Financial Stability Report Press Conference

1st December 2015

Opening remarks by the Governor

Good morning.

There are three major elements to the FPC's announcements today:

- First, we are publishing the results of the 2015 stress tests;
- Second, we are clarifying the overall capital framework for banks including the approach we will take to using the countercyclical capital buffer; and
- Third, we are updating our view of the major risks and vulnerabilities to UK financial stability and encouraging targeted actions to address them.

Stress Test Results and Overall Levels of Resilience

UK banks are now significantly more resilient than before the global financial crisis.

Capital requirements for the largest banks have risen ten-fold. Their holdings of liquid assets have increased four-fold. Their trading assets are down by a third, and inter-bank exposures have shrunk by two-thirds.

The results of the Bank of England's 2015 stress test underscore these improvements.

This year's test complements last year's effort. It is focused on an emerging market stress that prompts reassessments of global prospects and asset prices; considers the implications of deflation not inflation; and places greater emphasis on exposures to corporates rather than households. It also includes an unrelated but important stress of costs for known misconduct risks.

The stress test results, taken together with banks' capital plans, indicate that the UK banking system would have the capacity to continue to lend to the real economy even under such a severe scenario.

They testify to the value of the reforms that have rebuilt capital and confidence in the UK banking system.

Capital framework

While the benefits of increased resilience are clear, higher capital costs are ultimately passed on to borrowers.

And uncertainty about the final resting place for capital can prevent banks from taking the types of prudent risks the economy needs to create jobs and grow incomes.

Moreover, investors, parliamentarians and the public are right to expect proportionate, predictable and transparent standards.

At our Open Forum last month we heard concerns about a seemingly endless wave of regulatory change and a ratcheting-up of capital.

All should be clear: there is no new wave of capital regulation coming. There is no "Basel IV."

Our objective has never been to raise capital without limit. Or by stealth.

Given the progress in recent years, the FPC has assessed the capital needs of the system and is now providing clarity on:

- The amount of capital our banking system needs given the risks it faces; and
- How that capital should be allocated across different types of firms and risks.

The FPC has concluded that the appropriate Tier 1 equity requirement for the banking system, in aggregate, is **11% of risk weighted assets**. Of this, 9.5 percentage points should be in the highest quality common equity capital and roughly half should be buffers, which are macro-prudential tools for use in stress.

This is a little above the basic international standards set out for major global banks but is lower than some might have expected.

Indeed, analysis by the Basel Committee five years ago concluded that the optimal equity ratio was around 18 percent. The Vickers Commission settled on similar numbers.

Today's announcement is the result of two years of work by the FPC on the optimal medium-term capital framework for UK banks.

In reaching this judgement, we have stepped back and taken stock of the cost of the crisis and the benefits of cumulative reforms made since. And we've been informed by two years of severe-but-plausible stress tests.

Three factors have been particularly decisive.

The first is progress on resolution.

With the endorsement of G20 Leaders last month, the biggest global banks will in future have greater total loss-absorbing capacity – about twice our system-wide level of capital – ensuring there are sufficient liabilities to be bailed in to resolve a failing institution without recourse to public funds. By allowing a more efficient and cost-effective overall capital structure, the baseline amount of equity that banks need to hold can be lower. We will consult by the end of the year on how to implement these measures.

The second factor comprises effective supervision and structural reform.

The PRA's forward-looking, judgment-led supervision helps ensure that individual banks do not take excessive risks, but do carry additional capital for idiosyncratic exposures.

Structural reform will further increase the resilience of ring-fenced banks so that they can continue to provide the services that we use on the high street or online, regardless of volatility in the global financial system.

The third factor is the active use of countercyclical tools.

The FPC is today making clear its intention to use the countercyclical capital buffer to ensure capital in the system is commensurate with risks that will inevitably vary over time.

Like other buffers, the countercyclical buffer is there to absorb losses in stress, enabling banks to continue to support the real economy and to avoid amplifying any shocks.

Unlike other buffers, the countercyclical buffer is explicitly time-varying. It will be flexed up and down as risks wax and wane in order to ensure the banking system can withstand stress without restricting the supply of credit to the real economy.

By moving early, before risks are elevated, the FPC expects to be able to vary the countercyclical capital buffer gradually.

Active use of the counter-cyclical buffer means a more efficient capital structure as the system won't be capitalised to withstand high-risk conditions at all times.

This is something the FPC already explicitly recognised when setting the basic leverage ratio requirement at 3% - a lower requirement than would have been the case without active use of the counter-cyclical buffer.

With today's announcement, the basic amount of capital our system requires is settled.

UK banks are already most of the way there, even though they have until 2019 to comply in full. In the first three quarters of 2015 alone, UK banks improved their CET1 capital ratios by a full 100 basis points, which is more than the shortfall to 2019.

Our priority now is to allocate capital to various risks in a clear, consistent and coherent fashion.

The new framework will differentiate between minimum capital standards that must be met at all times and buffers that are there to be used in stress.

And for the first time it will separate the capital required to insure against macro-prudential risks from that needed for idiosyncratic firm risks.

We will now focus on clarifying the remaining elements of the system and supporting an orderly transition to the new framework by 2019.

By the end of the first quarter, we will consult on the UK Systemic Risk Buffer. That buffer will help ensure the retail banking services on which our economy depends can continue even in the face of stress elsewhere in the system. This is an essential factor in enabling the UK to sustain a banking system many times the size of its GDP.

By the end of next year, the Basel Committee is expected to address many of the shortcomings in measures of risk-weighted assets.

Setting the countercyclical capital buffer

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

The FPC intends to set the countercyclical buffer above zero before the level of risk becomes elevated. More specifically, the Committee expects to set a countercyclical capital buffer in the region of 1% when risks are judged to be neither subdued nor elevated. This expectation will be kept under review and may change over time.

Domestic developments are consistent with the aggregate level of risk having increased. Buy-to-let and commercial real estate activity has been strengthening. Both the UK current account deficit and household indebtedness are still high. Aggregate UK credit growth remains modest, but is rising and is close to nominal GDP growth.

As a first step in setting the buffer, we intend to separate those risks currently captured by existing supervisory requirements that will in future be captured by the countercyclical capital buffer. To this end, the PRA Board has agreed to review individual firms' buffer requirements in the first quarter of next year.

This one-off process will increase the counter-cyclical buffer from zero but will not, in itself, change the overall capital requirements for UK banks.

Following the completion of this process, the FPC will carefully review the appropriate setting of the buffer rate in March.

Risks Assessment and Calibrated Actions to Promote Financial Stability

The FPC's latest assessment is that the global macroeconomic environment remains challenging.

Risks have continued to rotate from advanced to emerging market economies, and global growth remains subdued.

Asset prices are being underpinned by low long-term real interest rates. An adjustment could come were growth prospects to deteriorate or rates to rise.

Shocks to asset prices may be amplified if market liquidity proves to be fragile. That is why the Bank included more severe financial market stress in this year's test.

This quarter, the Committee has completed its review of the potential risks arising from open-ended investment companies offering short-term redemptions.

The FPC welcomes the FCA's recently announced study of investor awareness of liquidity risks in these products. Following our survey of 143 investment funds' liquidity management plans, the Bank will test the resilience of markets to widespread redemptions. We will bring investment funds into our system-wide stress tests and work at the FSB to internationalise such efforts.

As set out in its response to the Chancellor's remit letter, the FPC will assess the costs and benefits of the cumulative impact of regulatory reforms, including any unintended consequences for market liquidity in core financial markets. In doing so, we will draw on inputs from the Open Forum.

Finally, with respect to potential risks from the rapid growth of buy-to-let, the FPC welcomes the PRA's intention to review underwriting standards amongst buy-to-let lenders, and we take note of recently announced tax changes that will affect this sector. The FPC will monitor developments in buy-to-let activity closely.

Conclusion

The global environment is unforgiving, and the legacy of the crisis means private and public balance sheets remain stretched. This calls for resilience not fatalism.

Today we have reaffirmed the strength of our banks in the face of these risks.

We are providing additional certainty about the shape of the capital framework and the amount of capital required.

We are setting out how macro-prudential capital buffers will be used to match resilience with risks.

Our actions are carefully calibrated and take account of measures by other authorities.

We are not just building the resilience of the system but also seeking to increase general understanding of how we are delivering it.

All this means the people of the United Kingdom can focus on what matters most to them as we enter the Christmas season.