Publication date: 5 April 2016

RECORD OF THE FINANCIAL POLICY COMMITTEE MEETING

23 MARCH 2016

This is the record of the Financial Policy Committee meeting held on 23 March 2016.

It is also available on the Internet:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1604.pdf

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is established as a sub-committee of the Bank of England's Court of Directors.

The FPC's next policy meeting will be on 28 June 2016 and the record of that meeting will be published on 12 July.

RECORD OF FINANCIAL POLICY COMMITTEE MEETING HELD ON 23 MARCH 2016

At its meeting on 23 March, the Financial Policy Committee made no new Recommendations and considered that its Recommendation (15/Q2/2) on the use of Additional Tier 1 capital to meet minimum leverage ratio requirements had been implemented.

The FPC increased the countercyclical capital buffer rate for UK exposures from 0% to 0.5%.

1. The Committee met on 23 March to agree its view on the outlook for financial stability and, on the basis of that, its intended policy actions. It assessed the outlook for financial stability by identifying the risks faced by the financial system and weighing them against the resilience of the system.

Risks to financial stability

2. The Committee reviewed financial system and economic developments since its meeting in November 2015.

Global economy and financial markets

3. The global macroeconomic environment had continued to be challenging and risks had increased since November. Some previously identified risks had crystallised and others had increased.

4. Market prices had been volatile and the global growth outlook had deteriorated somewhat. Global growth appeared to have slowed in the last quarter of 2015. Around the turn of the year, there had been a continuation of outflows of capital from emerging market economies (EMEs) and widespread falls in the price of risky assets. Reflecting in part these developments, the Monetary Policy Committee's latest forecast had included a modest downward revision to global growth prospects. In the weeks in the run up to the Committee's meeting, earlier declines in risky asset prices had partly reversed as authorities had taken further action to boost growth, commodity prices had stabilised and China's exchange rate policy had been clarified. A substantial fall in advanced economy government bond yields had persisted.

5. Overall, the net effect of these market moves had been that the premia attached to risky assets had increased since November. Chinese equities were around 15% below their end-November level and, despite additional support from lower long-term interest rates, advanced economy equities had fallen slightly. Some market-based measures of liquidity premia had increased since November. At its previous meeting, the Committee had noted that there had been evidence that market and liquidity risks were not fully reflected in the prices of some financial assets. The market moves since then had, to some extent, reflected a crystallisation of these risks.

6. In an environment of low inflation and continued weakness in investment and productivity growth, prospects for global nominal growth were subdued. Global nominal GDP growth had fallen to around 4% in 2015. This raised questions about resilience to future adverse shocks, particularly for EMEs where debt levels continued to rise and terms of trade had deteriorated. In general, levels of private and public indebtedness for periphery euro-area economies remained high. Negotiations between Greece and its European partners continued. Debt repayments were due to step up in the summer. In some advanced economies, lower nominal interest rates associated with weak growth prospects were restraining profitability in banking systems that were still in post-crisis repair and posed challenges for some banking business models. Globally, bank equity prices had fallen significantly; despite the recovery since mid-February, equity prices for US and European banks were around 20% below their November levels. A material proportion of banks were trading below book value.

7. In this environment of weaker nominal growth, the reacceleration of credit growth in China was concerning. Borrowing by non-state entities, as measured by total social financing, had grown by around 13% in the twelve months to February, around double the equivalent growth rate for nominal GDP. The gap in China between the ratio of credit to GDP and its long-term trend was now approaching 30%. Though pressure on their exchange rate had now receded, China's foreign exchange reserves had fallen by $320bn since end October.

UK property markets

8. Growth in mortgage lending had continued to be driven by the buy-to-let sector. The outstanding stock of buy-to-let mortgages, by value, had risen by 11.5% in the year to 2015 Q4, while the stock of lending to owner occupiers was unchanged. There had been a further increase in the number of buy-to-let mortgages of 6% in January, compared to December 2015, ahead of planned changes to stamp duty. Buy-to-let mortgages now accounted for 17%, by value, of the stock of total secured lending.

9. The FPC remained alert to potential threats to financial stability arising from rapid growth in buy-to-let mortgage lending. The macroprudential risks centred on the possibility that buy-to-let investors could behave pro-cyclically, amplifying cycles in the housing market as a whole. This behaviour could put upward pressure on household indebtedness in an upswing and have an impact on consumption and broader economic activity in a downturn, as well as affecting the

resilience of the banking system and its capacity to sustain lending to the wider real economy in a stress.

10. Since the FPC met in November, the PRA had undertaken a review of lenders' underwriting standards in the buy-to-let market. The review had assessed the lending plans of the top 31 lenders in the industry, which represented over 90% of total buy-to-let lending. It had revealed that some lenders were applying standards that were somewhat weaker than those prevailing in the market as a whole. A number of these lenders and other firms planned to grow their gross buy-to-let lending significantly over the next three years; there was therefore some risk that competitive conditions would lead more firms to relax underwriting standards to meet these plans.

11. In response to the review, the PRA Board planned to issue a Supervisory Statement to clarify its expectations for underwriting standards in the buy-to-let market. This would include guidelines for testing the affordability of interest payments, including a minimum stressed interest rate to be used when lenders were conducting affordability tests.

12. The FPC welcomed and supported the Supervisory Statement. The PRA's action was a prudent supervisory measure intended to bring all lenders up to prevailing market standards. It would guard against any slipping of underwriting standards that could threaten the safety and soundness of firms, during a period in which rapid growth plans could be challenged by the impact of changes to the taxation of buy-to-let house purchases and mortgage interest tax relief for landlords.

13. In the Supervisory Statement, the PRA Board had set the baseline minimum stressed interest rate to be used in the affordability test at the greater of 5.5% or a 200 basis points increase in buy-to-let mortgage interest rates. Although this was lower than the interest rate stress applied to owner-occupied lending under the FPC's June 2014 Recommendation, lenders tended to assess affordability for buy-to-let mortgages using interest cover ratios of at least 125%. In addition, loan-to-value ratios at origination in excess of 75% were less common in buy-to-let mortgages than in owner-occupied mortgages. Buy-to-let loans therefore typically started with a larger equity cushion for lenders, which reduced the associated credit risk in the first few years of the loan given that these loans were typically non-amortising.

14. The PRA's Supervisory Statement would provide a mechanism by which the FPC could set further guidance on the appropriate minimum stressed interest rate to be used in affordability tests, if it deemed it appropriate to do so for macroprudential reasons.

15. The FPC considered that no action beyond the PRA Supervisory Statement was warranted at this stage for macroprudential purposes. The growth of buy-to-let mortgage lending was likely to slow in Q2 as changes to stamp duty took effect. Looking ahead, the combination of forthcoming changes to mortgage interest tax relief and the implementation of the PRA Supervisory Statement would probably dampen growth of buy-to-let mortgage lending relative to lenders' plans. It was important to see how these developments affected the market and the FPC therefore agreed it would not take action now. But it would continue to monitor closely these developments and potential threats to financial stability from the buy-to-let mortgage market.

16. HM Treasury had consulted on giving powers of direction to the FPC on buy-to-let mortgage lending, and would respond to that consultation, including with final secondary legislation, in due course. The FPC would prepare a statement of its policy for the use of powers of direction ahead of any such powers being approved by Parliament.

2016 stress test scenario

17. These global and domestic risks would be reflected in the 2016 stress test scenario for major UK banks. The stress test, designed and calibrated by Bank staff under the guidance of the FPC and PRA Board, was due for publication shortly after the FPC's policy meeting. As in previous years, the stress test scenario did not represent a forecast of what was likely to happen; rather it was a coherent tail risk event, against which to test the resilience of the banking system as a whole and the individual banks within it.

18. This was the first annual stress test scenario that was being designed under the Bank's new 'Annual Cyclical Scenario' (ACS) framework. Under this ACS approach, the severity of the stress test would vary each year linked to the FPC's assessment of risk across various markets and regions. When risks were assessed to be around their standard level, neither elevated nor subdued, the stress scenario would generally be severe and broad, in order to assess the resilience of major UK banks to tail risk events. In addition, where risks were judged to be heightened, the related aspects of the test would be more severe, and *vice versa*.

19. With this in mind, the calibration of the 2016 scenario would reflect the FPC's judgements that global risks were heightened, particularly in China and some other EMEs, and that, overall, domestic risks to the UK banking system had risen beyond their subdued levels in the immediate post-crisis period, but were not yet elevated.

20. The FPC agreed that the stress scenario should incorporate a synchronised global downturn in output growth, linked to the crystallisation of several vulnerabilities. This would be associated with a deterioration in market sentiment and a reduction in investors' risk appetite. A number of emerging market currencies would depreciate against the US dollar, and risky asset prices would fall sharply. Interest rates facing households and businesses would increase in the early part of the stress, partly reflecting a rise in term premia on relatively safe long-term government debt. Credit spreads on more risky assets such as corporate bonds would rise sharply too. Bank funding spreads would also increase. Although policymakers would pursue additional monetary stimulus, which would start to reduce long-term interest rates, the overall cost of credit would rise in the short term. Equity prices would fall materially. In common with other risky assets, property prices would be assumed to fall globally. Reflecting heightened risks, falls in economic growth and property prices for China and Hong Kong would be particularly pronounced.

21. In the United Kingdom, under the scenario residential property prices would fall by 31% and commercial property prices by 42%. The combined impact of increases in the cost of credit, the contraction in world demand, falls in asset prices and heightened uncertainty would have a pronounced impact on domestic growth. The level of UK GDP would fall by 4.3%, accompanied by a 4.5pp rise in unemployment. As in 2015, the test would require banks to satisfy the assumed demand for credit from the UK real economy throughout the stress scenario.

22. An important motivation for the ACS framework was to help the FPC set capital buffers for the system and PRA set capital requirements for individual firms, whether their business models were focused on UK or global lending and trading activity. So the ACS framework would incorporate a broader range of domestic and global risks than the Bank's previous concurrent stress tests. Some of the global shocks in the 2016 scenario would be more comparable to those in the 2015 test, while some of the domestic shocks would be more akin to those contained in the 2014 stress test.

23. As set out in 'The Bank of England's approach to stress testing the UK banking system', the stress test hurdle rate framework for the stress test had evolved in two ways since the 2015 test. First, each bank would be expected to meet all of its minimum common equity Tier 1 (CET1) capital requirements in the stress scenario. These comprised both the internationally agreed minima ('Pillar 1') and any uplift to that minimum capital requirement set by the PRA through Pillar 2A. As Pillar 2A varied across banks, there would no longer be a common CET1

risk-weighted hurdle rate across banks. The Tier 1 leverage ratio hurdle rate would continue to be 3% for all participating banks.

24. Second, the 2016 stress test would more closely mirror the overall capital framework by considering the results for global systemically important banks (G-SIBs) against both the hurdle rate and a 'systemic reference point'. The systemic reference point would be the sum of the hurdle rate and the phase-in path of a bank's G-SIB buffer. In a real stress, banks would be able to use the G-SIB buffer, like other buffers, to absorb losses. The use of the systemic reference point would therefore not make the G-SIB buffer unusable in practice; instead it would ensure that banks of greater systemic importance would be able to withstand a stress in practice that was more severe than the Bank's stress scenario in order to reflect the greater impact of their failure on the real economy.

EU referendum

25. The FPC considered the channels through which uncertainty associated with the 23 June referendum on the United Kingdom's membership of the European Union, and any period of extended uncertainty following the vote, could increase risks to financial stability.

26. The Committee noted that the effect of uncertainty had been most marked in sterling spot and options foreign exchange markets. Sterling's trade-weighted exchange rate was 8% lower than when the FPC had last met in November. Implied volatility in sterling-dollar was elevated, particularly at maturities spanning the referendum date. Risk reversal measures derived from foreign exchange options continued to show that the price of insuring against the risk of a large depreciation in sterling, particularly against the US dollar, greatly exceeded the pricing of insuring against a large appreciation. Looking ahead, heightened and prolonged uncertainty had the potential to increase the risk premia investors required on a wider range of UK assets, which could lead to a further depreciation of sterling and affect the cost and availability of financing for a broad range of UK borrowers.

27. These pressures had the potential to reinforce existing vulnerabilities for financial stability. The UK current account deficit remained high by historical and international standards. The financing of that deficit was reliant on continuing material inflows of portfolio and foreign direct investment. Those flows had contributed to the financing of the public sector financial deficit and corporate investment, including in commercial real estate. Heightened uncertainty could test the

capacity of core funding markets at a time when the liquidity of these markets had shown signs of fragility across advanced economies. In addition, the impact of a decision of the United Kingdom to withdraw from the European Union could spill over to the euro area, driving up risk premia and further diminishing the prospects for growth there.

28. The Committee assessed the risks around the referendum to be the most significant near-term domestic risks to financial stability. It would continue to monitor the channels of risk closely and support mitigating actions where possible. In that regard, the FPC considered the results of the 2014 stress test of major UK banks, which incorporated an abrupt change in capital flows, a sharp depreciation of sterling, a marked increase in unemployment and a prolonged recession. The results of that test, when combined with revised bank capital plans, had suggested that the banking system was strong enough to continue to serve households and businesses during the severe shock.[1] Since then, UK banks' resilience had increased further.

29. The Committee welcomed the Bank's announcement on 7 March that it would offer three additional indexed long-term repo operations and would continue to offer dollar liquidity in weeks around the referendum, to provide banks, building societies and broker dealers with an opportunity to obtain liquidity against the full range of collateral eligible in the Bank's Sterling Monetary Framework.

30. The FPC received a briefing on the contingency planning being done by the Bank ahead of the referendum, in addition to the provision of additional indexed long-term repo operations. These operations supplemented the Bank's existing market-wide auction facilities, including in dollar liquidity, the Bank's bilateral discount window facility, its swap lines with other central banks, and its ability to provide emergency liquidity assistance.

31. Supervisors were engaging with banks, insurers and central counterparties on their contingency plans for risks related to the referendum, including for managing funding and liquidity risks in sterling and foreign currency. This engagement was part of the regular

---

[1] *Stress testing the UK banking system: 2014 results* and the December 2014 *Financial Stability Report*: http://www.bankofengland.co.uk/financialstability/Documents/fpc/results161214.pdf and http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr36.aspx

supervisory dialogue with firms, supported by cross-firm analysis. Several firms had reported that they were conducting stress tests with referendum-related scenarios of varying severity.[2]

Cyber risk

32. The FPC judged that cyber attack remained a significant threat to the resilience of the UK financial system. Market intelligence suggested that firms continued to consider cyber risk as a key concern. There was some evidence of an increase in the frequency and scale of Distributed Denial of Service (DDoS) attacks against UK financial institutions in recent months.

33. The Committee had previously emphasised the importance of the UK authorities' and firms' cyber resilience work programme. This included: defining and developing a clear set of capabilities that would enhance ex-ante cyber resilience within the UK financial system and improve the effective ex-post capability of the sector and the authorities to respond to and recover from a major cyber attack; and reviewing the list of core firms to ensure that it captured those most critical to financial stability in the event of a major cyber attack. The FPC would receive an update on the work programme by summer 2016.

Overall assessment of financial stability risks from domestic credit

34. The Committee then reviewed its overall assessment of financial stability risks stemming from domestic credit. It considered this against the backdrop of a global environment that had deteriorated since November.

35. Overall risks stemming from domestic credit had risen beyond their subdued levels during the immediate post-crisis period. However, the FPC judged that they were not yet elevated. Supported by low interest rates, debt servicing costs remained below historic averages and the proportion of highly indebted households had not increased.

---

[2] The Committee decided not to publish this text, as permitted by Section 9U(8)(b) of the Act. It was of the opinion that publication at this time was against the public interest. It would keep this under review. Subsequently, the Committee agreed at its 28 June 2016 meeting to release this text, for the reasons set out in the Record of that meeting.

36. Nevertheless, the FPC remained vigilant to risks in this area. Although private non-financial sector indebtedness had fallen since the crisis, the household sector debt-to-income ratio was 134% in Q4 2015. Lending at high loan-to-income ratios remained significant and had picked up since the turn of the year: nearly 15% of new mortgages extended in 2015 Q4 had loan-to-income ratios just below the FPC's threshold of 4.5. Growth of the stock of credit extended to the private sector had been driven by pockets of strength in buy-to-let mortgage lending, as already discussed, and in consumer credit. The four-quarter growth in credit to the private nonfinancial sector was 2.1% in 2015 Q3, broadly in line with the growth rate of nominal GDP, which itself was weak by historical standards.

37. Strong growth of consumer credit, which reached 9% in the year to January 2016, in part reflected increased use of finance secured on the purchase of vehicles. The FPC would continue to monitor the composition of new consumer credit, and the implications this had for the debt-servicing ability of the most vulnerable households and the resilience of lenders.

38. The Committee also considered the Basel 'buffer guide' – a simple metric based on the gap between the ratio of credit to GDP and its long-term trend, which the FPC was required by legislation to consider when setting the countercyclical capital buffer (CCyB) rate. As the Committee had discussed in previous meetings, there was not a simple, mechanistic link between the buffer guide and the CCyB rate. The credit-to-GDP gap remained near historical lows in 2015 Q4. The buffer guide based on this indicator implied that the CCyB rate should be set at 0%. However, given the size of the current gap and the MPC's GDP forecast, it would require credit growth of around 9% per year for three consecutive years for the gap to close, all else equal pushing the level of debt relative to GDP back to its pre-crisis level. As the economy moved from the period following a financial crisis, the Committee noted that the buffer guide could be an incomplete and potentially misleading metric for setting the CCyB rate. The long-run trend on which the indicator was based gave undue weight to the period before the crisis and in the view of most members might not be reliable, as the strong growth trend prior to the crisis was clearly not sustainable and might not be consistent with the path in years ahead.

Resilience of the financial system

39. In assessing the outlook for financial stability, the Committee weighed the level of risks against the resilience of the financial system.

Resilience of the UK banking system

40. The FPC noted that measures of bank resilience had continued to strengthen. Major UK banks' aggregate CET1 ratio had increased further, to 12.6% at end-2015. The aggregate Tier 1 capital ratio of major UK banks had reached 13.8% and the Tier 1 leverage ratio had reached 4.8% – both a little higher than the FPC's view of the steady state capital requirements for the major UK banks as currently measured.

41. At the same time, major UK bank share prices had fallen by around 15% since November 2015 and most were trading below their book value, though there were significant differences in expectations of performance across bank business models. These falls did not appear to reflect concerns around bank resilience, as shown by the fact that the average spread on senior unsecured bank debt was currently 77 basis points, relative to an average spread of 235 basis points in late 2008 / early 2009.

42. The recent declines in UK bank share prices were more likely to reflect weaker investor expectations about future bank profitability. The Committee considered that weaker expectations were likely to be driven by concerns over the future profitability of global investment banking businesses and exposure to commodities and emerging markets. They were also likely to be driven in part by lower nominal interest rates associated with weak growth prospects. The Committee noted that banks' average return on equity masked a significant difference between retail and investment banking activities. If expectations of weaker bank earnings were to materialise, this would reduce the future capacity of the system to withstand shocks through internal capital generation.

43. Overall, the Committee therefore judged that, although measures of current bank resilience had improved since November 2015, future developments would require close monitoring as banks' business models evolved.

Current setting of the countercyclical capital buffer

44. The FPC had detailed its strategy for setting the UK CCyB rate in the December 2015 *Financial Stability Report*. In that, the primary objective of the CCyB was to ensure that the UK banking system was able to withstand stress without restricting essential services, including the supply of credit, to the real economy. To achieve this, the Committee intended to vary the buffer in line with the risk that banks, at the system level, could incur losses on their UK exposures in the future.

45. As discussed earlier, the FPC judged that the overall threat to banks' UK exposures was at a relatively standard level: risks associated with domestic credit were no longer subdued, as they were in the period that followed the financial crisis; and global risks, which could influence the risks on UK exposures indirectly via their potential effects on UK economic growth, were heightened. As the Committee set out in December 2015, it expected to set a UK CCyB rate in the region of 1% in such an environment. This would provide an additional buffer of capital that could be released quickly in the event of an adverse shock.

46. In reaching its decision on the setting of the CCyB rate in Q1 2016, the FPC wanted to balance the desirability of having a capital buffer in the region of 1% when risks were neither subdued nor elevated with the importance of increasing the CCyB gradually to reduce the costs to the economy of building additional resilience into the banking system. The Committee therefore discussed the merits of two options for the CCyB in Q1: increasing the CCyB rate from 0% to 0.5% of risk-weighted assets; and from 0% to 0.75% of risk-weighted assets.

47. The FPC took account of the review by the PRA Board of the overlap between the risks captured by current supervisory capital buffers and a possible positive UK CCyB. To avoid duplication in capital required to cover the same risks, the PRA Board had concluded that existing PRA supervisory buffers set for individual firms should be reduced, where possible, by up to 0.5%. This was a one-off adjustment that reflected the transition to the new capital framework and would take place as soon as practicable after a positive UK CCyB rate came into force. The PRA Board would set out in a forthcoming statement the PRA's overall approach to adjusting firms' existing PRA buffers as the CRD IV combined buffer – of which the CCyB is a part, alongside conservation and systemic buffers – was implemented in the period up to 2019. The one-off adjustment outlined above, which would occur when the CCyB was first increased, was part of that process. Following it, capital requirements for system-wide cyclical risks would be set (for both increases and cuts) by the FPC, via the CCyB.

48. As the FPC had set out in December, there were a number of benefits to replacing this component of existing supervisory buffers for individual firms with the system-wide CCyB: it would be more transparent; firms would be subject to automatic distribution restrictions in the event of their combined buffer requirement, which includes the CCyB, not being met; a greater proportion of buffers would be regularly reviewed from a macroprudential perspective; and once that component of PRA supervisory capital buffers had moved to the CCyB, it could be cut more rapidly, if appropriate, by the FPC, were risks to crystallise or recede.

49. The Committee discussed the arguments for setting the CCyB at 0.5%. Given the PRA Board's decision, this would mean only a very small net increase in regulatory capital buffers for the system as a whole in Q1 2017. However, it could have a more material impact on the regulatory capital buffers of some individual banks. Uncertainty about the effects of the CCyB on credit conditions and the macroeconomy might suggest only a small net change of this nature, as part of a graduated path towards a UK CCyB in the region of 1%. A CCyB rate of 0.5% could also be appropriate given that the recovery in credit growth might not be fully established and might be tested by the likely slowing in buy-to-let mortgage lending in Q2 and if uncertainty increased around the forthcoming EU referendum. Although financial conditions had shifted out of the post-crisis phase, one member put particular weight on not going further than the amount that would result in a subsequent reduction in existing supervisory buffers, linked to their assessment of very subdued conditions in corporate credit growth in particular.

50. The Committee also actively discussed the merits of setting the CCyB at 0.75%. A 0.75% CCyB was closer to the CCyB rate that the Committee expected to set when risks were judged to be neither subdued nor elevated. The FPC's ability to support the economy in the future by cutting the CCyB in the event of adverse shocks occurring required there to be a meaningful buffer of capital that could be released so, given the lags in implementation, there were greater resilience benefits to increasing the CCyB to 0.75% now. Not moving above 0.5% now would mean that these resilience benefits would not be secured for some time. The FPC's judgement concerning the appropriate level of going concern equity in the UK banking system – both in terms of risk-based capital requirements and leverage requirements – was predicated on its making active use of the CCyB.

51. A majority of FPC members initially preferred to increase the CCyB rate from 0% to 0.5% of risk-weighted assets. Consistent with the statutory requirement that the person chairing the meeting must seek to secure that decisions of the Committee are reached by consensus wherever

possible, the Governor asked whether it was possible for the Committee to reach a consensus around 0.5%. Those members who had initially favoured moving to 0.75% were content to join a consensus that made clear that the setting of 0.5% was on a path to a setting of 1%, consistent with the FPC's overall strategy for the prevailing risk environment. Any further moves would as usual be subject to the Committee's assessment of the risk environment and the cost of increasing the CCyB.

52. The FPC would review again the appropriate setting of the CCyB at its next meeting in June, where it would have more information on the impact of tax changes on the buy-to-let market and the result of the EU referendum would be known.

53. On that basis, the FPC decided to increase the CCyB from 0% to 0.5% of risk-weighted assets. This new setting would become binding with effect from 29 March 2017, at which time the overlapping aspects of Pillar 2 supervisory capital buffers would be lifted.

54. Given the PRA Board's action, banks accounting for around three-quarters of the outstanding stock of UK lending would not see their overall capital buffers increase as a result of the UK CCyB rate being increased to 0.5%. The FPC's action would raise the future required capital buffer of some banks, including that of many smaller banks which had contributed around half of the increase in net lending to the real economy over the past year. Almost all of these banks had capital resources in excess of the 2019 Basel III requirements and the 0.5% countercyclical capital buffer. The FPC recognised that these banks might want to rebuild capital over time in order to retain some excess over regulatory capital buffers, but their current position meant that any such action was able to take place gradually.

55. The UK CCyB rate would apply to all UK banks and building societies and to investment firms that had not been exempted by the Financial Conduct Authority. It would apply to branches of EU banks lending into the United Kingdom. The FPC would work with other authorities to achieve reciprocity, consistent with its own policy on reciprocity. Each firm's CCyB would be a weighted average of the CCyB rates that apply in the jurisdictions where the credit exposures of the institution are located.

56. In addition, in line with the approach set out in the FPC's policy statement for using its powers over leverage ratio tools, the countercyclical leverage ratio buffer would be set at 35% of

countercyclical capital buffers, rounded to the nearest 10 basis points. This requirement applied only to major UK banks and building societies.

57. As required by statute, the FPC would keep the setting of the UK CCyB rate under review each quarter. As discussed, at its next meeting in June the FPC would have more information on the impact of tax changes on the buy-to-let market and the result of the EU referendum would be known. And later in the year, the Committee would be able to consider the appropriate CCyB rate in the light of a full set of results from the 2016 concurrent stress test exercise of major UK banks.

Resilience of market-based finance

58. The FPC had continued to review the level of market liquidity – the ease with which securities could be exchanged for cash at predictable prices – in dealer-intermediated markets such as gilt and UK corporate funding markets.

59. Some measures of liquidity, such as bid-ask spreads, did not suggest deteriorating conditions. However, the Committee also placed weight on indications of lower market depth, smaller trade sizes on average and greater price impact of asset sales. It further noted the increasing size and persistence of pricing anomalies between related cash and derivative instruments, such as spreads between government yields and swap rates and differences between corporate bond yields and credit default swap spreads.

60. Market intelligence suggested that broker dealers, which are central to supporting trading activity in government and corporate bond markets, were less willing to expand their inventories of securities in response to sales by other investors and to provide financing to other leveraged investors. Moreover, there had been a reduction in the volume of, and increase in the price of, the provision of financing through reverse repo arrangements secured against gilts. This increase in the cost incurred by leveraged investors to obtain financing using gilt collateral could reduce activity in financial markets going forward, with potentially adverse implications for market liquidity. The Committee continued to emphasise the importance of market participants managing their liquidity prudently, in the light of evolving market conditions, and pricing risks accordingly.

61. These developments had taken place during a period of structural change in markets when many post-crisis regulations had been implemented or planned and market participants were in the process of adjusting to the post-crisis economic and financial environment. The FPC considered

the regulations to be an important part of the post-crisis reform agenda to build the resilience of the core of the global financial system. While these regulations might reduce the normal level of market-making services provided by core intermediaries, they should also enhance the resilience of that provision in times of stress, promoting the effectiveness of markets.

62. Members expressed a range of views on the balance between the potential benefits of liquidity and increased resilience. The FPC judged that some market developments motivated careful review and consideration of whether there were any possible refinements to internationally agreed post-crisis regulations that could further promote market effectiveness without compromising the resilience of the core of the financial system. The FPC was undertaking such a review and intended to publish its assessment later in 2016.

Existing recommendations

63. The Committee reviewed the progress made on implementing its existing Recommendations and Directions since its previous policy meeting. The full text of the outstanding Recommendations and Direction is in Annex 1 of this Record (identifiers in brackets below refer to that annex).

64. Powers of Direction over housing instruments (14/Q3/1): The FPC had been granted powers of Direction over mortgage lending for owner-occupied properties earlier in 2015. The outstanding part of this Recommendation related to the powers of Direction over buy-to-let mortgage lending. In December 2015, HM Treasury had published a consultation on granting the FPC powers of Direction over buy-to-let lending, along with a draft Statutory Instrument and impact assessment. The consultation had closed on 11 March. The FPC agreed to review progress on this Recommendation at its next meeting, once the outcome of the consultation was known.

65. Leverage ratio (15/Q2/1(D); 15/Q2/2): In response to the FPC's Direction, the PRA had in December 2015 published a policy statement, along with finalised rules and supervisory statements, to implement the UK leverage ratio framework. The minimum leverage ratio requirement for major UK banks and building societies was now in force, and the PRA was in the process of implementing the additional leverage ratio buffer for G-SIBs. The FPC agreed to review the implementation of this Direction at its next policy meeting. The Committee also

agreed that the Recommendation (15/Q2/2) on the use of Additional Tier 1 to meet minimum leverage ratio requirements had been implemented.

66. CBEST vulnerability testing (15/Q2/3): In June 2015, the FPC had recommended that the Bank, the PRA and the FCA work with firms at the core of the UK financial system to ensure that they complete CBEST tests and adopt individual cyber resilience action plans, and that the Bank, the PRA and the FCA should also establish arrangements for CBEST tests to become one component of regular cyber resilience assessment within the UK financial system. Since then, progress on CBEST testing had continued, with 20 core firms having completed CBEST tests, up from five at the time of the FPC's Recommendation. As agreed at its September 2015 meeting, the Committee intended to review this Recommendation, alongside a report from the UK authorities on their wider cyber resilience work programme, expected by summer 2016.

Remit and recommendations

67. On 16 March, the FPC had received from the Chancellor a letter setting out his recommendations to the FPC as required under Section 9E of the Bank of England Act 1998 (as amended by the Financial Services Act 2012). The FPC would respond in due course.

The following members of the Committee were present:
Mark Carney, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Andrew Bailey, Deputy Governor responsible for prudential regulation
Ben Broadbent, Deputy Governor responsible for monetary policy
Alex Brazier
Clara Furse
Donald Kohn
Richard Sharp
Martin Taylor
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

Tracey McDermott, Acting Chief Executive of the Financial Conduct Authority, was unable to attend the policy meeting as she was overseas.

Nemat Shafik, Deputy Governor responsible for markets and banking, also attended the meeting.

ANNEX: PREVIOUS FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

Identifier(*)	Recommendation/Direction
14/Q3/1	The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to: (a) loan-to-value ratios; and (b) debt-to-income ratios, including interest coverage ratios in respect of buy-to-let lending.
15/Q2/1(D)	The FPC directs the PRA to implement in relation to each major UK bank and building society on a consolidated basis measures to: • require it to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3%; • secure that it ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific countercyclical capital buffer rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points; • secure that if it is a global systemically important institution (G-SII) it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate. The minimum proportion of common equity Tier 1 that shall be held is: • 75% in respect of the minimum leverage ratio requirement; • 100% in respect of the countercyclical leverage ratio buffer; and • 100% in respect of the G-SII additional leverage ratio buffer. Common equity Tier 1 may include such elements that are eligible for grandfathering under Part 10, Title 1, Chapter 2 of Regulation (EU) 575/2013 as the PRA may determine.
15/Q2/3	The FPC recommends that the Bank, the PRA and the FCA work with firms at the core of the UK financial system to ensure that they complete CBEST tests and adopt individual cyber resilience action plans. The Bank, the PRA and the FCA should also establish arrangements for CBEST tests to become one component of regular cyber resilience assessment within the UK financial system.

(*) Each Recommendation and Direction is listed with an identifier to allow tracking of progress. For example, ‘14/Q3/1’ refers to the first Recommendation made at the 2014 Q3 meeting.

Other FPC policy decisions which remain in place

The table below sets out previous FPC decisions, which remain in force, on the setting of its policy tools. The calibration of these tools is kept under review.

Topic	Calibration
Countercyclical capital buffer (CCyB)	The current UK CCyB rate is 0.5%. This rate is reviewed on a quarterly basis. The United Kingdom has also reciprocated a number of foreign CCyB decisions — for more details see the Bank of England website.[3] Under PRA rules, foreign CCB rates applying from 2016 onwards will be automatically reciprocated if they are less than 2.5%.
Prevailing FPC Recommendation on mortgage affordability tests	When assessing affordability in respect of a potential borrower, UK mortgage lenders are required to have regard to any prevailing FPC Recommendation on appropriate interest rate stress tests. This requirement is set out in FCA rule MCOB 11.6.18(2).[4] In June 2014, the FPC made the following Recommendation (14/Q2/1): *When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination. This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).*
Recommendation on loan to income ratios	In June 2014, the FPC made the following Recommendation (14/Q2/2): *The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The Recommendation should be implemented as soon as is practicable.* The PRA and the FCA have published their respective approaches to implementing this Recommendation: the PRA has issued a Policy Statement, including rules,[5] and the FCA has issued general guidance.[6]

[3] http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx
[4] https://www.handbook.fca.org.uk/handbook/MCOB/11/6.html
[5] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[6] http://www.fca.org.uk/news/fg14-08