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Financial Policy Committee Statement from its policy meeting, 12 March 2018

At its meeting on 12 March, the Financial Policy Committee (FPC) reviewed the outlook for UK financial stability, risks to UK financial stability from Brexit, and risks from crypto-assets. The FPC also finalised the main elements of the design of the 2018 stress test of major UK banks.

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 standard overall, and that risks from global vulnerabilities remain material.

While the outlook for global growth has strengthened further, there are material risks associated with interest rate volatility. The principle risks are in debt markets. Across major markets, spreads between corporate and sovereign bond yields remain compressed, particularly for high-yield corporate bonds.

Against that market backdrop, risks stemming from corporate debt in the United States have continued to build. Financial vulnerabilities in China remain elevated.

In the United Kingdom, aggregate private (non-financial sector) debt has increased only a little faster than GDP over the past couple of years and, relative to incomes, remains well below pre-crisis levels. Debt-servicing costs, for both households and companies, are low.

However, the Committee noted some signs of rising domestic risk appetite in recent quarters. Gross issuance of leveraged loans and high-yield bonds by UK companies increased in 2017. Valuations in some segments of the UK commercial real estate sector appear stretched. In the mortgage market, the proportion of new owner-occupier mortgages at high loan-to-income ratios, including just below 4.5 (the level at which the FPC's limit on the flow of new mortgages applies), has increased, and spreads between mortgage rates and risk-free rates have tightened.

In addition, the United Kingdom's current account deficit remains large by international standards. And over recent quarters this deficit has been increasingly funded by capital inflows (rather than sales of foreign assets by UK residents), thus increasing the UK's reliance on the confidence of foreign investors.

Balancing all these factors, the FPC is setting the UK countercyclical capital buffer (CCyB) rate at 1%, unchanged from November. The Committee will reconsider the adequacy of the 1% CCyB rate in June with a particular focus on the evolution of domestic risk appetite.

Risks to UK financial stability from Brexit

Consistent with its statutory duties, 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.

The FPC continues to judge that the 2017 stress test encompassed a wide range of UK macroeconomic outcomes that could be associated with Brexit. **The UK banking system could continue to support the real economy through a disorderly Brexit.**

As the FPC noted in November 2017, the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could, however, result in more severe conditions than in the stress test. At the time, the FPC judged that the likelihood of this combination occurring simultaneously could be seen as extremely remote. Reflecting the resilience of major UK banks, which have an aggregate Tier 1 capital ratio of 16.8%, **the FPC judged that Brexit risks did not warrant additional capital buffers for banks. Developments since November have not changed this assessment.**

Brexit could also disrupt the financial system directly. The November *Financial Stability Report* outlined the main cross-cutting issues and a checklist of actions that would mitigate risks of disruption to important financial services used by households and businesses.

Since November, in the United Kingdom, progress has been made towards mitigating risks of disruption to the availability of financial services. Nonetheless, material risks remain, particularly in areas where actions would be needed by both the UK and EU authorities – as set out in Annex 1. The FPC re-emphasises the importance that preparations continue to be made and actions taken by relevant authorities to tackle these risks.

Crypto-assets

The Committee recognises the potential benefits of the technologies underlying crypto-assets and of their potential to create a more distributed and diverse payments system. It welcomes the work of the Bank and other authorities to explore ways of achieving these benefits in a robust and efficient manner.

The FPC judges that existing crypto-assets do not currently pose a material risk to UK financial stability – as set out in Annex 2. The FPC will act to ensure the core of the UK financial system remains resilient if linkages between crypto-assets and systemically important financial institutions or markets were to grow significantly. In the event that one or more crypto-assets were likely to become widely used for payments, or as an asset intended to store value, the FPC would require current financial stability standards to be applied to relevant payments and exchanges.

The 2018 stress test of major UK banks

The 2018 stress test scenario will be the same as that used in 2017. It is therefore more severe than the global financial crisis. The use of the same stress scenario will allow the Bank to isolate, as far as possible, the impact on the stress test results of the new accounting standard which came into effect on 1 January 2018 (International Financial Reporting Standard 9, or IFRS 9). The consistency of the scenario also recognises the deployment of resources both within the Bank and at private institutions in 2018 to prepare for Brexit and the introduction of ring-fencing requirements on 1 January 2019. The calibration of the stress scenario remains appropriate given the current risk environment. In 2019 the stress test scenario will be updated in line with the Bank's usual approach.

The hurdle rates for the 2018 test will evolve from those used in earlier years. The Bank will hold banks of greater systemic importance to higher standards: each participating bank will now be assessed against single risk-weighted capital and leverage hurdle rates that incorporate any buffers to reflect their systemic importance. These will now include, for the first time, capital buffers for domestic, as well as global, systemic importance. In addition, adjustments will be made to hurdle rates to reflect the increased loss absorbency that will result from higher provisions in stress under the new IFRS 9 accounting standard.

These changes are set out in *Stress testing the UK banking system: key elements of the 2018 stress test* – available at: https://www.bankofengland.co.uk/news/2018/march/key-elements-of-the-2018-stress-test.

Annex 1: Risks to the provision of financial services from Brexit

Consistent with its statutory duties, 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. Through this, the FPC is aiming to promote an orderly adjustment to the new relationship between the United Kingdom and the European Union.

There are a range of possible outcomes for the future UK-EU relationship. Given its remit, the FPC is focused on outcomes that could have most impact on financial stability. That includes outcomes in which there are barriers to providing financial services across the UK-EU border in the same way as they are provided today.

In November, the Committee outlined a checklist of actions that would mitigate risks of disruption to important financial services used by households and businesses to support their economic activity.

Although focused on the availability of financial services to end users in the United Kingdom, where appropriate the FPC also considers risks of disruption to services available to end users in the European Union because the impact of that could spill back to the UK economy.

The checklist covers:

- Ensuring the UK legal and regulatory framework is in place;
- Timely agreement on an implementation period to allow firms to maximise their own preparations;
- Actions to ensure the continuity of existing cross-border contracts; and
- Actions to avoid disruption to new services in the presence of barriers to cross border financial service provision and data sharing.

The FPC is tracking progress against the checklist. Its judgements are summarised in the table below, which the Committee intends to update and publish quarterly from this point.

The checklist is not a comprehensive assessment of risks to economic activity arising from Brexit. It covers only the risks identified to date that could stem from disruption to the availability of financial services. There are also other risks to economic activity that could arise as a result of, for example, restrictions on exports of goods and services or a reduction in the appetite of foreign investors to provide finance to the United Kingdom. The FPC has considered these separately and concluded that its stress test scenario for major UK banks encompasses a wide range of UK macroeconomic outcomes that could be associated with Brexit.

FPC judgement of progress against actions to mitigate the risk of disruption to end users of financial services as at 12 March 2018.

Notes: Risks are categorised as low, medium or high. The judgement reflects the underlying scale of disruption to end users and probability of that materialising, taking account of progress made in mitigating actions. Arrows reflect developments since November. A downward arrow indicates a reduction in risk. Blue text denotes news since November.

Legal frameworks

	Risk to UK	Risk to EU	
Ensure 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. Directly applicable EU law will need to be brought into UK law. Changes will need to be made to the resulting legal framework to make it workable when the UK is no longer a member of the EU. The Government plans to achieve this with the EU Withdrawal Bill and related secondary legislation. The Bill continues to progress through Parliament and is now under scrutiny in the House of Lords. HM Treasury has begun drafting the secondary legislation, including the highest priority for early progress (e.g. those delivering the temporary permissions regimes).
Implementation period to allow mitigating actions by firms			Financial institutions will need time to complete any necessary restructuring of their operations, re-papering of contracts and obtain necessary regulatory permissions. Timely agreement on an implementation period would significantly reduce all of the risks set out below. In December, the European Council agreed that "sufficient progress" had been made in the first phase of negotiations, such that they could move on to transitional arrangements and the framework on the future relationship. Negotiations between the UK and EU are ongoing.

Preserving the continuity of outstanding cross-border contracts

	Risk to UK	Risk to EU	
Insurance contracts			Insurers in the UK and the European Economic Area (EEA) may not be able to pay claims to, or receive premiums from, policyholders in the other jurisdiction. Based on latest data, this could affect around £27 billion of insurance liabilities and 10 million UK policyholders. Around £55 billion of insurance liabilities and 38 million EEA policyholders could also be affected. On 20 December 2017 the UK Government committed to legislate, if necessary, to allow EEA insurance companies to continue to service insurance policies held by UK-based customers (through a temporary permissions regime and additional legislation). EEA customers are currently reliant on their UK insurance company transferring existing contracts to legal entities located in the EU.
Derivative contracts (uncleared)			UK and EEA parties may no longer have the necessary permissions to service over-the-counter (OTC) derivative contracts with parties in the other jurisdiction. Around a quarter of contracts entered into by parties in both the UK and EEA, with a notional value of £26 trillion, could be affected. The UK Government committed on 20 December to legislate, if necessary, to allow EEA counterparties to service contracts with UK entities (through a temporary permissions regime and additional legislation if required). However, the majority of contracts also require the UK counterparty to have permission from the EEA. EU authorities have not announced their intention to grant such permissions.
Derivative contracts (cleared)			Many major UK and EEA counterparties are obliged to clear contracts in certain products using central counterparties (CCPs) that are authorised or recognised under EU legislation. EEA banks and their clients currently rely heavily on CCPs based in the UK. The ECB estimates that UK CCPs clear approximately 90% of euro denominated interest rate swaps used by euro-area banks. A loss of recognition could interfere with EEA clearing members' ability to meet existing contractual obligations to the CCP. Migration of existing contracts to address this would be complex and difficult to achieve. The notional amount of outstanding cleared OTC derivative contracts that could be affected is over £70 trillion (around £27 trillion of which matures after 2019 Q1). The Bank of England is in active discussions with UK CCPs on options to address these risks.

Avoiding disruption to availability of new financial services

	Risk to UK	Risk to EU	
Clearing services			In the absence of an agreement or recognition by ESMA of UK CCPs (see above), EEA banks and their clients will need new arrangements for future clearing services with other CCPs. Given their current heavy reliance on UK CCPs, this could disrupt the availability of services to EEA end-users. UK banks use EU-based CCPs for some clearing activities. The UK Government has committed to legislate regarding the recognition of non-UK CCPs so that they would continue to be able to provide clearing services to UK banks if necessary to avoid disruption.
Banking services			EEA businesses rely on UK-based banks for certain services. UK-incorporated banks provide around half of wholesale banking services used by EEA customers. Disruption to this would create risks to the availability of services to end users in the EEA. To continue providing these services, some UK-based banks are in the process of undertaking restructuring and obtaining necessary regulatory permissions for EU subsidiaries. There are 77 branches of EEA banks operating in the UK under the current 'passporting' regime. These provide services to both UK and EEA end users. These firms will require new regulatory permissions from the Prudential Regulation Authority (PRA) after Brexit. The PRA has announced that it intends to permit branch structures for banks that are not conducting material retail business and where sufficient supervisory cooperation and assurance on resolution exists. The UK Government has committed to legislate, if necessary, for a temporary permissions regime that would enable EEA banks to continue to operate pending authorisation should a fallback be required.
Asset management			Delegation of fund management across borders is a global practice. It is estimated that the management of around 10% of funds domiciled in non-UK EEA countries is undertaken in the UK. The management of at least an additional estimated 20% of funds domiciled in these countries is delegated to countries outside the EEA and UK. Restrictions on this delegation could require disruptive changes to asset managers' business models. Both EU and UK investors use funds domiciled in the EU. Further, asset managers require authorisation to market funds across borders. To enable funds domiciled in the EU to continue to be marketed to investors in the UK, the UK government has committed to legislating for a temporary permissions regime if necessary.
Personal data			Even with the necessary regulatory permissions, the ability of financial companies to carry out both new and existing financial services may be impaired by barriers to the cross-border flow of personal data between the UK and EEA. These barriers could disrupt firms' ability to service EEA clients from their data centres, which are typically located in the UK. This risk could be mitigated if the UK and EU were to recognise each other's data protection regimes as 'adequate'. The UK Government has indicated it is pursuing such an EU-UK agreement. Companies can also take steps to mitigate this risk by, for example, introducing new clauses into contracts that permit data transfer, but this solution may not be comprehensive or completely effective.

Annex 2: Crypto-assets

The Committee recognises the potential benefits of the technologies underlying crypto-assets and of their potential to create a more distributed and diverse payments system.

- It is important to distinguish the crypto-assets themselves from the distributed ledger and cryptographic technologies upon which many of them rely. These underlying technologies have significant potential and, over time, could have material benefits, including for the efficiency and resilience of the financial system.
- Banks are already working to apply new technologies to wholesale markets and banks and payment providers are innovating to improve the speed and efficiency of payments.
- The FPC welcomes the work of the Bank and other authorities to explore ways of achieving these benefits in a robust and efficient manner.

The FPC judges that existing crypto-assets do not currently pose a material risk to UK financial stability.

- In contrast to the underlying technologies, crypto-assets that use them may have limited utility. Their values are currently too volatile to be widely used as a currency or a store of value and, with transaction costs high and settlement times slow, they are an inefficient media of exchange. Their use in payments is minimal in the United Kingdom.
- They should be considered as assets rather than currencies. However, as assets, they establish no claim on any future income streams or collateral. They have no intrinsic value beyond their currently limited potential to be adopted as money in the future, and hence could prove worthless.
- Nevertheless, the UK financial system is resilient to this risk. The total stock of crypto assets is small relative to the financial system. Even at their recent peak, the combined global market capitalisation of crypto-assets was less than 0.3% of global financial assets. Systemically important UK financial institutions currently have negligible exposures to these assets and to the system around them.

The FPC will aim to ensure the core of the UK financial system remains protected if linkages between crypto-assets and systemically important financial institutions or markets were to grow significantly.

- The FPC will continue to monitor exposures – both direct and indirect – of UK banks and insurers, including any arising through derivatives or through exposure via counterparties.
- The FPC welcomes the intention of the Prudential Regulation Authority to assess how existing requirements – including those for capital – will apply to crypto-asset exposures.

In the event that one or more crypto-assets were likely to become widely used for payments, or as an asset intended to store value, the FPC would require current financial stability standards to be applied to relevant payments and exchanges.

- In this event, financial stability could be affected both directly – if payments or asset markets were to be disrupted – and indirectly – through confidence effects on the wider financial system. Financial stability standards should address both of these channels.
- If needed, the FPC will consider recommending to HM Treasury that the regulatory perimeter be expanded.
- Material improvements in the integrity of the crypto-asset ecosystem, including a strengthening in cyber defences of exchanges, and systems and controls more generally, would be required to meet the standards to which payments and trading infrastructure is currently held.

Crypto-assets also raise a number of other public policy concerns, many outside the purview of the Committee.

- These include consumer and investor protection, market integrity, and the potential to facilitate money laundering and terrorism financing.
- It is possible, if the use of crypto-assets were to increase substantially, that these issues could also pose risks to confidence in the financial system.
- Given the international nature of the market, the Committee welcomes forthcoming discussions at the Financial Stability Board and G20 on these issues.

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