Financial Stability Report
Executive summary
December 2015

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Executive summary

The Financial Policy Committee (FPC) assesses the outlook for financial stability in the United Kingdom by identifying the risks faced by the UK financial system and weighing them against the resilience of the system. By doing so, it assesses the ability of the financial system to continue to provide its core functions to the economy, even under adverse circumstances. Following the global financial crisis, there was a period of heightened risk aversion and retrenchment from risk-taking as financial institutions, businesses and households sought to repair their balance sheets. The FPC judges that the system has now moved out of that period. Household debt has fallen relative to income, but is still elevated, banks are more resilient and credit is generally more available.

Risks faced by the UK financial system
The global macroeconomic environment remains challenging. Risks in relation to Greece and its financing needs have fallen from their acute level at the time of the publication of the July 2015 Report. But, as set out in July, risks arising from the global environment have rotated in origin from advanced economies to emerging market economies. Since July, there have been further downward revisions to emerging market economy growth forecasts. In global financial markets, asset prices remain vulnerable to a crystallisation of risks in emerging market economies. More broadly, asset prices are currently underpinned by the continued low level of long-term real interest rates, which may in part reflect unusually compressed term premia. As a consequence, they remain vulnerable to a sharp increase in market interest rates. The impact of such an increase could be magnified, at least temporarily, by fragile market liquidity.

Domestically, the FPC judges that the financial system has moved out of the post-crisis period. Some domestic risks remain elevated. Buy-to-let and commercial real estate activity are strengthening. The United Kingdom’s current account deficit remains high by historical and international standards, and household indebtedness is still high.

Against these elevated risks some others remain subdued, albeit less so than in the post-crisis period to date. Comparing credit indicators to the past alone cannot provide a full risk assessment of the level of risk today, but can be informative. Aggregate credit growth, though modest compared to pre-crisis growth, is rising and is close to nominal GDP growth. Spreads between mortgage lending rates and risk-free rates have fallen back from elevated levels.

The FPC judges that cyber risk continues to pose a threat to the financial system. More broadly, in the context of elevated geopolitical risks, the FPC emphasises the importance of market participants having robust contingency planning arrangements in place.

Resilience of the UK financial system
In assessing the outlook for UK financial stability, the FPC weighs these risks against the resilience of the financial system.

The UK banking sector has become more resilient in line with regulatory requirements. The aggregate Tier 1 capital position of major UK banks was 13% of risk-weighted assets in September 2015.

The resilience of the UK banking sector to deterioration in global financial market conditions and the macroeconomic environment, including in emerging market economies, has been assessed in the 2015 annual stress test. The stress-test results and banks’ capital plans, taken together, indicate that the banking system would have the capacity to maintain its core functions, notably lending capacity, in a stress scenario such as the one in the 2015 stress test. The results of the 2015 stress test also suggest that UK banks’ capital adequacy is resilient to stressed projections for misconduct costs and fines, over and above those paid or provisioned for by end-2014 (Box 3).
Box 1
The framework of capital requirements for UK banks

Since the crisis, authorities have worked to establish standards for bank equity and other capacity to absorb losses in order to fix some of the major fault lines that caused the financial crisis.

The work to design those standards is reaching completion and is now moving into the phase of full implementation. As that transition takes place, the FPC judges it appropriate to clarify the future requirements on UK banks.

The Supplement to this Report finalises the FPC’s view on the overall calibration of the capital framework for UK banks. It sets out the FPC’s view on the overall amount of capital for the system and the appropriate structure of those requirements. It describes how the framework of capital requirements is expected to evolve between now and the end position in 2019.

The FPC’s aim is a prudent, coherent and transparent framework of capital requirements for UK banks. It expects the framework to be rationalised so that each element captures a specific form of risk and there is no duplication of requirements.

In reaching its assessment, the FPC has considered the overall amount of equity the banking system should have to absorb losses in ‘going concern’. That judgement has been informed by new, and forthcoming, requirements for banks to have additional capacity to absorb losses in resolution (that is, as a ‘gone concern’).

Overall, based on analysis of the economic costs and benefits of going concern bank equity, the Committee judges the appropriate Tier 1 equity requirement for the system, in aggregate, to be 11% of risk-weighted assets. A small part of this can be met with contingent capital instruments. The FPC considers the appropriate level of common equity Tier 1 (CET1) to be 9½% of risk-weighted assets.

This assessment refers to the structural equity requirements applied to the aggregate system that do not vary through time. It also assumes that existing shortcomings in the definitions of equity resources and risk-weighted assets will be corrected.

The FPC considers it appropriate that around half of the system’s going concern equity requirement should be in the form of buffers that can be used to absorb losses under stress rather than in hard minimum requirements. These buffers serve a macroprudential purpose. By absorbing the impact of stress, they reduce the need for banks to withdraw services, such as credit provision, to the real economy.

Planned requirements will, after being fully phased in by 2019, take the equity requirement of the UK banking system as a whole to around 11% of risk-weighted assets. This comprises:

- a 6% minimum;
- a 2½% capital conservation buffer that establishes a baseline ability to absorb stress across the system; and
- an additional buffer of equity for globally systemic banks (of between 0% and 2½% for UK banks), depending on their systemic importance. This buffer reduces the probability that these banks will fail in line with the greater costs of their failure to the global economy. It skews equity in the system towards these banks and raises system equity levels by 1½% of risk-weighted assets.

The Committee will also consult in January 2016 on the precise framework for a buffer of equity that domestic ring-fenced banks and large building societies will be required to hold to reflect the particular damage their distress would cause to the UK real economy. As already established by Parliament, this buffer will vary between 0% and 3% of risk-weighted assets. The systemic risk buffer is expected to add around ½% of risk-weighted assets to equity requirements of the system in aggregate.

Requirements on the system in aggregate are therefore likely to sum to around 11%: the level the FPC judges appropriate for the system. The FPC is not therefore seeking further structural increases in capital requirements for the system as a whole. It considers the remaining ongoing work at international level to be concerned with the allocation of capital across the system and the various components of the capital framework.

In addition, individual banks are subject to supervisory equity requirements to reflect specific risks to which they are exposed. For example, their balance sheets may be more sensitive to a given level of economic risk than the system as a whole. By 2019, these requirements are expected to be small, on average, but will add capital to the system.
The FPC notes that the aggregate Tier 1 capital position of major UK banks was 13% of risk-weighted assets in September 2015, even though some elements of the requirements have yet to be phased in. And banks expect to build their equity ratios further in coming years.

The difference between the level the FPC judges appropriate and these plans in part reflects the definitional shortcomings in measures of risk-weighted assets, which are compensated for today in additional requirements including for trading book risk and defined-benefit pension fund risk. In part, it reflects supervisory requirements for specific risks, many of which are associated with the banking system being in transition and dealing with legacy issues. It probably also reflects banks’ preference to run with some additional buffer of equity on top of their mandatory requirements. Some part of those voluntary buffers may reflect uncertainty about the future level of equity requirements. In clarifying the future framework, the FPC is seeking to minimise that motivation.

If no definitional corrections were to be made and prevailing risk-weight measures remained in place, the system would require measured Tier 1 equity of around 13.5% of risk-weighted assets to be consistent with the FPC’s judgement about the appropriate level of capital. The measured level of equity in the system therefore has a little further to increase before 2019 in order to meet planned requirements.

The Committee’s judgement about the appropriate amount of going concern equity, at 11% of risk-weighted assets, is substantially lower than some estimates, such as those made by the Basel Committee in the aftermath of the crisis. These had pointed to an appropriate level of going concern equity of around 18% of risk-weighted assets. The FPC’s judgement that a lower level is now appropriate reflects three important changes since the crisis.

First, the Committee judges that effective arrangements for resolving banks materially reduce both the probability of financial crises and the economic costs of bank failure. An effective resolution regime has been established in the United Kingdom. Banks are restructuring in ways that will facilitate their resolution, including through ring-fencing. And new requirements for total loss-absorbing capacity for global systemically important banks will ensure these banks have liabilities that can be used to absorb losses and recapitalise them in resolution. These liabilities, which do not need to be Tier 1 capital instruments, should be roughly equal in size to their equity requirements. The FPC judges these standards to be appropriate and expects the principle behind them — to facilitate resolution — to be extended across the UK banking system. The Bank of England will consult on this shortly.

Second, the Committee places weight on other structural changes since the crisis that will reduce the exposure of the banking system to risks. Importantly, these include the ring-fencing of major UK banks as required by the Banking Reform Act. In addition, the FPC places weight on the role of pre-emptive, judgement-led prudential supervision conducted by the Prudential Regulation Authority.

Third, the Committee intends to make active use of the time-varying countercyclical capital buffer that will apply to banks’ UK exposures. It is updating and clarifying its strategy for using this macroprudential instrument. That strategy has five core principles:

- The purpose of the countercyclical capital buffer, like the other equity buffers, is to absorb losses in stress, enabling banks to continue to support the real economy and therefore to avoid them amplifying the stress.

- The Committee intends to vary the countercyclical capital buffer according to changes in its view of the risks of potential losses on banks’ UK exposures, and to do so symmetrically. In doing so, the Committee is avoiding the need to capitalise the banking system for high-risk conditions at all other points: an outcome it judges to be economically inefficient.

- Increasing the countercyclical capital buffer may restrain credit growth somewhat and mitigate the build-up of risks to banks, but the effect is unlikely to be substantial. This is not its primary objective and will generally not be expected to guide its setting.

- The FPC intends to set the countercyclical capital buffer above zero before the level of risk becomes elevated.

- By moving early, the FPC expects to be able to vary the countercyclical capital buffer more gradually. This approach is likely to be more robust to the inherent uncertainty in assessing the degree of risk and to uncertainty about the impact of additional equity requirements on credit conditions and the real economy. In addition, there are important time lags between when risks become clear and macroprudential policies to address them are implemented fully — for instance, banks typically have twelve months to adjust to any FPC decision to increase the countercyclical capital buffer.

During periods after the recovery and repair phase that typically follows a financial stress, but before the risks facing the system have become elevated, the Committee currently expects the countercyclical capital buffer to be in the region of 1% of risk-weighted assets. This will be kept under regular review and would change, for example, if the structure of
banks’ balance sheets were to evolve, making them more sensitive to a given degree of economic risk.

In future, as set out in the Bank’s approach to stress testing the UK banking system,(1) stress testing will be used to assess regularly whether the system-wide capital conservation buffer and countercyclical capital buffer together are sufficient to absorb the impact across the system of the prevailing risks materialising. Stress tests will assume that, at the system level, the capital conservation buffer can be used to absorb stress and that any prevailing countercyclical capital buffer would be cut rapidly to zero when the stress occurs.

The FPC continues to view leverage requirements as an essential part of the framework. These requirements, for equity relative to total — rather than risk-weighted — exposures, manage the problems with risk-weighting. The FPC’s leverage framework requires major banks and building societies to satisfy a minimum leverage ratio of 3%.

As with its assessment of the appropriate risk-weighted equity requirement, the FPC’s judgement about the appropriate minimum leverage ratio was informed by its intention to use the countercyclical capital buffer actively. As a guiding principle, leverage requirements will be scaled up in proportion to any countercyclical capital buffer on UK exposures and also for systemically important banks.

The principle behind the FPC’s leverage requirements is that they are 35% of a firm’s risk-weighted equity requirements. For example, a bank subject to a 2.5% equity buffer requirement for its systemic importance and a countercyclical capital buffer of 1% would have a risk-weighted capital requirement of 12%. Its leverage requirement would be 4.2%. As with the risk-weighted equity buffers, the FPC views the purpose of these additional systemic and countercyclical leverage buffers as to absorb the impact of stress.

The FPC’s view of the equity requirements for the system as a whole will not apply to each and every bank and building society — there will be a distribution of requirements across firms reflecting the view of the Board of the Prudential Regulation Authority on the risks faced by each business relative to the system as a whole. For example, non-systemic banks could face lower requirements. Systemic banks that use risk-weight models that are highly sensitive to economic shocks or that have weak risk management and governance could face higher requirements. This distribution will reflect supervisory requirements for equity buffers for individual firms.

Ongoing work at the domestic and international level is seeking to adjust definitions of risk-weighted assets to address excessive variability across banks and to better capture some specific risks, such as those associated with trading book assets. These will result in offsetting reductions in microprudential supervisory requirements in the United Kingdom, which currently correct for the shortcomings of risk measures. So the FPC does not expect forthcoming adjustments to add to system-wide capital requirements.

In addition, some elements of the framework of going concern equity requirements are to be phased in between 2016 and 2019. However, some of the risks that these requirements are designed to capture are already being captured by individual supervisory requirements for going concern equity. To avoid duplication, the FPC and Board of the Prudential Regulation Authority will co-ordinate work as system-wide requirements are phased in to ensure that existing requirements on individual banks are phased out appropriately. This will result in a prudent, transparent and consistent framework of going concern equity requirements in which different risks are captured by specific requirements.

Executive summary

Emerging market economy risks (pages 16–19)
The UK financial system has substantial exposures to emerging market economies, reflecting the large build up in private sector debt in many of these countries in recent years. At end-2014, private sector debt across emerging market economies was over 110% of annual output, an increase of 40 percentage points since 2008. In China, this ratio was close to 200%. A further downgrade to GDP growth prospects, capital outflows and currency depreciations have all acted to increase the burden of servicing elevated levels of emerging market economy debt. In October 2015, the IMF lowered its forecast for 2015 emerging market economy GDP growth for the fourth year in a row.

In a number of emerging market economies, businesses have issued a large volume of US dollar-denominated debt, and may be particularly vulnerable to exchange rate movements. Since 2009, the stock of emerging market economy non-financial companies’ foreign currency denominated debt securities has tripled to US$940 billion. The maturity profile of emerging market economy dollar-denominated corporate debt suggests refinancing needs will increase significantly in 2017 and 2018 (Chart A).

Countercyclical capital buffer decision
The shift in financial conditions out of the post-crisis phase means that the FPC is actively considering the appropriate setting of the countercyclical capital buffer.

The risks currently captured by existing supervisory requirements have some overlap with those that will in future be captured by the FPC’s intended approach to using the UK countercyclical capital buffer. The Board of the Prudential Regulation Authority will review individual requirements to reflect the FPC’s strategy outlined in Box 1 and the Supplement to this Report, alongside its regular updating of supervisory requirements in 2016 Q1. The result of this process will mean an increase in the countercyclical capital buffer that will probably not change the overall capital requirements for individual banks. However, transparency would be enhanced, contributing to the overall resilience of the UK banking system, and potential overlap avoided. Of course, the FPC will take a decision at its next meeting about the appropriate level of the countercyclical capital buffer.

Therefore and in the light of this, the FPC is maintaining the UK countercyclical capital buffer rate at 0% at this stage. The FPC will carefully review the setting of the countercyclical capital buffer rate in March 2016, in view of the pending review by the Board of the Prudential Regulation Authority of individual requirements.

Beyond the core banking sector, the resilience of important intermediaries of market-based finance continues to improve; but underlying market liquidity in some core financial markets could be fragile, as underlined by recent episodes.

The Committee has completed its review of the potential risks to UK financial stability arising from the investment activities of open-ended investment funds offering short-notice redemptions, as part of its regular review of risks beyond the core banking sector. The FPC supports the Bank’s intention to incorporate the activity of investment funds into system-wide stress testing and, in the near term, to assess the resilience of markets to large-scale fund redemptions. It supports further work by the Financial Conduct Authority to assess investor awareness of the liquidity risks associated with investment funds, to communicate good liquidity management to the asset management industry and to assess leverage in investment funds, including through international initiatives to address data gaps. The FPC also supports the recent Financial Stability Board statement that encouraged appropriate use of stress testing by funds to assess their ability individually and collectively to meet redemptions under difficult market liquidity conditions. The FPC will reassess its position in the light of these international initiatives.

Chart A

Refinancing needs for maturing US dollar-denominated bonds increase in 2017 and 2018
Maturity profile of US dollar-denominated bonds issued by non-financial companies in selected EMEs

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Direct UK bank claims on China, Hong Kong and other emerging market economies were around 340% of CET1 in 2015 Q2 (Chart B). The FPC assessed the UK banking system’s resilience to a severe downturn in emerging market economies through the 2015 annual stress test. That scenario also included a protracted period of debt-deflation in the euro area, which has the strongest trade links with emerging market economies of the major advanced economies (Box 3). The results, taken together with the improvements in banks’ positions in 2015 and their capital plans, suggest that the UK banking system would have the capacity to maintain its core functions in that scenario.

Financial market fragility (pages 20–25)

Financial market prices remain vulnerable to a sharp increase in market interest rates or the compensation demanded by investors for holding risky assets. Long-term interest rates in advanced economies remain at historically low levels. This partly reflects market expectations of a gradual normalisation of policy rates, but estimates of term premia — that is, the compensation investors require for uncertainty around the expected future path of interest rates — have also been at very low levels over the past year (Chart C). Against this backdrop, the compensation that investors demand for holding risky assets may be compressed in some market segments.

There are a number of developments that might cause term and risk premia to increase. These include a worsening in the outlook for the global economy and an associated deterioration in creditworthiness, and a rise in uncertainty about the future course of economic activity and interest rates. Crystallisation of these risks could pose a threat to UK financial stability, particularly if shocks to asset prices were amplified by fragile market liquidity. This vulnerability came to the fore in August 2015, when an episode of intense volatility in some markets materialised against the backdrop of concerns among market participants about a possible slowdown in economic growth in China.

Despite such periods of intense volatility, there is evidence that market and liquidity risks may not be fully reflected in the prices of some financial assets. For example, estimates of the compensation investors require to bear the liquidity risk associated with corporate bonds remain around historical norms (Chart D). It is possible that liquidity premia might increase rapidly if fragile market liquidity is exposed in some markets. While it is desirable that liquidity risks are priced prudently, the concern is that spreads could overshoot if any such market correction proves disorderly. This could arise, for example, in response to large-scale redemptions from investment funds in the event of a fall in risk appetite (Box 2).

It is important that market participants recognise the underlying risks in different asset classes, and price them.
Executive summary

The FPC has included financial market stress in the 2015 annual stress test and has reviewed the activities of investment funds. As the FPC set out in its response to the Chancellor’s remit letter to the FPC in August 2015, it will assess the costs and benefits of the cumulative impact of regulatory reforms to make the financial system more resilient, including any unintended consequences for the provision of market liquidity in core financial markets. In doing so, it will draw on inputs from the Bank’s recent Open Forum.

UK current account (pages 26–28)

In recent years, the UK current account deficit has been large by historical (Chart E) and international standards. The deficit narrowed in 2015 Q2, but most of that narrowing was likely to have been driven by temporary factors. A persistent current account deficit could lead to a sudden adjustment in capital flows or depreciation of the exchange rate, with adverse consequences for UK financial stability.

The UK external balance sheet has become more resilient and the composition of the capital flows financing the deficit does not suggest any vulnerability over and above its size. Seventy per cent of the stock of UK inward foreign direct investment is equity-financed. Recent portfolio investment inflows appear to have been concentrated in equity, gilts and private sector debt securities. While there could be risks to UK financial stability associated with large-scale redemptions of investment fund shares, those are estimated to be only a small proportion of overall UK inward investment.

Nonetheless, the composition of capital flows can change over time and vulnerabilities can build quickly, particularly when the deficit is persistently large. The FPC monitors capital inflows to assess the extent to which vulnerabilities, such as refinancing risk, may be building, and remains vigilant to the possibility that capital inflows may amplify risks in specific sectors such as commercial real estate.

UK property markets (pages 29–33)

The buy-to-let sector continues to drive growth in the UK mortgage market. Since 2008, the outstanding stock of buy-to-let lending has grown by 5.9% per annum on average, compared with only 0.3% growth in the stock of lending to owner-occupiers. In the year to 2015 Q3, the stock of buy-to-let lending rose by 10%. Greater competition in this sector has not to date led to a widespread deterioration in underwriting standards of UK banks. But some smaller lenders have loosened their lending policies, for example by raising their maximum LTV thresholds. Strong growth in buy-to-let lending is driven in part by a structural shift in tenure to the private rental sector. But it may have implications for financial stability.
New loans to buy-to-let investors are often subject to less stringent affordability tests than loans to owner-occupiers. Assessed against relevant affordability metrics, buy-to-let borrowers may be more vulnerable to an unexpected rise in interest rates or a fall in income, which could exacerbate the scale of a fall in house prices. During an upswing in house prices, investors seeking capital gain can increase leverage including through the purchase of multiple properties. The resulting boost in demand can add further pressure to house prices, prompting both buy-to-let and owner-occupier borrowers to take on larger loans, thereby increasing indebtedness. Since 2010, credit loss rates incurred on buy-to-let loans in the United Kingdom have been around twice those incurred on lending to owner-occupiers.

The FPC remains alert to financial stability risks arising from rapid growth in buy-to-let mortgage lending and notes the difference in underwriting standards in the owner-occupier and buy-to-let mortgage markets, in particular in the typical interest rates used in affordability stress tests. The FPC will monitor developments in buy-to-let activity closely following the tax changes to the buy-to-let market announced by the Chancellor in the Budget and Autumn Statement. It supports the programme of work initiated by the Prudential Regulation Authority to review lenders’ underwriting standards. HM Treasury is planning to launch this year a consultation on giving to the FPC similar powers of Direction on buy-to-let mortgage lending as those it has already provided on owner-occupier mortgage lending. In the interim, the FPC stands ready to take action if necessary to protect and enhance financial stability, using its powers of Recommendation.

The FPC continues to monitor closely developments in the UK commercial real estate market. Prices in the UK commercial real estate market have risen significantly and the funding of investments is becoming riskier. Following the financial crisis, equity financing of commercial real estate investment increased significantly, with a diminished role for leverage. But the use of leverage, particularly in London, has begun to increase a little over the past year or so. There have also been strong inflows to open-ended funds (Chart F). Exposures of the major UK banks remain substantial, averaging around 50% of their CET1 at end-2014. A severe downturn in the commercial real estate market could reduce the ability of some firms to access bank finance, given their use of commercial real estate as collateral. A recent Bank review of bank lending to small and mid-sized companies found that 75% of firms that borrow from banks rely on commercial real estate as collateral to support their borrowing.

Cyber risk (pages 34–35)
Cyber attack is a serious and growing threat to the resilience of the UK financial system. Cyber attacks have the potential to threaten the vital services that the financial system
provides to the real economy. The risk from cyber attack has grown over time, reflecting increased use of technology in financial services. Awareness of cyber risk has continued to grow since the July 2015 Report. The proportion of respondents to the Bank’s Systemic Risk Survey highlighting cyber risk as a key concern was 46% in 2015 H2, up from 30% in 2015 H1 (Chart G).

UK and international authorities have already taken action with regard to cyber risk, including through a joint UK-US cyber exercise in November 2015. The FPC will receive a report on a work programme implemented by UK authorities by Summer 2016. Progress on ‘CBEST’ vulnerability testing has continued with ten core firms now having completed CBEST tests, up from five at the time of the July 2015 Report. Firms need to build their resilience to cyber attack, develop the ability to recover quickly from attack given the inevitably that attacks will occur, and ensure effective governance of cyber risk across their functions.

Part A of this Report sets out in detail the Committee’s analysis of the major risks and action it is taking in the light of those risks. Part B summarises the Committee’s analysis of the resilience of the financial system.