brexit) that can amplify economic shocks have not changed materially since July and remain at a standard level overall.**

- Credit growth remains moderate. Household and corporate debt-servicing burdens are low. Interest rates would need to rise materially in order to return the share of households and companies with high debt-servicing burdens to historical averages.

**Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.**

## Bank capital requirements

Stepping back from current risks, the FPC, together with the Prudential Regulation Committee and the Bank, has reviewed the structural level and balance of capital requirements for the UK banking system. As a result of that review:

- The FPC is raising the level of the UK countercyclical capital buffer (CCyB) rate that it expects to set in a standard risk environment from in the region of 1% to in the region of 2%.
- Reflecting the additional resilience associated with higher macroprudential buffers, the Prudential Regulation Authority (PRA) will consult in 2020 on proposals to reduce minimum capital requirements in a way that leaves overall loss-absorbing capacity (capital plus bail-inable debt) in the banking system broadly unchanged.
- The Bank, in its capacity as the UK resolution authority, is also clarifying that, in the event of a bank resolution, it expects all debt that is bailed in to be written down or converted to the highest quality of capital, CET1.

Together, these changes will ensure the banking system can support the wider economy through financial and business cycles. They:

- **Increase resilience.** While leaving the overall loss-absorbing capacity for the banking system broadly unaffected, the changes will shift the balance of that capacity towards higher-quality Tier 1 capital.

The changes will keep capital requirements for major UK banks in line with the benchmark level first set by the FPC in 2015. That benchmark balances the need for banks to be able to keep lending through downturns with the need for them to provide the finance that supports growth over the medium term.

Unless banks increase their risk appetite significantly, the Committees expect overall capital requirements for major UK banks to remain broadly flat in the coming period.

- **Improve the responsiveness of capital requirements to economic conditions.** By shifting the balance of capital requirements from minimum requirements that should be maintained at all times towards buffers that can be drawn down as needed, these changes will mean banks are more able to absorb losses while maintaining lending to the real economy through the cycle.

In a stress, the FPC would be prepared to release the CCyB. If the UK CCyB rate was cut from 2% to 0%, this would enable banks to absorb up to £23 billion of losses, which might otherwise lead them to restrict lending. Given losses of that scale, a cut in the UK CCyB rate to 0% could preserve up to £500 billion of banks' capacity to lend to UK households and businesses. This compares with around £100 billion of net lending in the past year.

A higher setting of the UK countercyclical buffer rate in standard conditions will allow the FPC to pursue a gradual approach to raising the buffer as the risks faced by banks build up. It will also ensure that the buffer is sufficiently large when risks are elevated to create the capacity for banks to lend through subsequent downturns.

- **Enhance resolvability.** The Bank's intention, in resolution, to write down or convert debt to CET1 capital will make resolved banks resilient to further losses, supporting their resolution and minimising the wider economic costs of their failure.

**The FPC judges a 2% UK CCyB rate to be appropriate for the current standard risk environment. It is therefore raising the CCyB rate from 1% to 2%. This will take effect in one year.**

- Alongside the Prudential Regulation Authority, the FPC will now pilot options for an enduring approach for incorporating the new IFRS 9 accounting standard into bank stress tests and capital requirements. The approaches to be piloted are consistent with the principle that the new accounting standard, which is being phased in until 2023, should not result in an unwarranted *de facto* increase in capital requirements.

**The FPC stands ready to move the UK CCyB rate in either direction as economic conditions and the overall risk environment evolve. If a major economic stress were to materialise, the FPC is prepared to cut the UK CCyB rate, as it did in July 2016. In the absence of such a stress, the FPC remains vigilant to developments, particularly in the domestic credit environment.**

## Review of FPC mortgage market Recommendations

The FPC has reviewed its limit on the amount of new mortgage lending at or above 4.5 times the borrower's income, and its calibration of the test that lenders should use to assess whether a borrower can afford a mortgage.

- Mortgages are households' largest financial liability and lenders' largest loan exposure. In the past, lenders' underwriting standards have loosened sharply and at times shifted from responsible to reckless. This can lead to a significant increase in the number of more highly indebted households.
- In a downturn, these households are more likely to face difficulties and can cut back sharply on spending to make their mortgage payments. This poses risks to the wider economy and ultimately to lenders.
- To insure against this, the FPC has, since June 2014, recommended a limit of 15% on the proportion of new mortgages extended at or above 4.5 times a borrower's income. Building on Financial Conduct Authority (FCA) rules, the FPC has also recommended that lenders assess whether borrowers could meet their mortgage payments if their mortgage interest rate switched to the contractual reversion rate and increased by 3 percentage points.

**The FPC's measures prevent a loosening of underwriting standards that would otherwise lead to an increase in the number of more highly indebted households. These benefits substantially outweigh any macroeconomic costs. These standards therefore maintain financial stability and support economic growth through the cycle.**

**Alternative policies to achieve similar benefits would be much more costly to the wider economy and pose greater risks to the Committee's secondary objective to support the Government's economic policy of strong, sustainable and balanced growth.**

- Without the FPC's insurance policies, monetary policy might need to address the financial stability consequences of deteriorating underwriting standards and rapid credit growth. Since monetary policy cannot be targeted at the mortgage market alone, this could generate a potentially severe economic slowdown, far outweighing any macroeconomic costs of the FPC's policies.
- Alternatively, looser underwriting standards would result in an increase in the number of more highly indebted households and greater economic volatility. In those circumstances, to maintain the resilience of banks, the prudential authorities would need to require banks to have materially higher levels of capital, raising the cost of credit.

**The FPC therefore judges it is appropriate to maintain both Recommendations. It views them as structural measures intended to remain in place through cycles in the housing market.**

**These measures have had limited effect to date on mortgage availability. Lenders have maintained their underwriting standards in recent years.**

- The FPC's limit on high loan to income mortgage lending has not been reached. Mortgage approvals have remained steady. First-time buyers — who tend to have a greater reliance on borrowing at higher loan to income ratios — now account for a higher share of activity than when the measures were introduced. Thus far, the measures have not constrained a material number of prospective home buyers from purchasing a home.

## Financial market liquidity

**The recent period of volatility in the US dollar repo market shows how markets can become illiquid in the face of shocks and may not be able to rely on dealers to maintain levels of liquidity. Investors should not assume that markets will remain liquid at all times.**

- Post-crisis reforms have contributed to the resilience of, and reduced the interconnections between, dealers that sit at the centre of many financial markets. That, in turn, has reduced the risk of severe and sudden reductions in market liquidity.
- Maintaining those standards is crucial to supporting financial stability. However, these reforms may have affected how some dealers behave in response to shocks, reducing market liquidity in some circumstances.

- The FPC emphasises that firms are able to draw down liquidity buffers and draw on Bank of England facilities to support market functioning through the cycle, as well as in a stress. The 2019 biennial exploratory scenario will be used to illustrate how liquidity buffers can be drawn down, how the Bank of England's facilities can be used, as well as how the PRA's approach to supervision would align with this.

### Vulnerabilities in open-ended funds

The FPC judges that the mismatch between redemption terms and the liquidity of some funds' assets means there is an advantage to investors who redeem ahead of others, particularly in a stress. This has the potential to become a systemic risk.

As part of the ongoing review by the Bank and FCA of open-ended funds, the FPC has established that there should be greater consistency between the liquidity of a fund's assets and its redemption terms. In that regard:

- Liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a representative sample (or vertical slice) of those assets or the time period needed for a sale to avoid a material price discount. In the US, the Securities Exchange Commission (SEC) has recently adopted measures of liquidity based on this concept.
- Redeeming investors should receive a price for their units in the fund that reflects the discount needed to sell the required portion of a fund's assets in the specified redemption notice period.
- Redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

In addition to enhancing financial stability, these changes should also promote funds' ability to invest in illiquid investments, helping to increase the supply of productive finance to the economy through business and financial cycles, in line with the Committee's secondary objective.

### Ensuring that rapidly evolving payment systems support financial stability

Innovation in payments could bring significant benefits for users.

At the same time, the ability to transact safely and smoothly is critical to financial stability and the regulatory framework will need to keep pace with innovation. HM Treasury's current review of the payments landscape is an opportunity to ensure that it can.

The FPC considers that the current framework will need adjustment in order to accommodate innovation in this sector. It has therefore developed the following approach that could usefully inform the Treasury review.

- Regulation of payments should reflect the financial stability risk, rather than the legal form, of payments activities. Firms that are systemically important should be subject to standards of operational and financial resilience that reflect the risks they pose.
- The systemic importance of any single firm should be informed by whether it is part of one or more systemic 'payment chains' — the set of activities necessary for a payment to be made — and whether its failure could disrupt the end-to-end chain. Innovation has made payment chains more complex. New firms, separate to regulated banks and payment systems have become involved in providing payment services and could become systemically important.
- In order to ensure the information necessary for regulation and supervision to be effective, all firms above a certain threshold carrying out the activities that make up the payment chain should provide sufficient information to support the identification of systemically important payments firms as they emerge.

In future, digital tokens known as stablecoins might increasingly be used to make payments. Stablecoin-based payment chains pose additional issues for regulation. In assessing how stablecoins should be treated in the regulatory framework, the FPC has

considered them against its principle that the regulation of payments activities should reflect the financial stability risks they pose, rather than their legal form. It judges that:

- Payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Firms in stablecoin-based systemic payment chains that are critical to their functioning should be regulated accordingly.
- Where stablecoins are used in systemic payment chains as money-like instruments they should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

**Libra is a high-profile example of a stablecoin proposal. It would have the potential to become systemically important. The regulatory framework that would apply to Libra must be clear and in place in advance of any launch.**

#### The transition away from Libor

Continued reliance of financial markets on Libor poses a risk to financial stability that can only be reduced through a transition to alternative risk-free rates. The intention is that sterling Libor will cease to exist after the end of 2021. No firm should plan otherwise.

Sterling markets show encouraging signs in the development of new products linked to the sterling overnight interbank average (SONIA), and the transition of some legacy products. But important gaps remain so these efforts will need to continue to accelerate in the first half of 2020.

- The UK industry working group for transition has set a target to cease issuance of cash products linked to sterling Libor by 2020 Q3. The FPC endorses this target and encourages all lenders and borrowers to take the necessary steps to prepare themselves to meet this timeline.
- The PRA and FCA have taken steps to ensure that each of the largest regulated firms has nominated a senior manager to be responsible for that firm's transition away from Libor, and the FPC considers this good practice for all firms with material Libor exposures.
- The Bank is currently reviewing its risk management approach to Libor-linked collateral delivered in its Sterling Monetary Framework.
- The FPC has also considered further potential supervisory tools that could be deployed by authorities to encourage the reduction in the stock of legacy Libor contracts to an irreducible minimum ahead of end-2021, and will keep this under review in light of progress made by firms in the transition.
- Compared to progress in sterling Libor markets, transition remains further behind in US dollars, the largest Libor market.