BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

Financial Policy Committee Statement from its policy meeting, 3 October 2018

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 3 October, the FPC reviewed developments since its meeting on 19 June.

Risks to UK financial stability from Brexit

The FPC continues to judge that the UK banking system would be strong enough to serve UK households and businesses through a disorderly, cliff-edge Brexit.

- Consistent with its remit to ensure the financial system is resilient to major shocks, the FPC continues to review estimates of possible 'worst case' economic outcomes associated with Brexit, however unlikely they may be.

- The FPC continues to judge that the 2017 stress test encompassed an appropriately wide range of UK macroeconomic outcomes that could be associated with Brexit. As it has set out previously, the FPC judges that Brexit risks, including those of a disorderly, cliff-edge Brexit in which there was no agreement or implementation period, do not warrant additional capital buffers for banks.

- The 2017 stress test scenario included the UK unemployment rate rising to 9.5%, UK residential property prices falling by 33% and UK commercial real estate prices falling by 40%. It also included a sudden loss of overseas investor appetite for UK assets, a 27% fall in the sterling exchange rate index and Bank Rate rising to 4%.

The UK banking system lies at the core of the UK financial system. Reflecting the substantial increase in its resilience over the past decade, the UK banking system now has the capacity to absorb, in addition to a disorderly, cliff-edge Brexit, further misconduct costs and stresses that could arise from intensifying trade tensions and a further sharp tightening of financing conditions for emerging markets.

- At 16.8%, the aggregate Tier 1 capital ratio of the major UK banks is around three times that of ten years ago. Losses on a scale that would have wiped out the common equity capital base of the system in 2007 can now be readily absorbed by available capital.

An implementation period would reduce the risks of disruption to the supply of financial services to UK and EU households and businesses as the UK exits the EU. The FPC has been monitoring risks of disruption that could arise in the absence of an implementation period or any other agreement (see the updated checklist in Table 1). There has been considerable progress in the UK to address these risks, but only limited progress in the EU. In the limited time remaining, it is not possible for companies on their own to mitigate fully the risks of disruption to cross-border financial services. The need for authorities to complete mitigating actions is now pressing.

- The UK government is taking forward legislation that will allow UK households and businesses to continue to access financial services provided by EU companies. That legislation needs to be passed by Parliament prior to Brexit to be effective.

- EU or member state rules will restrict EU households and businesses from continuing to use some financial services provided by UK firms. In some cases, particularly in insurance, UK financial companies are restructuring so they can continue to serve their EU customers post Brexit. However, actions by firms alone can be only partially effective.

- Timely action by EU authorities is needed to mitigate risks to financial stability, particularly those associated with derivative contracts and the transfer of personal data.

- Absent action by EU authorities, EU rules create legal uncertainty about whether EU clearing members could continue to meet their ongoing obligations to UK CCPs and about the consequences for UK CCPs of continuing to provide services to the EU. To ensure the safe operation of CCPs and avoid financial stability risks, particularly in a stress, the contracts EU clearing members have with UK CCPs will need to be closed out, or transferred, before March 2019. This will be costly to EU businesses and could strain capacity in the derivatives market.

Irrespective of the particular form of the UK'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. 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.

The outlook for UK financial stability and the UK countercyclical capital buffer rate decision

The FPC continues to judge that, apart from those related to Brexit, domestic risks remain at a standard level overall.

- Levels of household and corporate debt in the UK relative to incomes remain materially below their 2008 levels but remain high by international and historical standards. However, debt servicing burdens remain low.
- Over the past year, the debt of UK households and businesses has grown only a little faster than nominal GDP.

The risk appetite of creditors remains strong. But financial conditions have tightened over the course of the year and borrower demand has been restrained. As a consequence credit growth has slowed.

- Although financing conditions have tightened, they remain accommodative for large companies. The extra compensation investors demand for the market and credit risk in corporate bonds is compressed.
- The stock of bonds issued by UK companies has increased by around 3% in the past 12 months. Borrowing by UK companies from UK banks has also been subdued, rising by just 2.7% in the past year.
- In the mortgage market, the additional interest rate charged on a 90% LTV mortgage compared to a 75% LTV mortgage has compressed and the proportion of new mortgage lending at LTV ratios above 90% has further increased to 17.8% in 2018 Q2.
- Despite these very attractive terms, household mortgage borrowing increased by only 3.1% in the year to August, broadly in line with household disposable income growth. Soft demand may reflect affordability challenges and uncertainty.

The Committee is concerned by the rapid growth of leveraged lending, including to UK businesses. The FPC will assess any implications for banks in the 2018 stress test and also review how the increasing role of non-bank lenders and changes in the distribution of corporate debt could pose risks to financial stability.

- The global leveraged loan market[1] is larger than – and growing as quickly as – the US subprime mortgage market was in 2006. The Committee is reviewing the implications for UK financial stability more intensively, even though it recognises that there are important differences between these two markets, for example with less reliance now on short-term wholesale funding.

- In common with the US and Europe, high investor demand has driven strong growth in UK leveraged loans. Lending terms have loosened with the proportion of UK leveraged loans with maintenance covenants falling from close to 100% in 2010 to around 20% currently. Gross issuance of leveraged loans by UK non-financial companies reached a record level of £38 billion in 2017 and a further £30 billion has already been issued in 2018. Taking high-yield bonds and leveraged loans together, the estimated stock of debt outstanding in UK non-investment grade firms is now estimated to account for about 20% of total UK corporate sector debt.

- Leveraged loans are typically sold to non-bank investors (including to collateralised loan obligation funds), whose ability to sustain losses without materially impacting financing conditions is uncertain. However, banks retain some exposure and make other loans to the same highly indebted companies. The FPC is therefore assessing the implications of rapid growth of leveraged lending for both non-banks and banks.

Given the current balance of risks, the FPC is maintaining the UK countercyclical capital buffer (CCyB) rate at 1%. The FPC will conduct, as normal, a comprehensive assessment of the resilience of the UK banking system in the 2018 stress test and review the adequacy of the 1% CCyB rate at its meeting on 28 November.

Risks to the UK from global vulnerabilities remain material. Accordingly, the 2018 stress scenario incorporates a synchronised global downturn in output growth.

- The tightening of US monetary policy that began in December 2015 has begun to contribute to a tightening in global financial conditions, particularly over the past six months in emerging market economies.

[1] Although there is no standard definition of leveraged loans, the term typically refers to loans to firms who have a non-investment grade rating and are highly indebted or are owned by a private equity sponsor.

- The most acute market pressures to date have focused on Turkey and Argentina, which have large current account deficits and high levels of debt. But a more widespread change in risk appetite could expose broader vulnerabilities, including for other emerging market economies with high debt levels and large current account deficits.

- The imposition of trade barriers by the US and China, although detrimental to the outlook for global growth, does not itself pose a material risk to UK financial stability. But deepening tensions could trigger a further and more severe tightening of global financial conditions. They could also encourage China to ease domestic financial conditions and, in doing so, encourage a further build-up of risks.

- Recent further increases in Italian government bond yields underline the vulnerabilities created by high public debt levels and interlinkages between banks and sovereigns in the euro area.

- Risks from the US corporate sector remain material, as leverage has continued to increase and underwriting standards have loosened further.

The 2019 biennial exploratory scenario

Recognising the deployment of resources both within the Bank and at private institutions to prepare for Brexit, the FPC and Prudential Regulation Committee have decided to delay the Bank's launch of the next biennial exploratory scenario to September 2019. The Bank expects to publish the results of this exercise alongside the *Financial Stability Report* in June 2020.

Table 1 Checklist of actions to avoid disruption to end-users of financial services during Brexit

Consistent with its statutory responsibility, the FPC continues to identify and monitor UK financial stability risks associated with Brexit so that preparations can be made and actions taken to mitigate them.

This checklist reflects the risk of disruption to end users, including households and companies, if barriers emerge to cross-border trade in financial services. The risk assessment takes account of progress made in mitigating any risks. It assesses risks of disruption to end users of financial services in the UK and, because the impact could spill back, also to end users in the EU.[1]

Risks of disruption are categorised as low, medium or high. Arrows reflect developments since June. Blue text is news since the FPC's previously published checklist in the June *Financial Stability Report*.

The checklist is *not* a comprehensive assessment of risks to economic activity arising from Brexit. It covers only the risks to activity that could stem from disruption to provision of financial services.

Legal frameworks

	Risk to UK	Risk to EU	
Ensure a UK legal and regulatory framework is in place			Much of the UK's legal and regulatory framework for financial services is derived from EU law. Changes will need to be made to the domestic legal framework to make it workable when the UK is no longer a member of the EU. The EU (Withdrawal) Act has come into force. HM Treasury is legislating for the necessary secondary legislation. The instruments establishing the Temporary Permissions and Recognition Regimes have been presented to Parliament.
Implementation period to allow mitigating actions by firms			Financial institutions will need time to obtain necessary regulatory permissions and complete any necessary restructuring of their operations and re-papering of contracts. In March, the UK Government and European Commission negotiated a political agreement on an implementation period that will form part of the Withdrawal Agreement, elements of which are still in negotiation. Once finalised and ratified, this would reduce all of the risks set out in the FPC's checklist.

Preserving the continuity of outstanding cross-border contracts

	Risk to UK	Risk to EU	
Insurance contracts			The UK government is legislating to ensure that the 16 million insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced by those EU companies after Brexit. That legislation needs to be passed by Parliament prior to Brexit to be effective. EU or member state rules may prevent UK insurance companies collecting premiums from, or paying claims to, their 38 million policyholders in the EU. Most UK insurance companies are making good progress in restructuring their business in order to serve their EU customers after Brexit. If all current plans are delivered successfully, the number of EU policyholders at risk will fall to 9 million. However, given the volume of restructuring and the process of court approval of plans, there are material execution risks.
OTC derivative contracts (uncleared)			In the absence of action certain 'lifecycle'[2] events could not be performed on cross-border derivative contracts after Brexit. This could compromise the ability of derivative users to manage risks and therefore amplify any stress around the UK's exit from the EU. The UK government is legislating to ensure that these lifecycle events can continue to be performed after Brexit on derivative contracts that UK clients have with EU banks. That legislation needs to be passed by Parliament prior to Brexit to be effective. Once passed, UK clients, such as non-financial companies and asset managers, will avoid disruption to their derivative contracts. However, national rules in some EU member states may prevent certain lifecycle events being performed on derivative contracts that EU clients and banks have with UK banks. These affected contracts account for the majority of (uncleared) derivatives between the EU and UK, which have a total notional value of £30 trillion, of which an increasing share (£18 trillion) matures after March 2019. These restrictions will affect the ability of EEA clients and banks, and of UK banks that have the contracts with them, to manage risks in stress.

(1) In most cases, the impact on EU end users will apply to the wider European Economic Area (EEA).
(2) These lifecycle events include amendments, compressions, rolling of contracts, or exercise of some options.

Preserving the continuity of outstanding cross-border contracts continued

Risk to UK | Risk to EU

OTC derivative contracts (cleared)

The UK government is legislating to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses. That legislation needs to be passed by Parliament prior to Brexit to be effective.

Under EU law, after March 2019 EU clearing members will be acting unlawfully if they access clearing services from UK central counterparties (CCPs), and UK CCPs will not be permitted to provide such services, unless they are recognised by the European Securities and Markets Authority.

There is therefore legal uncertainty about whether EU clearing members could continue to meet their ongoing obligations to UK CCPs under existing contracts. Any inability to meet obligations would jeopardise the safe operation of CCPs, particularly in an episode of stress. This would amplify any stress around Brexit and increase financial stability risks. There is also uncertainty under EU law and member state law as to the legal consequences for UK CCPs of continuing to provide services to EU clearing members in relation to existing contracts.

Absent action by EU authorities to address these issues, the contracts EU clearing members have with UK CCPs will need to be closed out, or transferred, before March 2019. The ECB estimates EU-based firms clear 90% of their interest rate swaps in the UK. Overall, EU-based firms have OTC derivative contracts with a notional value of £69 trillion at UK CCPs, an increasing share (£41 trillion) of which matures after March 2019. The movement of a large volume of contracts in a short time frame would be costly to, and disrupt the derivatives positions of, EU businesses and could strain capacity in the derivatives market. In addition, fragmentation of central clearing would raise costs for EU businesses. Industry estimates suggest that every single basis point increase in the cost of clearing interest rate swaps alone could cost EU businesses around €22 billion per year.

Avoiding disruption to availability of new financial services

Risk to UK | Risk to EU

Clearing services

The UK government is legislating to ensure that UK firms can continue to use clearing services provided by EU-based clearing houses. That legislation needs to be passed by Parliament prior to Brexit to be effective.

Under EU law, EU-based clearing members and trading venues may only access clearing services from UK CCPs after March 2019 where those CCPs are recognised by the European Securities & Markets Authority. Without such recognition, EU customers would need to make new arrangements with CCPs authorised or recognised by the EU authorities. This creates material risks of disruption to those EU customers.

Banking services

The UK government is legislating to ensure that UK households and businesses can continue to be served by EU-based banks after Brexit. That legislation needs to be passed by Parliament prior to Brexit to be effective.

EU or member state rules may prevent EU customers from accessing UK-based banks. EU households and businesses currently rely on UK banks for around half of their wholesale banking services. Although UK banks are in the processes of restructuring and obtaining necessary regulatory permissions to set up operations in the EU, there remain material risks of disruption to EU households and businesses.

Asset management

The UK government is legislating for a temporary permissions regime to ensure that funds domiciled in the EEA can be marketed to investors in the UK. That legislation needs to be passed by Parliament prior to Brexit to be effective.

EU rules allow asset managers to delegate the management of their assets to entities outside the EEA when a co-operation agreement is in place between the authorities. In the absence of a co-operation agreement, there is a risk of changes to asset managers' businesses that could be disruptive.

Personal data

The UK government has announced its intention at the point of exit to continue to allow the free flow of personal data from the UK to the EU. Once in effect, this would allow the transfer of personal data to the EU, supporting UK households and businesses in accessing services from, and continuing contracts with, EU financial service providers.

Without equivalent action by EU authorities, EU rules would restrict the flow of personal data from the EU to the UK. This could restrict EU households and businesses in accessing financial services from, and continuing contracts with, UK financial service providers. Although companies can add clauses into contracts in order to comply with the EU's cross-border transfer rules, these are subject to some legal and operational risk.