Bank of England

Financial Stability Report Q&A
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Jason Douglas,
Wall Street Journal: Can I ask you, please, to maybe say a little bit about the interplay between macroprudential policy and monetary policy, particularly with regard to the countercyclical buffer? It sometimes seems that maybe people misunderstand what it's for, that it's about restraining credit growth and therefore sort of influencing aggregate demand and so on.

So, yes, how these sort of tools address what the MPC is doing. Thank you.

Mark Carney: Thanks, Jason. Well, the first thing, in part because of that potential misunderstanding or - to put it more positively - to provide additional clarification, we've set out the principles on how we would use the countercyclical buffer, which one can think of also applying more broadly to macroprudential tools - but specifically about the countercyclical buffer in this Report.

And one of the key points we make is that the principal purpose of this buffer is to increase resilience of the banks, and to be even clearer, the primary purpose is not restraining credit growth.

Now, we recognise that in the process of increasing capital requirements there will be costs passed on to borrowers. That will have an impact on output - on demand, on output and ultimately some impact on inflation. The question is the orders of magnitude of those changes.

To give you a rough sense of that, all things being equal, a one percentage point increase in the countercyclical capital buffer has on the order of magnitude about a 10 basis point, or .1%, impact on GDP growth, at the level of GDP, after three years. That's quite a marginal impact. Now there's some uncertainty around those levels and - to the extent to which we're as transparent as possible about the use of the buffer, the extent to which we use the buffer, gradually, we

gradually build it up - one can expect that impact to be less as opposed to more - the impact of .1 on GDP is even smaller impact on the level of inflation.

So this is something that the MPC has to take into account, but in the grand scheme of a variety of other shocks and the scheme of the use of monetary policy, these are relatively marginal effects.

What they do do though, and the intent of them in increasing the resilience of the system, is to take out tail risks from the system; in other words, they improve the sustainability of the expansion as opposed to - and create the prospect of a longer expansion.

Last point I'll make, which is that we are conscious whether - John and I are members of both Committees, we're conscious with both of our hats in terms of the potential risks to the sustainability of the expansion from a low for long interest rate environment, regardless of the precise path of tightening of monetary policy. It's in the orders of magnitude of relatively low interest rates for a long period of time.

And so the active use of macroprudential tools to promote resilience, to sustain that resilience, is an important component of ensuring that we can continue to have strong, sustainable and ideally balanced growth.

Tim Wallace, The Telegraph: On the buy to let market, do you think the Chancellor's doing your job for you? Can you give us your assessment of the impact of his latest taxes on the market and on the risks to the financial sector?

Mark Carney: Yes, well I think the first thing we'd say on buy to let - and I'm going to ask Andrew to expand in a moment - is that part of doing the job, or the collective job, is ensuring that the underwriting standards of the banks and building societies,

who are providing the capital for buy to let, are maintained. And so the review that's announced today with this Report, the review by the PRA of those underwriting standards - and I'll ask Andrew to say a few words on that in a moment - that is very much doing the job as well, ensuring that the quality of those standards is maintained, and there's not a shift from responsible to reckless in that area.

In terms of the tax changes that were announced in the last Budget and in the Autumn Statement, we do think they will have an impact on that market. I think we will wait to see the actual impact as those changes come into force. Our assessment of the risks in that market will be taken in the round, both in terms of underwriting standards, in terms of the likely behaviour of the ultimate owners of buy to let properties, including in a severe house price shock.

And I would say on the last point, and then I'll pass to Andrew, the last point, we are informed - not just by this stress test, but importantly by the stress tests we took last year, which had a more severe shock to the housing sector - and we're thinking through the dynamics of - in a bigger price move, what will an increasing proportion of landlords do, given the fiscal environment and given the potential property environment? So that answer is- yes, it's something we take into account, but I would put it in a broader picture.

So, Andrew, do you want to say …

Andrew Bailey: Well, I'll just add a few things. I mean, I think the first thing to bear in mind - there's some quite interesting charts in the Report on this - that the flow of buy to let lending has sort of gone back really towards the level it was at sort of immediately before the crisis. It's interesting, as the Report illustrates, the flow of owner occupying is completely different and there's a chart which illustrates that quite startlingly on page 29.

Now on buy to let, it's not a regulated activity, so it's not subject to the sort of reasonably standardised set of tests that the mortgage market reviews and on which the FPC gave a recommendation last year. So the PRA's work is to look at the underwriting standards in the market, say when you don't have that starting point of commonality, if you like.

Now again, there's a quite an interesting chart on page 31 of the Report, which is quite carefully labelled actually, which says, "Buy to let lending appears more sensitive to interest rises." And the word "appears" is quite interesting there, because you can imagine that's one way into underwriting standards, which is to say - What are the current standards of interest rate, of stress testing in lending decisions in the buy to let market? How consistent are they across the industry? Are we seeing particular stresses and strains there in that pattern? And that will be the focus of the work.

Starting from this presumption that, while we don't observe a problem - if you look at arrears rates, for instance - we don't observe a problem, but of course we're in a very low interest rate environment. But we do have this background of what appears to be greater interest rate sensitivity.

Kamal Ahmed, BBC: Governor, in the Financial Stability Report you mention pretty much in passing the context of elevated geopolitical risks. I wonder if you could tell us your assessment of how events in Paris, the possibility of increasing levels of conflict in the Middle East, weigh on your judgement of the risks to the financial stability in the UK and more globally?

And then just secondly, I wonder if I could ask you to say how substantial the buy to let and commercial property markets are in terms of their risk to UK financial stability?

Mark Carney: Why don't I take the first one, and I'll ask Jon Cunliffe to comment on the second.

First, I said in my opening remarks that the global environment is unforgiving, and I think that's a fair way to characterise it. We have very subdued growth - you saw in the most recent MPC forecast, UK weighted global growth is about three quarters of a percentage point lower than its historic average, and the MPC doesn't see much of an acceleration over its forecast. That's factored in.

For good reason, we used as the 2015 stress test quite a severe growth shock to emerging markets which reverberate through the global economy and even hit UK institutions that have no exposure to Asia or Latin America, but just are exposed effectively to the UK household sector. There is an impact that flows through financial markets, overall demand, so we see that channel as well.

And obviously there - and you listed some of the geopolitical challenges; they are legion at the moment. The overall geopolitical environment is elevated. Now as a Committee, we have to think about the channels through which that can hit the UK economy, and I think that if you piece together the various components of what we've released today, we see many of them. So there is a global growth shock and financial market shock - quite elevated financial market shock - embedded in the stress tests. So just to give you the shorthand, the VIX, the equity market sort of fear index, goes to 46 in the stress test versus 16 today. You see quite ….. credit spreads; you see a sort of flight to quality type action in government bond markets, consistent with a difficult scenario, which is a deflationary type scenario that brings challenges to the financial institutions.

And so we model what we think is a more coherent and realistic financial market stress at the core of the stress that's

layered on top of a growth shock. You could have a different origin of that growth shock, unfortunately. You could have geopolitical origins of that growth shock. So that - those are some core channels that come through; we see a system that is still resilient to that.

The other area that I would draw attention to, where we're spending a lot of time, as are other agencies, is around cyber. It's another channel, if you will, of geopolitical risk. There are state actors, there are other non-state actors, but with a geopolitical bent that can come through cyber. And that work on resilience is ongoing.

So in that environment we need to build resilience. I think our overall message is that we have built resilience in the core of the system, without question; that we've looked at the overall level of capital we think this system needs. The system is within sight of it. It's been subject to a couple of severe stress tests and effectively come through both of those tests. And now we're layering on top of that capital this total loss absorbency, which gives the institutions and the authorities more tools to deal with more severe outcomes, whatever their source.

So - obviously we can't predict specific geopolitical outcomes, let alone financial market outcomes, but what we can do is work on the core of the system, make sure it's appropriately resilient. And one of our core messages today is that that work is bearing fruit and we see it, not just in the stress tests, but in the overall levels of capital.

Can I ask Jon to speak, to situate buy to let?

Jon Cunliffe: Yes. Just a couple of points to add on buy to let and maybe something on the commercial real estate market. On buy to let, the points I'd add to what the Governor and Andrew have said is that buy to let mortgages are now around 50% of the

stock of mortgages. That's been growing very sharply since around 2000. And we don't know how that much larger number of buy to let landlords will react to stress. As Andrew has said, there's reason to believe that they're more susceptible to interest rate stress, but also in surveys - in the survey that the Bank does - around 15% said they would consider selling if they couldn't cover their interest costs with rental income. Another 45% said they'd consider selling if house prices dropped by 10%.

And of course, in the end, there's only one housing market in the UK. There's buy to let and there's owner occupiers, but in terms of financial stability, one of the issues is whether if you got a rise in interest rates, a drop in house prices, that could encourage a lot of buy to let landlords to sell, and that would put general pressure on the housing market.

Most of them are small landlords with one or two properties and a surprising number of them are lower rate tax payers. So that's the sort of broader financial stability risk to the housing market that could come through that channel.

On commercial real estate, it's a much smaller stock of lending than for owner occupied - for housing generally. But it's an area where historically British banks have taken large losses in downturns. In the last crisis I think nearly 10% of commercial real estate loans by UK banks were materially impaired.

And that market's been growing very fast; prices rose by 10% in the last year across the country, and in London prices - there's a nice chart in the FSR - in London prices are now considerably above pre-crisis levels.

Now most of that - the majority of that lending into financing of commercial real estate has come from abroad, and after the crisis we saw much more equity financing than loan

financing. But nonetheless, UK banks still have about 50% of their CET1 accounted for by loans to CRE, and there is some evidence that leverage is starting to come back, and also the loan to value ratios are changing.

So generally there's an area there that I think is growing fast. It's smaller than, much small than residential housing, but it needs to be watched very carefully. And even if many of the flows are coming from abroad and are coming from equity, if you got a material downturn in commercial real estate prices, commercial real estate is the collateral that over half of small and medium-sized businesses use to secure their lending. So you can see a big impact on that channel and you can see an impact on UK banks.

We did, however, test in the 2014 stress test, against a big fall - 30% drop in CRE prices, and the banking system came through robustly.

Questioner: Can I just ask you to elaborate a bit on the 11% equity ratio that you want the banks to get by 2019? I just say the Basel Committee, the Vickers Committee, both said it should be much higher. What makes you confident that 11% is enough? I mean, are you worried that you're going to be accused of being too lax with the banks?

Mark Carney: No. I think the - there's a couple of key things. Let's start from those higher levels, and I've referenced 18% - it's referenced in the Report, which was work of the Basel Committee and governors and heads of supervision at the time. I was Governor at the Bank of Canada when we did this work and effectively came up with 18%, looking at a series of almost 90 financial crises through history, what the level of loss absorbency would be required. And it was measured relative to the old system, the old system of risk weights and the old system of capital.

Okay, so a number of things have changed since then. One, the definition of capital is much more robust - I won't go into all the details, but there's a variety of ways we've made the definition of capital - true capital, true loss-absorbing capital, which isn't just changing what's on the capital side of the equation, but also making adjustments on the asset side of the equation of the balance sheet.

The second thing is some improvements to those risk weight measures; there's more to come, and I'll come back to that.

The big change has been to improve the prospects for resolution of banks, and with the MREL Agreement in Europe and then crucially the TLAC Agreement at the G20 in the last month, we now have the real prospect of having a layer of loss-absorbing capacity, true layer of loss-absorbing capacity, that can reload equity once that equity is used up - so that we have much more confidence that, once this is fully implemented, then we'll take a few years to fully implement, that we will be able to resolve even the largest banks in the United Kingdom.

And that means we can run a more efficient capital structure. That improvement in TLAC alone accounts for almost probably - and there's a background paper that's being released today from our staff - but it's on the order of magnitude of five percentage points of the reduction of that overall level of capital, we can run a more efficient structure.

The third element is to have a countercyclical buffer that is actively used, and so that we don't carry extra capital in all states of the world, but we increase when the system requires it. And we've given a signal in terms of where we think we are in terms of the phases - the phases of risk.

And then you do have to have active supervision, forward looking supervision. And if individual firms have individual

risks that are above and beyond those for the system, they have to provide for them. I'll give you once example, which is the case in the UK, is that there are some banks that have defined benefit pension programmes that in a very low interest rate environment they'd need to make, in our judgement, extra provisions for in terms of capital that they're not required to do on an accounting basis. So that's an example where those individual banks would carry more.

It's important to recognise that when we say the system as a whole should have about this amount of capital, that individual - there will be a distribution around that, depending on the riskiness of the various banks. But this is a judgement in terms of what the system actually requires.

Now, we will spend, as I said, and as we detail in the Report, we will spend the next few years implementing this system and clarifying the various elements of the system. There is important work to set the buffer for ring-fenced banks. There's important works to implement MREL, also known as TLAC, which is this bail-inable debt. And there's important works to take things out of individual bank buffers and put them into the core capital, through improving the measurement of risk in the system.

The key point to take is that this system has built capital steadily since the crisis. It's within sight of this resting point, of what the judgement of the FPC is, how much capital the system needs. And that resting point - we're on a transition path to 2019, and we would really like to underscore the point that a lot has been done, this is a resilient system, you see it through the stress tests. There will always be individual institutions who have to do certain things, but a system as a whole - this is a well-capitalised system and it's time to provide that clarity and the clarity of message so that we can focus on other priorities.

Caroline Binham, Financial Times: Governor, you repeated a phrase you used when you were introducing the TLAC proposals last month where you said there is no Basel IV. The banks would counter that things like fundamental review of the trading book is very much fundamental in that they're going to have to put aside perhaps four times as much capital against their market risk.

My second comment would be just to pick you up on - you mentioned the remit letter requiring you to do a cost benefit analysis of the impact of regulation. With the introduction of the remit letter, do you feel under political pressure to water down any of the current regulations?

Mark Carney: No. Well let me be very, very clear on the second one, absolutely not. There's no change in the statute, there's no change in our responsibilities to promote financial stability. We will continue to take our decisions.

I mean the responsibility for financial stability rests clearly with the FPC and its membership, and I can assure you that all members fully recognise the weight of that responsibility and we will do whatever is necessary in order to promote financial stability, in a way that's promoting strong, sustainable, balanced growth. And so we won't increase capital without limit, but we will make sure that the system is adequately capitalised for plausible but severe stress scenarios. And that's - you know you can make your judgements based on what we've been doing there.

Let me go on to Basel IV; there is no Basel IV; there is no - I'll say it again and I would like you to print it. There is no big wave of additional capital. There are things that need to be done in order to, you know, to clean up the system. There are excessive variants of risk weights for example, across various jurisdictions and between institutions within jurisdictions, and there are ways to reduce that variance and that's what the Basel Committee is looking at.

We will not increase capital in the United Kingdom because of those adjustments, those sensible adjustments. So the overall level of capital isn't going to increase in the system. That's the very clear message from the FPC. For individual firms, depending on whether they've been stretching the limits of risk variants, risk weights, they may have to adjust, but not for the system as a whole.

I'll say one word on the fundamental review of the trading book and then I'll ask Andrew maybe just to elaborate. And this is a word about process, which is that the way the Basel Committee used to operate in consultations was they would go to the bunkers of Basel, come up with the answer, put out a piece of paper, which was the answer as far as they were concerned, and that was called a consultation. And then, you know, they would get some letters in, they wouldn't necessarily open them, and then they would say - well the answer is the answer; we already told you the answer and this is what it is.

That has changed. The form of consultation is much more wide ranging in terms of potential outcomes. And so some institutions and analysts have taken extreme versions of what - of the previous consultation and read that as that's what's going to come. I can understand that, you know, maybe from a prudence perspective they would. But that's not the likely outcome.

We see the fundamental review of the trading book proceeding well, we see it as quite modest in terms of its overall impact in the UK and you know I meant what I said, and we meant what we said in the FPC endorsed documents here, is that - look, this system is within sight of where it needs to be.

You follow this very closely Caroline, so you won't be confused by me throwing different numbers at you, but if you measure it on an apples to apples basis, that 11% translates to 13.5% with current risk weights and various measures. The system is about 13% right now. So that gives you a sense of where we are. Ultimately as things get ported into a more transparent and clear system, 11 will be 11 if you know what I mean. But Andrew can I just ask you to just say a few words on …

Andrew Bailey: Well the one other thing I would add and it really refers you back to the capital structure paper that we've released today. You'll see from that, we've got this sort of complicated stack of buffers and requirements, and one of the things we've done today is to sort of rationalise that down as much as we can.

Now traded risk is quite interesting because we've got traded risk capital in Pillar 1, which is what the Basel Committee looks at, and then we've got some more in what we call Pillar 2A, which is where we've put some on to compensate for the things that aren't in Pillar 1. And the capital structure paper makes the very clear point that of course, you know, wherever possible we want to rationalise that. And that's where you can see the - you know the fundamental review of the trading book is about. But the point is that we've got another pot of capital there which we've judged to be necessary for traded risk.

So just to support what the Governor said, you know, we do not see this as increasing capital requirements, that's not the name of the game here. Rationalising the structure of course is entirely welcome, welcome to us, welcome to the banks, and moreover welcome to the transparency of the whole system, which is one of the big points about releasing this paper today.

Paul Davies, Wall Street Journal: So just going back to the countercyclical buffer, just to try and make sure I understand it. I mean I get that in normal times it's supposed to run at about 1% of UK risks, right, and then as things overheat you will increase it to increase resilience. Why would you decrease resilience below 1%? Why would you want to decrease resilience by moving it below 1%? What kind of conditions and what would you be trying to achieve by doing that?

And a small supplementary thing, the Q1 review means that by the end of Q1 some of this countercyclical buffer will be in place?

Mark Carney: Yeah, okay, so let me take the second part first and then I'll come to your core question, because it builds on something that Andrew was saying and maybe just to add to that, which is to Caroline's question - so just to repeat what Andrew is saying and this is, and I apologise, but this is part of the system, it's complicated and we're trying to make is more simple. The bottom line is this system is capitalised you know it's within sight of what it needs - where it needs to be capitalised. That's the main thing I would take away if you don't want to follow the details.

But the core issue is there are deficiencies such as how traded risk is measured. We make up for those by having additional buffers, the PRA makes up for those. Once we fix the system internationally those buffers just go into the risk weights as they are measured, they are properly measured and they move down.

There is an analogy here to your question, which is what is the PRA doing in this first quarter with respect to separating out risks that would more properly be in the countercyclical buffer? Effectively there is something called the PRA buffer, which individual banks have to hold additional capital for a variety of reasons. One of them is a product of historic

analysis of how they would react to stress. Some of that stress is of course just macroeconomic stress, the type of stresses we do in these stress tests. We're going to extract that, because it really belongs in the countercyclical buffer.

So this process of separation will identify a certain amount of buffer that's in the system already, that should be in the countercyclical buffer. Now it may be - and just to be clear, the countercyclical buffer can only be in increments of 25 basis points - so it may be 25 basis points, it may be 50 basis points. But at the end of that process there will be a number that is in the countercyclical buffer that is no longer in the sort of hidden buffer, if you will, of the system.

As I said in my opening remarks, the overall level of capital in the system will not have changed; it will just be more transparent. At that point, as we have to do every quarter, the FPC will assess, given the risk environment whether we think that there is enough in that countercyclical buffer. We may increase the countercyclical buffer; that's a decision still to be taken and we'll look at the various indicators of risk and make an assessment, and we may adjust it.

We are giving about as clear guidance as we can give about it in this type of risk environment into which we're moving, which is a more normal and more standard phase of risk - that level of this countercyclical buffer, should be in the range, in the region of around 1%. We'll make a judgement on how quickly in order to move there.

Your question is when would we ever reduce it? Well, when you go back - if the system goes into a risk environment where there is risk aversion of banks, and that risk aversion of banks or firms and individuals exceeds the likely losses that are going to happen, the system is carrying too much capital for the actual outcomes, then one lowers the

countercyclical buffer so that banks can deploy their capital more efficiently.

Ideally, we spend most of our time in a standard risk environment, with a countercyclical buffer around - in the region of that area. Now we'll have to continue - it's a new instrument, we'll have to continue to update our thinking about what's the right level of that. But we'll be very clear and transparent about it. And, as I say, ideally we would remain in what is a standard risk environment for as long as possible, because that's most commensurate with sustainable and balanced growth.

Jill Treanor, The Guardian: I just want to take you back to the first question you were asked about the impact of countercyclical buffers and the answer you gave about what it meant for interest rates. Is this a way of you allowing to keep interest rates lower for longer?

The second question I wanted to ask is - you talk about being ready to act in the buy to let market, even though you don't yet have the formal powers. Can you talk about what powers you've considered using to rein in the buy to let market?

Mark Carney: Well, in terms of the relationship again between macroprudential and monetary policy, I would lay the stress on the time horizons. Normally there is a different time horizon to price stability and financial stability. So the risks that can build up in the system - and of course this was the great problem with only having one instrument - is that you can build up risks in the system that aren't going to manifest over that two to three year horizon over which we have a statutory responsibility for achieving price stability.

So one doesn't - the Bank can't use monetary policy, it's not the best instrument to attack financial stability risk. By using macroprudential tools of a variety of sorts, including the

countercyclical buffer, we do increase resilience in the system and we make it less likely - we make the system more resilient to the manifestation of any of those risks, whether they come in the medium term or beyond. And that allows monetary policy to do its job, which is to achieve the inflation target.

It is important that the two Committees understand the reaction functions of each other, how each Committee is going to try to achieve its objectives. It's important that we share analysis, it's important that we have shared discussions. That is what we're doing, that's part of the reforms of the Bank of England that we've put in place. It's part of the reason why we want to move to eight meetings a year for the Monetary Policy Committee so we have more time to share these discussions.

Because the most likely scenario - and this is the judgement of everybody on the Monetary Policy Committee - is that interest rate moves, when they come, will be limited and gradual, you know move at a gradual pace and rise to a limited extent, because of a variety of headwinds that are affecting the economy. So that means effectively that these types of macroprudential risks could be present, and the FPC has to be particularly vigilant. The more vigilant the FPC is - the more effective maybe is a better way to put it - the FPC is, the greater confidence the MPC can take that it doesn't have to use monetary policy to address financial stability risk.

And so to segway to your second question, remaining question on buy to let, certainly the Monetary Policy Committee doesn't look at what's happening in the buy to let market and think - oh, we have to tighten interest rates in order to address a fast-growing pace of mortgages in buy to let. There are other measures that can be used.

And in terms of the types of measures I think the best way to - I mean there is a consultation of the government on directive powers and the specific powers are detailed in that, and there is value to powers of direction. Powers of direction means we have to have a clear policy statement, powers of direction means we can act immediately, powers of direction are particularly important in buy to let which, as Andrew pointed out, is an unregulated market unlike owner occupied.

So for all those reasons this is a very important consultation. What we focused on in this meeting was what's actually happened, the fiscal measures by the government and the impact of those, and what - and the importance of having underwriting standards, maintaining underwriting standards, which is why the PRA's action is very much welcomed by the FPC.

James Salmon, Daily Mail: On underwriting standards you mentioned that challenger banks were loosening their underwriting standards, whereas the major lenders were tightening theirs. I just wondered whether you could talk a bit about the risks posed by challenger banks and what you can do about it?

And just to clarify this point, on interest rate rises on buy to let, from what you were saying earlier I sort of read into it that you thought that when the countercyclical buffer is increased, lenders are likely to increase their rates but only slightly and much less than they would do if interest base rate increased. So is that the correct reading of what you were saying earlier or not?

Mark Carney: You mean the mapping of a 25 basis point increase in interest rates versus a 25 basis point increase in - a 25 basis point increase in interest rates has a bigger impact on the cost of borrowing, all things being equal, than a 25 basis point increase in the countercyclical buffer; that's probably the best

way to answer the second part of your question. That's a direct answer to the second part of your question.

But of course the purpose of the countercyclical buffer - to repeat myself - is different. It's about resilience as opposed to the interest rate which is about achieving the inflation target.

I might ask Andrew to say a word about the sort of dynamic between various institutions in the buy to let market.

James Salmon, Daily Mail: Is the likelihood is that rates will go up slightly in a countercyclical … ?

Mark Carney: Well, I think the - in terms of - there is some flow through of that - any time you increase capital there is a flow through ultimately to the cost of borrowing. I gave you the sensitivity that we've used; our calculation is - ultimately the impact on GDP is about a tenth of the - for a large increase, for a 1% increase in the countercyclical buffer, and you know so that's quite a modest impact.

To hammer home the point of the earlier question about what's in the system already, there is already something in the system. We're in the process for the next quarter of separating that out and making it transparent. So when we talk about in the region of 1%, there's not a cumulative one percentage point increase, if you will, in capital to come, in the judgement of the FPC at this stage. But to go to the challenger banks.

Andrew Bailey: Well, I'll just say two things. I mean firstly, the review of underwriting standards goes across the board because - unsurprisingly as you may expect - the biggest mortgage lenders are also the biggest buy to let lenders, so that's important.

I think the point about what I call challengers or the second tier is to check that - in the history of this country and particularly in the last two housing problems we've had, the early '90s and the period of around 2007 - there have been - both periods have had concentrations of exposure in rapidly growing parts of the market. So whether you go back to sort of second tier mortgages in the early '90s or you go to high LTV lending in the sort of pre 2007 period, what you tend to see sometimes is these pockets of concentration which lead to weaknesses in the system.

So my own view is that we have to be particularly alert, given that tendency, for that pattern to be seen in underwriting standards, but that doesn't take away from the fact that actually it's a review across the board.

Martin: Okay, I've got two questions. One, Governor if you could just clarify on the 11% figure on - you're saying that banks are within sight of the total capital requirements and you mentioned 11%. I mean, in your own Reports it talks about the major UK banks already having increased their common equity tier one capital ratio to 11.9% at the end of June, so I'm a little bit confused. But then you said 11% translates into 13% in today's money. So how close are they and how much further do they have to go?

And the second question is can you give us any indication or steers as to what the next stress test, the scenario will be, and is there any chance that at some point you will include a cyber-attack element in a future stress test?

Mark Carney: Well, hopefully there's not a cyber-attack while we're running the next stress test, but I'll ask Jon to speak to that.

The answer to your question is, it in part relates to my answer to your neighbour, Caroline, on - there are a series of deficiencies in the current system. So it's 11% properly

measured. If risk weights are properly measured, if banks account for their shortfalls properly of, for example, pension deficits would be a classic example, as well. And we're in a process of moving those issues into the numerator and denominator of that 11%, okay. That's the shorthand way of doing it.

The way the PRA operates, as good supervisors should, is to ensure that it has buffers that take into account those deficiencies, whether they're in concentration risk, interest rate risk, trading book risk, excessive variance in risk weights, certain risk model issues, pension deficits, a variety of things, okay. All very important details, but complicated.

What we set out in the Report is for an apples to apples comparison, and the system is in a process of doing that, of moving things to be properly measured - the top and the bottom of that ratio.

The way things are currently measured and currently addressed, the system has 13% total capital so that common equity plus additional tier one, AT1. And it would need that 11% translates to 13.5%. And it's detailed in the Report and - go through with it offline if you want, to give you the more detail. That gives you the sense of them being within sight, okay.

So, you know, without getting - we then jump into an entirely different degree of complexity in order to explain it, but that's the simplest way to explain it.

The key point again - just to repeat - is they are within sight. We're talking about less than one percentage point of capital, arguably 50 basis points of capital, that they need to build - the system needs to build - over the course of the next three years. And they've built twice that over the course of the last three quarters.

So there's no big wave of capital coming. There's lots of very worthy, important, detailed things that will make the back pages of the newspaper I'm afraid, not the front page - that merit the back page of the newspaper maybe, if I may lead. I'm sorry about that, but aren't headline grabbing, there's a big capital grab, bit capital cull for the system.

It's about cleaning this up, and I think it's time to be as clear as possible about that, because there is a confusion out there that there is additional waves of capital that's going to be required, when it really is about fixing the system and making it more transparent.

The next stress test, maybe say a word about the next couple of years.

Jon Cunliffe: The last two stress tests, and these were the first ones we had done for the banking system as a whole, each one chose a different scenario. The first one chose a scenario you know which interest rates went up going into recession, the second one was more deflation scenario with the shock coming from abroad.

We published in October details of how we propose to operate stress testing in future, and it's rather different. So we develop an approach in which we divide the stress test if you like into two different sorts of test. One, every year we do an annual cyclical test which will vary in severity with where we are in the financial cycle. So the higher asset prices are - the sort of stronger economic growth, the more severe the assumptions will be. And we'll use that to inform the countercyclical buffer and how we set that, so give us some idea of where we are in the cycle.

And because we're varying the severity from year to year, broadly the areas we test will be the main areas of risk for

the UK economy, housing, unemployment, some overseas exposures, but it won't change very much. I wouldn't envisage it would change very much from year to year.

Every other year we will in addition do something which we call an exploratory scenario where we'll take a particular type of risk and we'll explore that. And cyber could be a possibility for that; we haven't yet decided. We'll do that every second year, test the exploratory scenario in years when the European Banking Authority is not doing a test for European banks including the UK generally. So next year the EBA plans to do a Europe-wide test, so we won't do an exploratory scenario. The year after we will and we haven't yet decided which it could be. But there we can explore particular types of risk like cyber.

Dominic Elliott,
Reuters Breakingviews: Governor I just had a follow up question to Martin's question about the required amount as you see it currently. So 13.5% is based on tier one capital, I just wondered what that translates to in terms of common equity tier one?

And then secondly, just on these changes, these final completion points for Basel III that are not Basel IV. You said that it might require some tweaks for individual banks, but it wouldn't, you thought, see the sector as a whole needing to raise capital. I just wanted to understand how you square that circle? Presumably therefore, one takes it that you have second guessed these changes here at the Bank of England in terms of what's going to be required, so you have added on specific requirements for individual banks.

Now to harmonise it, are you suggesting that maybe in some cases you've gone just a little bit too far, in other cases perhaps you've undershot, and it will just be a slight flattening out? I just wonder how you can have the confidence that it won't lead to any capital raising.

Mark Carney: Yeah well the first thing - I'm going to give Andrew the last word since I've tried multiple times to explain the simplicity of our new approach -

Laughter

Mark Carney: - which underscores why we need this new approach to the overall capital.

But just on your second question, you know to the extent to which we've adjusted for a variety of things, and as I said interest rate risk, concentration risk if banks have excessive concentration, if they have models that are excessively pro cyclical for example in the mortgage market, something we flagged in last year's stress test. In all those cases, there's capital in the system already. The extent to which the approach, the baseline approach, is adjusted to correct for those - and it won't be able to correct for all of those, but it corrects for a variety of those - then that capital is just translated into the core ratio.

Now you can think about capital in terms of the pound value of capital and you can think of the capital ratio in terms of the numerator and the denominator, the extent to which the risk weighted assets go up because you fix these deficiencies, the overall pound amount of capital doesn't necessarily have to change if it's just a fixing of the denominator. What's required - changes right - that 11% hurdle as opposed to a 13% type hurdle, if you follow that.

So a lot of what happens here is just improving, if you will, the plumbing or the behind the scenes calculations of the capital ratios. And capital is just - it's moved, it's just re-characterised. And that's why the amount of capital in the system doesn't go up in that case.

But we are committed that, with the various changes, that we won't use them as a way to increase capital. As I said in my opening comments, we will not increase capital by stealth. If we step back as a Committee five years from now and the subsequent Committee says and thinks that we've got this wrong, they will be transparent and say that it's wrong for that - for these analytic reasons - and make an adjustment, not by changing something behind the scenes in order to increase it.

And so once you have that commitment, you know what capital is in the system, you know how it gets reallocated and there's a variety of ways to adjust so that the system as a whole doesn't - we don't change the overall amount.

So the work that's being done, whether it's on the trading book or whether it's on excessive variance of risk weights, all these worthy, important things, it's about relative risk, it's about relativities. And therefore if you have a different business model it will make an impact on individual institutions but not the system. So that's the second bit.

On the first part of the question which is the 13% I think it's just - actually you're just asking the AT1 component of the -

Andrew Bailey: Yeah we think that 11 maps to about 9.5, so you can sort of pretty much do the -

Mark Carney: Of CET1.

Andrew Bailey: Of CET1 which is your question about what does it map. So you can sort of do the extrapolation if you like and say - you can take sort of just over 1.5 off 13 and you're in the ballpark I would say is the right way to look at it.

Mark Carney: That's it. Exciting way to end the press conference.

Facilitator: Indeed. That's all we've got time for. Thank you very much for coming, particularly those who got up so early. We look forward to seeing you next time.

END