BANK OF ENGLAND

Financial Stability Report
Executive summary

November 2017

This pull-out contains the Executive summary of the *Report*.
The full *Report* is available on the Bank's website at
www.bankofengland.co.uk/publications/Pages/fsr/2017/nov.aspx

Executive summary

The Financial Policy Committee (FPC) aims to ensure the UK financial system is resilient to, and prepared for, the wide range of risks it could face — so that the system could support the real economy, even in difficult conditions.

The 2017 stress test shows the UK banking system is resilient to deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs.

- The economic scenario in the test is more severe than the global financial crisis.
- In the test, banks incur losses of around £50 billion in the first two years of the stress. This scale of loss, relative to their assets, would have wiped out the common equity capital base of the UK banking system ten years ago. The stress test shows these losses can now be absorbed within the buffers of capital banks have on top of their minimum requirements.
- Major UK banks' capital strength has tripled since 2007; their Tier 1 capital ratio was in aggregate 16.7% in September 2017.
- For the first time since the Bank of England launched its stress tests in 2014, no bank needs to strengthen its capital position as a result of the stress test.

The FPC is raising the UK countercyclical capital buffer rate from 0.5% to 1%, with binding effect from 28 November 2018.

- This will establish a system-wide UK countercyclical capital buffer of £11.4 billion.
- Capital buffers for individual banks ('PRA buffers') will be set by the Prudential Regulation Committee (PRC) in light of the stress-test results. These will in part reflect the judgement made by the FPC and PRC in September 2017 that, following recent rapid growth, the loss rate on consumer credit in the first three years of the scenario would be 20%.
- The setting of the countercyclical and PRA buffers, as informed by the stress test, will not require banks to strengthen their capital positions. It will require them to incorporate some of the capital they currently have in excess of their regulatory requirements into their regulatory capital buffers.
- The purpose of these buffers is to be drawn on as necessary to allow banks to support the real economy in a downturn.

The stress-test scenario and the resulting setting of capital buffers reflect the FPC's assessment that, apart from those related to Brexit, domestic risks are at a standard level overall, and that risks from global debt levels, asset valuations and misconduct costs remain material.

There are also potential risks arising from the macroeconomic consequences of some possible Brexit outcomes.

- There are many possible combinations of risks that could result from a sudden exit from the European Union without a trade agreement. The outcome would depend on many factors, including the extent of contingency planning and government policies in the United Kingdom and European Union.

- In the stress scenario, there is a sudden reduction in investor appetite for UK assets and the sterling exchange rate falls to its lowest ever level against the dollar. Bank Rate rises to 4% and unemployment rises by more than in the financial crisis. UK commercial property prices fall by 40%, and UK residential property prices fall by 33% — the largest fall on record.

- The stress-test scenario therefore encompasses a wide range of UK macroeconomic risks that could be associated with Brexit.

- As a result, the FPC judges the UK banking system could continue to support the real economy through a disorderly Brexit.

However, the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in the stress test. In such circumstances, capital buffers would be drawn down substantially more than in the stress test and, as a result, banks would be more likely to restrict lending to the real economy.

The FPC will reconsider the adequacy of a 1% UK countercyclical capital buffer rate during the first half of 2018, in light of the evolution of the overall risk environment.

The FPC continues to assess the risks of disruption to UK financial services arising from Brexit so that preparations can be made and action taken to mitigate them.

- Ensuring a UK legal and regulatory framework for financial services is in place is essential to financial stability. The Government plans to achieve this with the EU Withdrawal Bill and related secondary legislation.

- It will be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risks of disruption to financial services. Timely agreement on an implementation period would reduce risks to financial stability.

- To preserve continuity of existing cross-border insurance and derivatives contracts, UK and EU legislation would be required. Six million UK policyholders, 30 million European Economic Area (EEA) policyholders, and around £26 trillion of outstanding uncleared derivatives contracts could otherwise be affected. HM Treasury is considering all options for mitigating risks to the continuity of outstanding cross-border financial services contracts.

- EEA-incorporated banks that operate in the United Kingdom as branches will need authorisation to operate in the United Kingdom. To maintain financial stability, the conditions for authorisation, particularly for systemic entities, will depend on the degree of co-operation established between regulatory authorities. The Prudential Regulation Authority plans to set out its approach to authorisations before the end of the year.

- Irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the United Kingdom. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards.

The FPC and PRC have completed an exploratory exercise examining major UK banks' long-term strategic responses to an extended low growth, low interest rate environment with increasing competitive pressures from FinTech. Although banks suggest they could, by reducing costs, adapt without major strategic change or taking on more risk, there are clear risks to this.

- Competitive pressures enabled by FinTech may cause greater and faster disruption to banks' business models than banks project.

- The cost of maintaining and acquiring customers in a more competitive environment may reduce the scope for cost reductions or result in greater loss of market share.

- The cost of equity for banks may be higher than the 8% level they expect in this scenario. In a low growth, low interest rate environment, investors may perceive downside economic risks to be greater, raising the equity risk premium.

- Supervisors will now discuss the results of the exercise with banks, including the potential implications of these risks.

The FPC has completed an annual review of risk and regulation beyond the core banking sector. It is not recommending any changes to the regulatory perimeter at this stage.

- Market-based finance — the system of markets, non-bank financial institutions and infrastructure that provide financial services to support the real economy — now accounts for almost 50% of the UK financial system.

- The FPC has asked for an in-depth assessment of the use of leverage in the non-bank financial sector, focusing on leverage created through use of derivatives. The FPC has considered, and will continue to monitor, risks to the provision of market-based finance from the growth of electronic and algorithmic trading.

Overview of risks to UK financial stability and UK countercyclical capital buffer

The FPC judges that, apart from those related to Brexit, domestic risks are at a standard level overall, and that risks from global debt levels, asset valuations and misconduct costs remain material.

The 2017 stress test shows the UK banking system is resilient to deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs. Informed by the stress-test results, the FPC is raising the UK countercyclical capital buffer rate from 0.5% to 1%, with binding effect from 28 November 2018.

There are also potential risks arising from the macroeconomic consequences of some possible Brexit outcomes. The stress-test scenario encompasses a wide range of UK macroeconomic risks that could be associated with Brexit. As a result, the FPC judges the UK banking system could continue to support the real economy through a disorderly Brexit.

However, the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in the stress test. The FPC will reconsider the adequacy of a 1% UK countercyclical capital buffer rate during the first half of 2018, in light of the evolution of the overall risk environment.

The FPC assesses the risks the financial system could face in an economic stress.

The FPC assesses the losses the financial system could face in a severe economic shock. This 'risk assessment' covers:

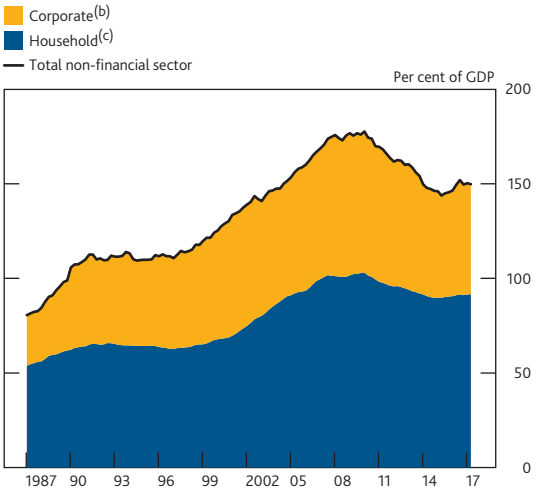
- The sensitivity of the financial system to economic shocks. To assess this, the FPC monitors the size and riskiness of the financial system's balance sheet.

- The size of economic shocks the system could face. For example, the FPC monitors the risk that highly indebted households could amplify economic downturns, or that falls in foreign investor sentiment for UK assets could drive a fall in domestic demand.

The FPC uses this assessment in aiming to ensure that the UK financial system is resilient to, and prepared for, the wide range of risks it could face — so that the system could support the real economy, even in difficult conditions. An important tool to achieve this is the system-wide countercyclical capital buffer (CCyB). This buffer of capital, which applies to the UK exposures of all banks, can be released following a stress,

Chart A.1 The ratio of debt to GDP in the UK real economy has fallen since the crisis, but remains high by historical standards

Components of private non-financial sector debt to GDP[a]

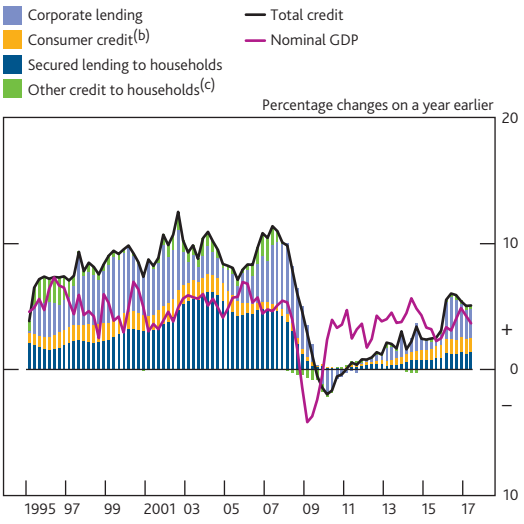


Sources: ONS and Bank calculations.

(a) Data are all currency and are non seasonally adjusted.
(b) Includes private non-financial corporations' (PNFCs') loans and debt securities, excluding direct investment loans and loans secured on dwellings.
(c) Includes all liabilities of households and non-profit institutions serving households (NPISH), except for unfunded pension liabilities and financial derivatives associated with NPISH.

Chart A.2 Total credit growth to the real economy is only a little faster than nominal GDP growth

Nominal GDP and contributions to total private non-financial sector credit growth[a]



Sources: ONS and Bank calculations.

(a) Credit is defined as debt claims on the UK private non-financial sector. This includes all liabilities of households and non-profit institutions serving households (NPISH), except for unfunded pension liabilities and financial derivatives associated with NPISH. Also contains PNFCs' loans and debt securities, excluding direct investment loans and loans secured on dwellings. Data are all currency and are non seasonally adjusted.
(b) Includes student loans. As student loans data are only available annually on a financial-year basis, periods after 2017 Q1 are estimated as total unsecured loans to households and NPISH, less monetary financial institutions' (MFIs') sterling loans to unincorporated businesses and the not-for-profit sector component.
(c) Calculated as the residual of total credit to households and NPISH, less secured and unsecured loans to individuals. The residual comprises of MFI loans to unincorporated businesses (for example sole traders), loans to NPISH, and household bills that are due but not yet paid.

enhancing the ability of the banking system to continue to support the economy.[1]

The FPC varies the UK CCyB rate to reflect the prevailing risk environment: when risks are high, either because banks could face bigger economic shocks or because they are more sensitive to them, a larger buffer is needed to absorb potential losses.

In its published strategy for setting the CCyB, the FPC signalled that it expects to set a UK CCyB rate in the region of 1% in a standard domestic risk environment. In June 2017, the FPC stated that, absent a material change in the outlook, it expected to increase the rate to 1% at its November meeting.

Stress testing supports this process. The annual cyclical scenario in the stress test was calibrated to reflect the FPC's view of the prevailing risk environment. The projected losses in the stress test provide an indication of the size of the capital buffers necessary for banks to withstand a shock.

The FPC's risk assessment currently focuses on: the domestic risk environment; asset valuations; debt levels in the global economy; and risks associated with Brexit. This chapter sets out the FPC's aggregate risk assessment, while individual risks are discussed in more detail in the subsequent chapters of this *Report*.

The FPC judges that, apart from those related to Brexit, domestic risks are at a standard level overall.

The FPC judges that apart from those related to Brexit, domestic risks are at a standard level overall. This judgement takes into account domestic credit conditions, including consumer credit, as well as the United Kingdom's external financing position.

While debt levels are high, overall credit growth is only a little above nominal GDP growth, and debt-servicing costs are low…

Credit conditions are a core element of the overall risk environment. High levels of debt, particularly when built up during periods of rapid credit growth with looser underwriting standards, leave the financial system at risk of incurring a higher level of losses, by:

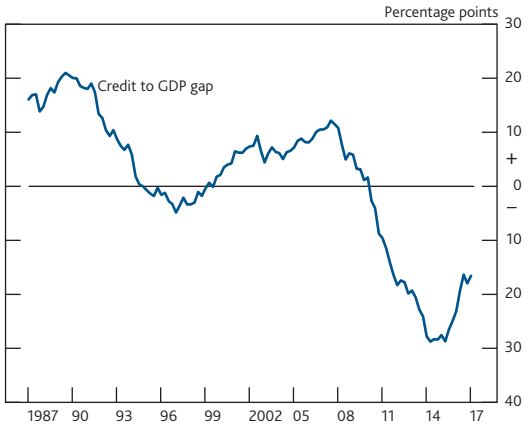
- Making lenders more exposed to losses. Highly indebted borrowers facing difficulties in servicing their debt can default, causing losses for lenders directly. This channel is most relevant to consumer credit.

- Raising the size of economic shocks banks could face. Highly indebted borrowers can cut their spending sharply in a downturn in order to continue to service their debts. This can amplify economic downturns and is most relevant to mortgage debt.

(1) The CCyB rate set by the FPC applies to all UK exposures, irrespective of the country of origin of the lender. Similarly, other countries set the CCyB rates that apply to lending by UK banks overseas. The CCyB applies to all banks, building societies and investment firms (other than those exempted by the FCA) incorporated in the United Kingdom. For more details on the CCyB see 'The Financial Policy Committee's approach to setting the countercyclical capital buffer', available online at www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement050416.pdf.

Chart A.3 The private non-financial credit to GDP gap is negative

Private non-financial sector credit to GDP gap[a]

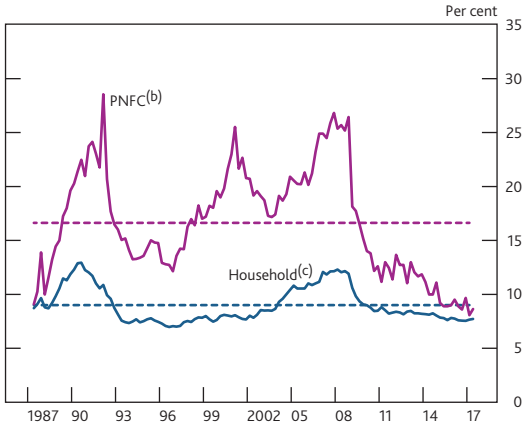


Sources: ONS, Revell, J and Roe, A (1971), 'National balance sheets and national accounting — a progress report', *Economic Trends*, No. 211, UK Finance and Bank calculations.

(a) Credit is defined as debt claims on the UK private non-financial sector. This includes all liabilities of households and non-profit institutions serving households (NPISH), except for unfunded pension liabilities and financial derivatives associated with NPISH. Also contains PNFCs' loans and debt securities, excluding direct investment loans and loans secured on dwellings. The credit to GDP gap is calculated as the percentage point difference between the credit to GDP ratio and its long-term trend, where the trend is based on a one-sided Hodrick-Prescott filter with a smoothing parameter of 400,000. See Countercyclical Capital Buffer Guide at www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx for further explanation of how this series is calculated.

Chart A.4 Aggregate debt-servicing costs are low

Aggregate household and corporate debt-servicing ratios[a]



Sources: ONS and Bank calculations.

(a) Dashed lines show 1987–2017 averages.
(b) PNFC interest payments as a percentage of gross operating surplus, excluding the alignment adjustment and the effects of financial intermediation services indirectly measured (FISIM).
(c) Calculated as interest payments, plus mortgage principal repayments as a proportion of nominal post-tax household income. Household income has been adjusted for the effects of FISIM.

The overall stock of outstanding private non-financial sector debt in the real economy has fallen since prior to the crisis, though it remains high by historical standards, at 150% of GDP (**Chart A.1**).[1] Excluding student debt, the aggregate household debt to income ratio is 18 percentage points below its 2008 peak (see **Chart A.9** in the UK household indebtedness chapter). The FPC's judgement about the overall credit environment is also informed by the rate of growth and serviceability of that debt.

Credit growth is, in aggregate, only a little above nominal GDP growth. In the year to 2017 Q2, outstanding borrowing by households and non-financial businesses increased by 5.1%; in that same period, nominal GDP increased by 3.7% (**Chart A.2**). Excluding student loans, household debt has increased only a little faster than household incomes.[2] Corporate debt has fallen relative to corporate profits in recent years.

The United Kingdom's credit to GDP gap, which measures the difference between the ratio of credit to GDP and a simple statistical estimate of its long-term trend, remained significantly negative in 2017 Q2, suggesting that risks from credit growth are very subdued (**Chart A.3**).[3]

The cost of servicing debt for households and businesses is currently low (**Chart A.4**). The aggregate household debt-servicing ratio — defined as interest payments plus regular mortgage principal repayments as a share of household disposable income — is 7.7%, below its average since 1987 of 9%. The share of households with very high debt-servicing ratios is also small, and the FPC has policies in place to guard against the risk of a marked loosening in underwriting standards and any significant rise in the number of highly indebted households (see UK household indebtedness chapter). The ratio of non-financial businesses' interest payments to profits is 8.6%, around half its average since 1987.

…though there is a pocket of risk in consumer credit.

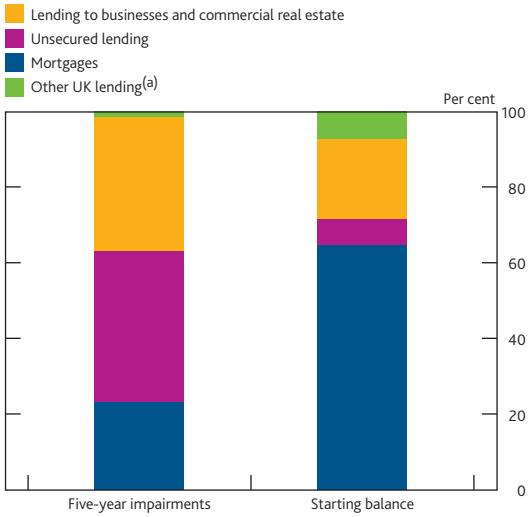
While overall domestic credit conditions do not point to elevated risk, consumer credit has been growing rapidly, creating a pocket of risk. The outstanding stock of consumer credit increased by 9.9% in the year to September 2017 (see **Chart A.15** in the UK household indebtedness chapter).

Rapid growth of consumer credit is not, in itself, a material risk to economic growth through its effect on household spending.

(1) In October 2017 the ONS published revisions to the National Accounts and Balance of Payments, which affected a range of indicators covered in this chapter, including measures of household and PNFC debt, the current account deficit and the stock of external debt. These changes are discussed in the box on 'Revisions to the National Accounts and the Balance of Payments' in the November 2017 *Inflation Report*; www.bankofengland.co.uk/publications/Documents/inflationreport/2017/nov.pdf.
(2) Repayments on UK student loans are income-contingent, unlike most other forms of household debt. Outstanding student loans are estimated to amount to 8% of disposable household income in 2017 Q2, their highest-ever level. The Bank's November 2017 *Inflation Report* set out that student loans are likely to continue to push up household debt in coming years; excluding them, debt is projected to grow broadly in line with income.
(3) This indicator has been strongly correlated with past financial crises. But as the FPC has previously noted, the long-term trend on which it is based currently gives undue weight to the rapid build-up in credit prior to the global financial crisis, which proved to be unsustainable.

Chart A.5 Consumer credit accounts for a high proportion of UK impairments in the stress test

Breakdown of major UK banks' starting balances and impairments for UK lending in the 2017 Annual Cyclical Scenario

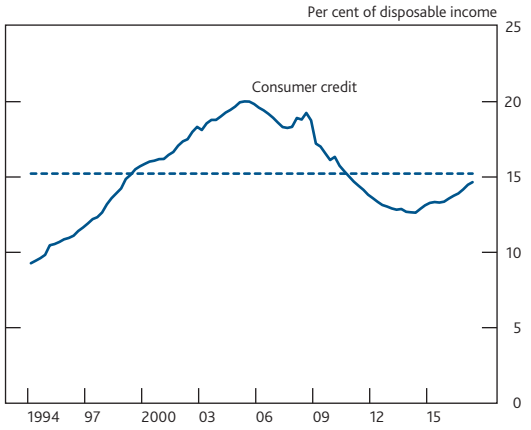


Sources: Participating banks' Stress Testing Data Framework data submissions, Bank analysis and calculations.

(a) Other UK lending includes exposures to financial institutions, local and central government, public sector entities and smaller wholesale portfolios.

Chart A.6 Consumer credit is not elevated as a share of household incomes

Outstanding consumer credit to income(a)(b)



Sources: Bank of England, ONS and Bank calculations.

(a) Gross consumer credit as a percentage of a four-quarter moving sum of disposable income. Includes all liabilities of the household sector except for the unfunded pension liabilities and financial derivatives of non-profit institutions serving households (NPISH). The household disposable income series is adjusted for financial intermediation services indirectly measured (FISIM).
(b) Dashed line shows 1994–2017 average.

The flow of new consumer borrowing is equivalent to only 1.4% of consumer spending, and has made almost no contribution to the growth in aggregate consumer spending in the past year.

Consumer credit can instead pose a risk to financial stability by increasing the losses lenders incur in an economic shock. In the 2017 stress test, consumer credit accounts for 40% of overall UK impairments incurred by UK banks over the five years of the scenario, despite accounting for only 7% of their starting balances of UK loans (**Chart A.5**).

As a share of income, consumer credit is not elevated by historical standards (**Chart A.6**), and defaults on consumer credit have fallen in recent years, with write-off rates falling from 5% to 2% between 2011 and 2016. Low arrears rates may reflect underlying improvement in credit quality. However, as set out in the UK household indebtedness chapter, the FPC has judged that lenders overall have been attributing too much of the improvement in consumer credit performance in recent years to underlying improvement in consumer credit quality and too little to the macroeconomic environment. This has driven an expansion of the supply of credit, with, for example, lending rates on personal loans falling and promotional interest-free periods on balance transfer credit cards lengthening.

The United Kingdom may be vulnerable to a reduction in foreign investor appetite for UK assets.

The United Kingdom has a large external balance sheet and current account deficit. As discussed in the UK external financing chapter, recent capital inflows, which have focused on direct investment and long-term securities, appear less vulnerable to reversals than during the run-up to the financial crisis.

However, the United Kingdom is vulnerable to a reduction in foreign investor appetite for UK assets. If that occurred, credit conditions would be expected to tighten, domestic demand would weaken and the sterling exchange rate would depreciate. In this way, the United Kingdom's external financing position increases the scale of economic shocks the financial system could face.

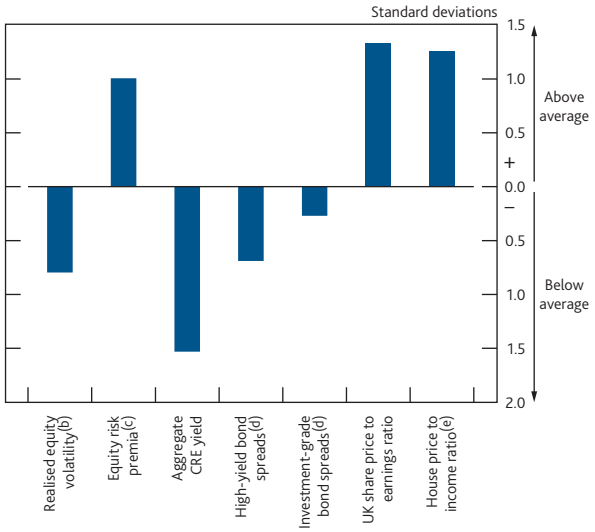
Some asset valuations may be vulnerable to adjustment…

Sharp downward adjustments in asset prices can amplify economic shocks, as the cost of bond and equity issuance increases and the value of collateral used to secure credit is diminished. Such asset price falls can also affect the financial system directly, through both adverse impacts on the collateral securing existing loans and losses on the assets held in trading portfolios. High asset valuations therefore increase the risks faced by the financial system.

As discussed in the Asset valuations chapter, investors in global markets may currently be placing excessive weight on the recent benign environment continuing. Growth has been moderate, inflation subdued, and market volatility low. In that

Chart A.7 There are signs that asset valuations may be vulnerable to a repricing

Indicators of asset valuations compared to historical averages[a]



Sources: Bloomberg Finance L.P., Department for Communities and Local Government, Halifax/Markit, HM Treasury, ICE BofAML, IMF *WEO*, MSCI Inc., Nationwide, ONS, Thomson Reuters Datastream and Bank calculations.

(a) Series start in 1987, except equity risk premia (2000), high-yield bond spreads (1997), investment-grade bond spreads (1998), and house price to income ratio (1990).
(b) Quarterly average of monthly standard deviation of log returns.
(c) Based on an estimated dividend discount model. See Dison, W and Rattan, A (2017), 'An improved model for understanding equity prices', *Bank of England Quarterly Bulletin*, Vol. 57, No. 2, pages 86–97; www.bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q2/a1.aspx.
(d) Three-month moving averages of daily data.
(e) Sum of gross disposable income of households and non-profit institutions serving households (NPISH), adjusted for financial intermediation services indirectly measured (FISIM). House prices are calculated as the mean of the average UK house price as reported in the Halifax and Nationwide house price indices. Seasonally adjusted. For more detail, see Annex 2 footnotes.

context, investors expect long-term interest rates to remain low and are willing to accept lower compensation for the risks they are taking. Risky asset prices may be vulnerable to a repricing, either through an increase in long-term interest rates or a downward adjustment in growth expectations, or both (**Chart A.7**).

In the United Kingdom, long-term interest rates and equity prices of domestically focused companies do appear to be factoring in pessimistic growth expectations and downside risks. In contrast, the compensation for risk demanded by investors in some sterling corporate bonds appears low, and valuations of some segments of the London commercial property market remain stretched. They appear to factor in the low level of long-term market interest rates but not necessarily the cash flows associated with the economic outlook embodied in such rates (see Asset valuations chapter).

…and risks stemming from debt in the global economy are elevated.

As with the domestic economy, high levels of debt can result in larger downside economic risks in foreign economies. If they materialise, these risks can spill over to the United Kingdom through trade and financial linkages. In particular, the UK banking system is directly exposed to the global economy. Forty-four per cent of large UK banks' total lending is to non-UK borrowers.(1)

Although near-term prospects for the global economy have continued to strengthen, risks from debt vulnerabilities in several major economies remain material. In China, economic growth continues to be supported by rapid credit expansion (see Global debt vulnerabilities chapter).

The risk environment was reflected in the 2017 stress-test scenario.

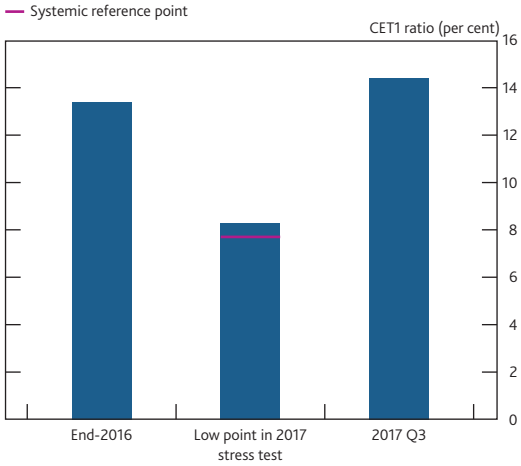
The annual cyclical scenario for the 2017 stress test captured a wide range of domestic and global risks.(2) In particular, the test incorporated:

- A severe consumer credit impairment rate of 20% over the first three years of the stress, as unemployment and interest rates increase sharply. The resulting losses across the banking system of £30 billion (of which £21 billion are incurred by the major banks in the stress test) are £10 billion higher than in the 2016 stress test.
- A sudden increase in the return investors demand for holding sterling assets and a 27% fall in the sterling exchange rate index.
- Sharp increases in interest rates and volatility measures, severe falls in sterling corporate bond and UK commercial real estate prices.

(1) Figure is from the seven banks participating in the 2017 stress test.
(2) See 'Stress testing the UK banking system: key elements of the 2017 stress test'; www.bankofengland.co.uk/financialstability/Documents/stresstesting/2017/keyelements.pdf.

Chart A.8 Major UK banks are resilient to the 2017 stress test

Aggregate common equity Tier 1 capital ratios for UK banks participating in the 2017 Annual Cyclical Scenario(a)



Sources: Participating banks' published accounts and Stress Testing Data Framework data submissions, Bank analysis and Bank calculations.

(a) The risk-weighted capital ratio is defined as CET1 capital expressed as a percentage of risk-weighted assets, where these are in line with CRR and the UK implementation of CRD IV via the PRA rulebook. Aggregate risk-weighted capital ratios are calculated by dividing aggregate CET1 capital by aggregate risk-weighted assets at the aggregate low point of the stress in 2018.

- A severe and synchronised global slowdown, with a 2.4% contraction in global output, larger than that experienced during the global financial crisis. Chinese GDP contracts by 1.2%.

- A separate stress of misconduct costs, which total around £40 billion over the five years of the stress. In aggregate, between 2011 and 2016 participating banks had paid out or provisioned for around £67 billion of misconduct costs. The stress scenario would therefore take total misconduct costs over the period from 2011 to 2021 to over £100 billion.

The stress test shows that the UK banking system is resilient to deep simultaneous recessions in the UK and global economies, large falls in asset prices and a separate stress of misconduct costs (**Chart A.8**).

The FPC is raising the UK countercyclical capital buffer rate to 1%.

The FPC is raising the system-wide UK CCyB rate from 0.5% to 1% with binding effect from 28 November 2018.(1)(2) This will establish a system-wide UK countercyclical capital buffer of £11.4 billion. This decision is:

- Consistent with the FPC's published strategy for setting the CCyB, in which it signalled that it expects to set a UK CCyB rate in the region of 1% in a standard risk environment.

- Consistent with the FPC's guidance in June 2017. At that time the Committee stated that, absent a material change in the outlook, it expected to increase the UK CCyB rate to 1% at its November meeting.

- Informed by the results of the stress test. The impact of the UK economic stress was equivalent to around 3.5% of relevant risk-weighted UK credit assets.(3) This suggests that the 2.5% capital conservation buffer should be supplemented with a 1% UK CCyB rate.

Capital buffers for individual banks ('PRA buffers') will also be set by the Prudential Regulation Committee (PRC) in light of the stress-test results. These will in part reflect the judgement made by the FPC and PRC in September 2017 that, following recent rapid growth, the loss rate on consumer credit in the first three years of the scenario would be 20%.

Once these buffers are set, banks will need to maintain a capital buffer that is, in total, big enough to absorb the effect of the stress-test scenario. The setting of the CCyB and PRA

(1) The increase in the CCyB rate will also lead to a proportional increase in major UK banks' leverage requirements via the countercyclical leverage buffer.
(2) Under EU law, the UK CCyB rate applies automatically (up to a 2.5% limit, and currently subject to a transition timetable) to the UK exposures of firms incorporated in other European Economic Area (EEA) states. The FPC expects it to apply also to internationally active banks in jurisdictions outside the EEA that have implemented the Basel III regulatory standards. Consistent with this, CCyB actions in 2017 by the Czech Republic, Hong Kong, Slovakia and Norway have been reciprocated.
(3) This does not include the part of UK consumer credit losses in the stress relating to the FPC's judgement on credit quality, which will be reflected in individual bank capital requirements rather than the UK CCyB rate.

buffers, as informed by the stress test, will not require banks to strengthen their capital positions. It will require them to incorporate some of the capital they currently hold in excess of their regulatory requirements into their regulatory capital buffers. The purpose of these regulatory capital buffers is to be drawn on as necessary to allow banks to support the real economy in a downturn.

The CCyB decision reflects the FPC's intention to vary the CCyB in gradual steps. The FPC is mindful of banks' capacity to generate capital internally through retained earnings. Increases in capital requirements that banks can meet through retained earnings should have a relatively small effect on the cost of capital to the real economy, whereas sharp increases that could prompt deleveraging by banks could have disproportionately large effects. The FPC recognises that banks may wish to maintain some headroom over their regulatory requirements, but the setting of capital buffers following this stress test is not expected to have a material impact on prevailing credit, or wider economic conditions.

The stress-test scenario encompasses a wide range of UK macroeconomic risks that could be associated with Brexit.

There are also potential risks arising from the macroeconomic consequences of some possible Brexit outcomes. The FPC has considered the risks associated with a range of possible outcomes for the United Kingdom's future relationship with the European Union and possible paths to that relationship. Consistent with its remit, the FPC is focused on scenarios that, even if they may be the least likely to occur, could have most impact on UK financial stability. This includes scenarios in which there is no agreement in place at the point of exit.

There are many possible combinations of risks that could result from a sudden exit from the European Union without a trade agreement. The outcome would depend on many factors, including the extent of contingency planning, and government policies in the United Kingdom and European Union across a very wide range of different issues such as tariffs, immigration, regulations and customs processes.

Given the severity of the 2017 stress-test scenario, the FPC judges that it encompasses a wide range of macroeconomic risks that could be associated with Brexit. As a result, the FPC judges the UK banking system could continue to support the real economy through a disorderly Brexit.

However, the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in the stress test. In such circumstances, capital buffers would be drawn down substantially more than in the stress test and, as a result, banks would be more likely to restrict lending to the real economy. The FPC will reconsider the adequacy of a 1% UK CCyB rate during the first half of 2018, in light of the evolution of the overall risk environment.