Financial Stability Report Press Conference

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Russell Lynch, The Telegraph: Can we talk about the variant? Now, obviously you've said in the FSR that you've tested against, you know, a very steep downturn, but has the bank done any work on the implications of the extended shutdowns in response to a variant, the impact of a rise in insolvencies on the financial system and financial stability, and also could that be mitigated by further support?

Andrew Bailey: Well, I'm just going to start, and I'm sure Sam and Jon will want to come in on this. The basis of this stress test is different from, if there is such a thing, normal stress, in the sense that it's not a countercyclical scenario. It posed the question what if things got markedly worse in the context of the pandemic, and what is the resilience of the banking system to that getting markedly worse? Just to give you a bit of background, I mean, the challenge we've had for the last two years, it's a reasonable challenge, is, if you like, the normal stress test we use is asking the question, 'In normal conditions,' you know, 'how resilient is the banking system to a stress?' Of course, the question we've been asking ourselves for the last two years, really, is that in abnormal conditions, in the condition of stress, if you like, how resilient is the banking system to further stress? We obviously didn't have the Omicron variant to hand, as it were, available when we ran the stress test, but I think it's safe to say the question the stress test sought to answer is highly relevant to it, and the sense that it asks generically how much resilience is there in the system to a much more severe stress of that sort? Sam or Jon may want to come in on that as well.

Sam Woods: Yes, maybe a quick word, which is to say it's absolutely not a prediction, and it wasn't designed specifically with the Omicron variant in mind, but we were definitely looking to examine a path in which the pandemic took a much worse turn than the one that we've experienced during this year. That's what we've done, and to your question, Russell, we have stressed pretty hard different sectors, so we've got a 7.8% overall impairment rate for UK core groups, but within that we've got considerably higher impairment rates for the particular sectors that you'd expect to see impacted. Interestingly, to your question about how could that affect the financial system, actually the core banking system's exposure to those particularly vulnerable sectors, like the one that we've done, is actually pretty small. So, we think, actually, we'd only add about 0.2% to the drawdown. That's included in the overall drawdown, but that's quite small in the overall context. Thanks.

Jon Cunliffe: Yes. I'd just maybe add a couple of points to that. So, as Sam says, the stress is pretty severe. I mean, you see another nine percentage point drop in UK GDP, which I think brings the, kind of, cumulative GDP fall from the beginning of COVID to over 35% in stress. Unemployment goes up to 12%, so in a way, we obviously didn't know Omicron was coming, but it's not necessary, if you like, to model the exact thing that happens. What's important is we modelled a really severe deterioration in the health position, which would lead to further lockdowns, would lead to unemployment going up, would lead to GDP going down, would lead to house prices dropping by, I think, 33% and the like. Then, to assume, and it assumes, no government intervention. So, it assumes that the economy reacts in that way and then the banks take the impairments, and on the basis of that, the banking system comes through and it comes through with capital and resilience to spare. So, I think, without saying exactly how Omicron will play out, because of course we don't know that, we can say that we tested the system specifically to a really severe deterioration in the pandemic and a major economic downtown, and the system came through assuming no government support. We don't know what the government will do, obviously. We don't know how the pandemic will play out. The one other point I'd make is we saw in March '20 that when COVID hit and the financial markets and the asset markets tried to, kind of, take into account the impact we had this dash for cash, this really severe liquidity squeeze in core financial markets and central banks had to come in and deal with that.

The international community is working to address some of those vulnerabilities. We've seen little repetitions of that over the last year, just that jump toward liquidity. So, there are issues here about how market-based finance will react if Omicron leads to a major repricing of global economic prospects, but I think the position of the system is, at the moment, resilient, but we need to take action to tackle some of those vulnerabilities on the marketplace on our side.

Andrew Bailey: Just a handy sort of reference that I find useful, Russell, is that last year, the system as a whole, I think, took about £20 billion of impairments. The test adds about £70 billion to that, so it's £90 billion in all.

Ed Conway, Sky News: Hello. Sorry I can't be there, obviously. Can I just hit upon the same theme, if that's alright? Obviously, Omicron is the big thing that a lot of people, households, etc., institutions are focused on. Have you seen, Andrew, any signs of stress in the financial system since that news of the variant arose? Just more broadly, you know, you said we didn't have the variant to hand when you were doing the stress test, but the question is very relevant to it. So, can you just, kind of, summarise for households, you know, how encouraged are you, how concerned are you with the results of the test in relation specifically to this variant and possibly the next one?

Andrew Bailey: Well, I think the summary of the test is that the system can stand a stress that is much larger than the stress we've, you know, seen so far. I've just given that statistic, you know, £20 billion of impairments last year. The test assumes another one, adds in another £70 billion, so I think that is solid in terms of the results, and I think you can read that across to, you know, the impact of Omicron, for instance, even though we didn't have Omicron to hand. The whole point is we're testing, you know, you're right to say for that type of event. On the point of about stress you asked first, Ed, in terms of post-Omicron, no, I don't think we've seen the signs of stress. I mean, we did obviously see quite a large movement in markets right at the point when the first news of Omicron came out of South Africa. In fact, you know, it was an almost instantaneous move in markets, but I would not classify that as a stressed move. It was quite a substantial move, which I think, obviously, you know, in sense, was recognition that this was major news, but it wasn't a stress as such, no.

Huw Jones, Thomson Reuters: Yes, thanks. This is probably the first Financial Stability Report that's fairly light on Brexit and your usual traffic lights, so maybe, you know, just one year on, what do you think is the damage to the City from Brexit and to markets of the City? Is it something that you're no longer paying, you know, close attention to? That you're quite, sort of, sleeping okay at night?

Andrew Bailey: I don't want to say we're not paying close attention to it, because you'll see there have been some quite major issues of relevance. I mean, you know, clearing being the obvious case in point, which we've discussed. So, I don't want you to give the impression that, you know, we've forgotten about it, but I think it's a sign of, you know, the relative goal and impact of issues that we're facing. Jon, you may want to come in on the subject.

Jon Cunliffe: Yes, I think I might. So, the thing we were focused on before Brexit and as the Brexit dates, sort of, came closer, as you know, there were a series of them, was that the financial system could cope with any shock coming out of a change in the arrangements for trading and financial services between the UK and the European Union. If you think about the traffic lights, they were all about, you know, were market participants prepared? Did they have the right clauses in contracts? Did we have the temporary permissions we needed on clearing to stop disorderly things happening at the point of transition? Well, of course, that point has happened now, so this question about what are the financial stability risks in the transition, I think, sort of, is no longer that relevant across most of financial services, to be honest. The one area where we know there is a, kind of, major cliff edge is when the clearing house permissions, or permission for UK clearing houses to sell services in Europe comes to an end in June. I know the Commissioner has said that they don't intend to have a cliff edge, and they intend to extend. We don't yet know how. I imagine there'll be decisions coming out of the European Commission. So, I think the way to think about the traffic lights was that was about financial stability disruption in the transition. The transition has happened. If there are particular issues now that could cause financial stability problems, we will call them out clearly as we did before, but I think the only one, really, that is there at the moment is that temporary permission on clearing houses.

Huw Jones, Thomson Reuters: One year on, how much of a hit do you think the City's taken from Brexit?

Jon Cunliffe: Well, in terms of financial stability, I think, yes, we've passed through the Brexit point without disruption, and that's due to a huge amount of preparation work that we did and others have done. Some business, I think, has moved, as you know, to the European Union, some has moved to the US, kind of, as a result, but from a financial stability point of view, I think that that's what we care about in that sense, which is the transition. We haven't seen the problems that could have occurred.

Laura Noonan, Financial Times: Sorry, just trying to find the unmute button, which I should really know where it is a year later. Given what you've said today about the bank's capital positions, are we safe to say that there isn't any immediate or any possible threat to dividends at this point, or at what stage could we see Omicron potentially leading to the kinds of restrictions around dividends that we saw earlier in the pandemic? Thanks.

Andrew Bailey: Well, I might get Sam to describe the, sort of, evolution of our approach on that, and how we've sought to get back to what we regard as the normal state of affairs, where, you know, the capital framework is the current framework, it's well understood, and firms take their own decisions on dividends in view of that. Sam might need to come in on this.

Sam Woods: Yes, thanks. Laura, I don't think the position that we're in now is at all analogous to the position we found ourselves in in Q1 of last year, when the only thing we knew was that several-hundred-year largest drop in GDP was approaching. We didn't know anything about the government's reaction function, we didn't know anything about how it would play out. We know a huge amount more now, and we felt confident to go back to our normal approach to dividends, and we intend to stick with that. What you will notice, though, of course, Laura, is that in this stress test, as indeed in every other stress test we've published, banks do hold back on their dividends, and that's one of the ways that they stay above their requirements in the stress. So, you could expect that if we actually went into a world which was as bad as the one we're describing in our stress test, then it's, of course, very likely that banks would withhold dividends, but we don't think we're in that world at the moment. If we got there, that's something we'd deal with when we came to it, but for the moment, it's BAU on dividends.

Ben Martin, The Times: Just on cryptocurrencies, what is in the last few months that's caused you to, sort of, strengthen its warning on this? Is it purely the rapid expansion of the market?

Andrew Bailey: I would say, and I'll bring Jon in, it's that plus something. I mean, certainly, as we've mentioned in the report, I mentioned in the introduction, there has been a very rapid expansion in the value of the market, and the number is, you know, large and growing rapidly, and it is mainly unbacked crypto assets, as distinct from, in inverted commas, stablecoins, which is another part of the digital world. The point we would make, and it's why we've drawn this distinction between where we are today and where it might go to from here on is that, on its own, that's, of course, important, but it's not the only thing. What would, of course, increase the financial stability risks quite rapidly would be to take that sort of market value of activity and then find it's being used, for instance, in ways that create leverage that then start to rapidly increase, you know, the notional value, but also create within it complexity as well. Now, we haven't seen that yet, but we hear talk about that sort of thing, and we're at the point now where, if you look back in history, that's the sort of thing that can now happen, and therefore that's why we've taken the position we have, which is, you know, it probably isn't a financial stability risk today, but it has all the makings of something that could become one and it's important as authorities, and I use that term in the plural because this has got to be an international approach that we do now design and come up with sensible policies to put this within a public policy regulation framework. Jon, do you want to-,

Jon Cunliffe: I'd say I'd be in line with that. A very large part of this is, as you say, the very rapid growth of the value of comeback to crypto assets, and then we're also seeing just more integration in what I call the traditional or the conventional financial sector. So, that's banks wanting to offer some services like custodian services or trading which are not on their balance sheet, but also market-making, which would be on their balance sheet, so these assets are coming into the established financial sector. You can see asset managers and hedge funds becoming involved. Derivatives are now available and credit card companies are providing on-ramps and off-ramps. So, now is the time, before it becomes heavily integrated into the existing financial system, to start thinking about what should the regulations be, for example, for banks holding crypto assets on their balance sheet. The last thing is crypto is a technology which is used for lots of different purposes, and we're seeing also just the beginning of the development of what I call an alternative financial system all happening on the blockchain and crypto. Goes under the name of decentralised finance. Again, we have to think about that because if that grows quickly how do we ensure that the same risk is treated in the same way whether it happens in the crypto world or whether it happens in the established finance world? It takes time to develop regulatory standards and the like. We've started to do that for payments for bank capital, but we really need to ensure that we've done the thinking, we've got the regulation in place before, as Andrew says, this becomes big enough to be a problem.

Phil Aldrick, Bloomberg: Afternoon guys. I just wanted to know if we've got any idea about the current state of play for the corporate sector. How resilient are they at this stage in the pandemic? Related to that, do you guys have any estimates of the losses borne by the state for the COVID support schemes? On the market-making of last resort stuff, I just wondered how close are we to actually having a facility like that, Jon?

Andrew Bailey: Well, we do not have any numbers on the estimated or actual losses on the schemes, I'm afraid. That's not something that we would directly observe. Sam and Jon want to come in. I think on the corporate sector I would say overall, as I said in the introductory remarks, the UK corporate sector I think has come through actually well. The increase in overall debt level has been, I think, more moderate than we expected it to be. You'll remember some publications we've done right since the beginning of the COVID period when we did an interim Financial Stability Report that obviously we were very focused on the expected financing needs of the corporate sector given the size of the stress. To date, subject to the point Ed raised about Omicron, that's a situation that's been managed well. Now, I would say this one point. You do have to look at the distribution within the corporate sector. There is a higher level of increase of indebtedness in small firms than there is in large firms, so that's a point that obviously we do have to focus on. It's not something that I think stands out as a particularly critical issue at the moment, but it's something we have to keep an eye on. Sam or Jon, do you want to-,

Sam Woods: Just a quick word to say there's nothing to see from the banks in terms of asset quality at this stage. Obviously we follow that very closely indeed and there is just no news. In fact, we've got quite a good chart on this in the report, chart 2.1. That is all exposure, it's not just corporate, but you have a look at that. In fact, what firms are having to do is, if you like, resist what their models are telling them in terms of how many provisions they should release. So, they released another .9 billion in the last quarter, but the models will be telling them to do more than that precisely because the data suggests that things are not problematic, but like the rest of us firms can obviously see the uncertainty.

Jon Cunliffe: Yes. Like I say, in the aggregate I think aggregate corporate indebtedness has gone up by about 3.5% over the COVID period, so that, as Andrew said, is pretty moderate given what we might have expected at the time. The picture is very different in different sectors and it's very different for SMEs and the like, but of course the lending to SMEs is-, first of all it's government-guaranteed, which creates protection for the banking system, but it's also on long tenors and there are, sort of, low fixed interest rates, and then of course the government has introduced some schemes for small firms that are having difficulty playing back. I'm sure within certain sectors, particularly on the SME side, there will be stress for some, but overall the picture doesn't look as bad as we thought it would be certainly when we went into this pandemic.

Andrew Bailey: It's worth saying we've also seen an increase in the cash balances of the corporate sector with the banking system, so that's on the deposit side, if you like. We've also seen in more recent times, and I think this is large corporates really, some large corporates then repaying drawdowns of lines of credit that they made during the peak of the crisis going back to last year.

Richard Partington, The Guardian: Thanks very much. I had two if I may, the first one on the mortgage rules. Is it an appropriate moment to be relaxing mortgage requirements when there is this rapid growth in house prices we're seeing and we're about to embark on a path to higher interest rates? Then second on Omicron, markets haven't reacted too much, but are you worried at all that we could be approaching a more dangerous moment than is currently being accounted for? Are markets being a little too sanguine perhaps?

Andrew Bailey: Thanks Richard. Let's start on the housing tools. First of all, I said in my opening remarks we don't regard it as a relaxation of the tools, rather as an efficiency point, because having now got a body of evidence running back seven years or so now we were able to, in this review, take, I think, a much more substantial judgement on the effectiveness of the test. The key point I did emphasise and would emphasise again is that we think that the LTI flow limit tool is the stronger tool in terms of the work it does and that the marginal, if you like, value added of the FPC affordability test-, bearing in mind that the FCA has an affordability test which is there for consumer protection reasons but obviously has an effect as well, it doesn't add that much value, so I would emphasise that point. The second point I'd make is that I think it is very interesting to look at the housing market at the moment, and there are really two lenses to look at it through. One, as you rightly said, is the house price lens, where obviously yes we have seen obviously an increase in house prices. The only point I'd make there is that we've done quite a lot of work on what is driving that, and to use the phrase that our regional agents often use, this race for space is evident in two respects. One is that it's really overturned the model of UK house price growth over the last twenty or 30 years really, which has been concentrated in London and the South East. The increase in house prices has actually been anywhere but London and the South East, it turns out, and London and South East have the weakest growth.

Secondly, when you look at the properties there's been a much stronger growth in larger houses than in flats and smaller houses, so there are differences there that actually help to interpret what this house price increase really looks like. The key point is that when we look at it through the lens of debt ratios, and particularly also then debt-to-income ratio, we don't see the same pattern that we saw in past periods of house price rises. The tools have been doing their job in that sense. We look at it through indebtedness, we look at it through lending standards, and we don't see the same pattern of worryingly large and uncontrolled increases. I'm not going to rise to the point on interest rates. That's not for today. On the markets, I mean, I think going back to-, I think it was Ed's question actually, I would say we did see obviously quite a marked movement in markets immediately on the announcement of the Omicron news from South Africa, and it was almost instantaneous actually. Some of that has reversed, some hasn't. There have been some further movements in markets. Now look, obviously we monitor it very closely and obviously there is a lot of news still to come on Omicron in terms of what its medical symptoms are going to be and on vaccine efficacy, and obviously we follow that very closely. I would say at the moment I think that, as I said I think in response to Ed's question, that I don't think that we are in a situation where there is stress around the corner in terms of markets. That doesn't mean to say markets won't move because markets have moved quite a lot in the last few months and there has been a lot of news in that sense, but I wouldn't say that at the moment I think it's going to be a big stress event. Obviously, as we were saying earlier in the context of the banking stress test, we do take through the financial stability lens quite a, sort of, severe approach to this in terms of how much stress could the system take. Yes. I think that was the question, wasn't it? Yes.

Lucy White, Daily Mail: Just wanted to ask on the risk and leverage loan markets point that you bring up, could this be a particular worry given the high level of private equity takeovers that we have seen in the UK so far this year which obviously make use of that kind of debt?

Andrew Bailey: Jon or Sam may want to come in. We've seen more, I would say, stress lending and signs of stress or extension in those markets outside the UK than inside the UK so far. Jon or Sam, do you want to-,

Jon Cunliffe: First of all, as you say Andrew, it's a global issue. I think it's been strongest, the increase in leveraged lending, in the US, where the issuance has now an all-time record. I think the stock overall, the global stocks, have about four trillion. Of course where the lending has originated, where it's packaged and where it's held are very different things, and much of this is not being held in the banking system. Actually much of it is passed out of the banking system and packaged up in CNOs which go around the world. So, looking at it from the terms of a financial stability issue, the fact that it's grown fast and also that many of the loan covenants have been weakened, so-called covenant-lite lending is now also at record levels. This is potentially a market that could correct, and when it corrects I think there will be stress in a number of areas. Looking at it from the other end of the telescope, what is the lending being used for? For us the key thing is what happens, who is holding it, and what happens if there's a sharp contraction of value? Does it knock on elsewhere?

Sam Woods: I think I would just add one brief point, which is that obviously some of our banks are active in this market and we've included a five billion hit on leveraged lending in the stress test because we do think it's something that would be a source of significant losses if we went into the sort of world we've got in the stress test, but that's not a change of practice. We've been doing that in recent years in stress tests and it would have been odd not to do it in this one too.

Matei Rosca, Politico: Thanks very much. I have two quick ones. First one on the indications that the clearing deadline is going to be extended if not scrapped. It is a bit of a climbdown from the EU, so I wonder if you could comment on that. Maybe it opens up a bit of a friendly space for reconciliation on that issue. The second one on cryptos. The Bank for International Settlement or the Basel Committee, I never know which is which, said this summer there should be a 1,250% risk weight on cryptos, so if you're afraid of cryptos creeping into the banking system why don't you just do that? Why don't you just bring in that risk weight and banish cryptos from the banking system? It's within your power, isn't it? Thank you.

Andrew Bailey: Let me start. I think obviously it's a question, Matei, for the EU in terms of-, and not for us to presume, and I'm not going to comment on climbdown because that, again, is in that sense a bit pejorative. What I am going to say is that I think we approached this whole question having put clearing houses right at the centre and heart of the financial system post-financial crisis, very sensibly so, very good reasons for that. To my mind it's worked and I think, by the way, the stress that we saw in the dash for cash amply illustrates the correctness of that approach and that clearing houses were robust through that. Our approach towards clearing house regulation is that of course we work together. It's a global business and we work together with other regulators, we work together with EU regulators, we work together with US regulators, we work together with other regulators around the world, and we adopt the same approach. We are a strongly cooperative regulator that wants to make these arrangements robust to withstand financial stability risks and that clearing houses can do what we want them to do and have intended them to do post-financial crisis. On the crypto question, it's the Basel Committee. That risk weight that you cited is right, but of course that tackles one bit of the financial stability landscape, which is the exposure of banks. We're making a broader point now. Jon was quite correctly describing it earlier. There is a broader landscape of financial stability here. It's an absolutely true observation that in the Financial Stability Board, for instance, which all three of us are heavily involved in, we spend much more time now on the non-bank world. That's correct.

It's grown much more rapidly, we've had experiences like the dash for cash, so we have to look at crypto not just through the lens of what if banks get exposures to it, but also how it fits into the broader financial market world the broader non-bank financial world. So, there are a whole range of issues which the FSB is heavily engaged on now which go beyond the particular point that the Basel Committee is addressing.