Financial Policy Summary and Record of the Financial Policy Committee Meeting on 30 June 2021

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This is the record of the Financial Policy Committee meeting held on 30 June 2021.

It is also available on the Internet: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/july-2021

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of Her Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is a committee of the Bank of England.

The FPC's next policy meeting will be on 23 September 2021 and the record of that meeting will be published on 8 October.

Financial Policy Summary

The Financial Policy Committee (FPC) aims to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face – so that the system can serve UK households and businesses in bad times as well as good.

The outlook for financial stability

Support for the economy during the pandemic

The UK financial system has provided support to households and businesses to weather the economic disruption from the Covid pandemic, reflecting the resilience that has been built up since the global financial crisis, and the exceptional policy responses of the UK authorities.

In recent months, the rapid rollout of the UK's vaccination programme has led to an improvement in the UK economic outlook. But risks to the recovery remain. Households and businesses are likely to need continuing support from the financial system as the economy recovers and the Government's support measures unwind over the coming months.

The UK banking system has the capacity to continue to provide that support. The FPC continues to judge that the banking sector remains resilient to outcomes for the economy that are much more severe than the Monetary Policy Committee's central forecast. This judgement is supported by the interim results of the 2021 solvency stress test.

The FPC expects banks to use all elements of their capital buffers as necessary to support the economy through the recovery. It is in banks' collective interest to continue to support viable, productive businesses, rather than seek to defend capital ratios by cutting lending, which could have an adverse effect on the economy and, consequently, on banks' capital ratios. To support this, the FPC expects to maintain the UK countercyclical capital buffer rate at 0% until at least December 2021. Due to the usual 12-month implementation lag, any subsequent increase would therefore not be expected to take effect until the end of 2022 at the earliest.

The FPC supports the Prudential Regulation Committee's (PRC's) decision that extraordinary guardrails on shareholder distributions are no longer necessary, consistent with the return to the Prudential Regulation Authority's (PRA's) standard approach to capital-setting and shareholder distributions through 2021. The FPC judges that the interim results of the 2021 solvency stress test, together with the central outlook, are consistent with the PRC's decision.

Debt vulnerabilities

As the economy recovers, the FPC will continue to remain vigilant to debt vulnerabilities in the financial system that could amplify risks to financial stability.

The FPC judges that UK corporate debt vulnerabilities have increased modestly. The increase in indebtedness has not been large in aggregate, but has been more substantial in some sectors and among small and medium-sized enterprises (SMEs). UK businesses' aggregate interest payments as a proportion of earnings did not increase over 2020, and are around historic lows. And a large part of the additional debt taken on by companies has been issued at relatively low interest rates via government-sponsored loan schemes. Support from the financial system and the Government has helped to keep business insolvencies relatively low. However, companies with weaker balance sheets, particularly in sectors most affected by restrictions on economic activity and SMEs, may be more vulnerable to increases in financing costs.

The share of households with high debt-servicing burdens has increased slightly during the course of the pandemic, but remains significantly below its pre-global financial crisis level. House price growth and housing market activity during 2021 H1 were at their highest levels in over a decade, reflecting a mix of temporary policy support and structural factors. However, so far, there has only been a small increase in mortgage borrowing relative to income in aggregate, and debt-servicing ratios remain low. The FPC's mortgage market measures are in place and aim to limit any rapid build-up in aggregate indebtedness and in the share of highly indebted households. The FPC is continuing its review of the calibration of its mortgage market measures.

Increased risk-taking in global financial markets

Risky asset prices have continued to increase, and in some markets asset valuations appear elevated relative to historical norms. This partly reflects the improved economic outlook, but may also reflect a 'search for yield' in a low interest rate environment, and higher risk-taking.

The proportion of corporate bonds issued that are high-yield is currently at its highest level in the past decade, and there is evidence of loosening underwriting standards, especially in leveraged loan markets. This could increase potential losses in a future stress, and highly leveraged firms have also been shown to amplify downturns in the real economy.

Asset valuations could correct sharply if, for example, market participants re-evaluate the prospects for growth or inflation, and therefore interest rates. Any such correction could be amplified by vulnerabilities in market-based finance, and risks tightening financial conditions for households and businesses.

Building the resilience of the financial system

Market-based finance

It is important that market-based finance is resilient to, and does not amplify, shocks. The FPC has previously identified a number of vulnerabilities in the sector. In March 2020, these vulnerabilities amplified the initial market reaction to the pandemic to create a severe liquidity shock (the 'dash for cash'). This disrupted market functioning and threatened to harm the wider economy. Significant policy action from central banks was needed to restore market functioning.

The FPC strongly supports the work, co-ordinated internationally by the Financial Stability Board (FSB), to assess and, where necessary, remediate the underlying vulnerabilities associated with the March 2020 'dash for cash'. Such work is necessarily a global endeavour, reflecting the international nature of these markets and their interconnectedness.

To reduce the likelihood and impact of disruptions to market-based finance in the future, the FPC has identified the following areas of focus: reducing the demand from the non-bank financial system for liquidity in stress, ensuring the resilience of the supply of liquidity in stress, and potential additional central bank liquidity backstops for market functioning. In particular:

- To address vulnerabilities in the global money market fund sector, a robust and coherent package of international reforms needs to be developed. The FPC welcomes the publication of a consultation paper by the FSB, which sets out policy proposals to enhance the resilience of Money Market Funds.
- The FPC supports the international work, co-ordinated by the FSB, to understand the role of leveraged investors in government bond markets.
- The FPC supports international work to assess whether there was more procyclicality in margin calls than was warranted, whether market participants were prepared for margin calls in a stress, and any consequent need for policy in light of this, without compromising the benefits of the post-global financial crisis margining reforms.
- The FPC judges that there would be value in exploring ways to enhance the capacity of markets to intermediate in a stress, without compromising on the resilience of dealers.
- In order for central banks to deal effectively with financial instability caused by market dysfunction, the FPC supports examining whether new tools are needed specifically for this purpose. Any tools would need to be both effective and minimise any incentives for excessive risk-taking in the future through appropriate pricing and accompanying regulatory requirements.

The FPC supports the development of international standards through the FSB work and, consistent with its statutory responsibilities, remains committed to the implementation of robust standards in the UK. The FPC will continue to undertake its own assessment of the resilience of market-based finance on a regular basis, and in light of the FSB's work, will consider whether there may be a need for additional policy responses in the UK.

The joint Bank-Financial Conduct Authority review of open-ended investment funds

As the FPC has noted previously, the mismatch between redemption terms and the liquidity of some funds' assets means there is an incentive for investors to redeem ahead of others, particularly in a stress. This first-mover advantage has the potential to become a systemic risk by creating run dynamics. It could result in forced asset sales by funds, further amplifying asset price moves and, by testing markets' ability to absorb sales, contributing to dysfunction in markets of the sort observed in March 2020. This could impair the issuance of new securities and thereby disrupt the supply of credit to the real economy.

As part of its domestic work to identify and reduce vulnerabilities in market-based finance, the Bank and Financial Conduct Authority (FCA) have concluded their joint review into risks in open-ended funds. In doing so, the Bank and FCA have developed a possible framework for:

- how an effective liquidity classification framework for open-ended funds could be designed — consistent and realistic classification of the liquidity of funds' assets is an essential step to ensuring funds can address mismatches between asset liquidity and redemption terms; and
- the calculation and use of swing pricing such that pricing adjustments more accurately represent, where possible, the cost of exiting a fund over the specified redemption period.

The FPC fully endorses this framework and views it as an important contribution to the international work currently in train. The FPC judges that this framework for liquidity classification and swing pricing could reduce the risks arising from the liquidity mismatch in certain funds.

The FPC emphasises the importance of addressing these issues internationally, given the global nature of asset management and of key markets.

The FPC recognises that further work is needed to consider how these principles could be applied, and a number of operational challenges will need to be addressed before any final policy is designed and implemented.

Funds that hold highly illiquid, infrequently traded assets, such as commercial real estate, may not be able to implement swing pricing effectively in practice. In these cases, longer redemption notice periods can address the first-mover advantage and financial stability risks that may otherwise arise. More generally, the development of funds with longer notice periods could help to increase the supply of productive finance to the economy. The FPC welcomes the FCA's consultation on a Long-Term Asset Fund structure.

The transition to robust alternative benchmarks to Libor

Most new use of Libor is due to stop by the end of 2021. The FPC emphasises that market participants should use the most robust alternative benchmarks available in transitioning away from use of Libor to minimise future risks to financial stability.

It is the FPC's view that recently created credit sensitive rates – such as those being used in some US dollar markets – are not robust or suitable for widespread use as a benchmark, and the FPC considers these rates to have the potential to reintroduce many of the financial stability risks associated with Libor. The FPC welcomes recent remarks made by members at the US Financial Stability Oversight Council, warning that widespread use of these credit sensitive benchmarks may replicate many of Libor's shortcomings, and calling for the use of robust risk-free rates. These credit sensitive rates would not appear to be in compliance with the IOSCO Principles for Financial Benchmarks if their use became widespread.

Cloud service providers

The FPC has previously highlighted that the market for cloud services is highly concentrated among a few cloud service providers (CSPs), which could pose risks to financial stability. Since the start of 2020, financial institutions have accelerated their plans to scale up their reliance on CSPs. Although the PRA and FCA have recently strengthened the regulation of firms' operational resilience and third party risk management, the increasing reliance on a small number of CSPs and other critical third parties could increase financial stability risks without greater direct regulatory oversight of the resilience of the services they provide.

The FPC is of the view that additional policy measures to mitigate financial stability risks in this area are needed, and welcomes the engagement between the Bank, FCA and HM Treasury on how to tackle these risks. The FPC recognises that absent a cross-sectoral regulatory framework, and cross-border co-operation where appropriate, there are limits to the extent to which financial regulators alone can mitigate these risks effectively.

Review of the UK leverage ratio framework

The FPC considers leverage requirements, including the scope of the regime, to be an essential part of the framework of capital requirements for the UK banking system. It has conducted a comprehensive review of the UK leverage ratio framework in light of revised international standards and its ongoing commitment to review its policy approach and agreed a number of proposed changes on which it is consulting. The FPC welcomes the approach set out by the PRA to implementing those changes, which are now also being consulted on.

Record of the Financial Policy Committee meeting held on 30 June 2021

1. The Committee met on 30 June 2021 to agree its view on the outlook for UK financial stability and, on the basis of that, its intended policy action. The FPC discussed the risks faced by the UK financial system and assessed the resilience of the system to those risks. Its aim was to ensure the UK financial system was prepared for, and resilient to, the wide range of risks it could face – so that the system could serve UK households and businesses in bad times as well as good.

Macroeconomic back-drop

Global outlook

2. The FPC was briefed on a range of international risks that could be relevant for UK financial stability. Vulnerabilities in the global financial system could spill over to the UK through a number of channels. For example, strong credit growth abroad could directly increase risks to the UK financial system via UK banks' foreign exposures. Tighter overseas credit conditions could affect UK businesses' ability to raise finance in overseas markets and also influence UK conditions, increasing the cost of businesses raising funding in domestic markets. Moreover, a downturn abroad could lead to reduced demand for UK exports.

3. The FPC noted that the Monetary Policy Committee's (MPC's) outlook for world activity in the May *Monetary Policy Report* (*MPR)* had improved relative to February. Furthermore, developments in global GDP since May had been somewhat stronger than anticipated, particularly in advanced economies. Global price pressures had also picked up further, and this had started to become apparent in consumer price inflation in some advanced economies. Activity was expected to continue to recover as vaccination programmes progressed and Covid-related measures eased. However, the speed and extent of the recovery was likely to vary across regions, and risks remained that restrictions could take longer to ease, for example if new variants of the Covid virus led to an increase in cases. In addition to the risks associated with the path of the virus, some emerging market economies were also vulnerable to a tightening in global financial conditions, for example if market participants reassessed the prospects for growth, inflation and interest rates in advanced economies.

4. Some risks to the UK financial system from global debt vulnerabilities, which were elevated before the pandemic, had grown further. Prior to the pandemic, the FPC had highlighted the risks to the UK arising from high levels of business indebtedness in some advanced economies, including the US and France. Since then, global corporate indebtedness had risen sharply – by around 12% in the year to 2020 Q4. That had pushed up the global corporate debt-to-GDP ratio by around 15 percentage points to 110% of GDP, compared to increases of around 1½ percentage points on

average per year between 2009 and 2019. Other things being equal, this increased the vulnerability of corporates to higher financing costs. A proportion of this lending would have been carried out under government guarantee schemes.

5. The Federal Reserve had highlighted the risks of heightened US corporate leverage in its May 2021 Financial Stability Report, and the European Central Bank had noted the risks associated with a tail of over-indebted businesses in Europe in its May 2021 Financial Stability Review.

UK outlook

6. The Committee noted that the UK economic outlook had improved since its March 2021 meeting. The MPC's central forecast for UK GDP set out in the May 2021 *MPR* had been somewhat stronger than its February 2021 projections, in part due to the rapid rollout of the UK's Covid vaccination programme.

7. Despite the improved outlook, the FPC noted that there remained downside risks to growth that could pose a threat to financial stability, particularly in the short term. For example, economic activity could be curtailed following a further pickup in Covid case numbers, or a possible drop in vaccine effectiveness arising from mutations of the virus. The Committee continued to judge that households and businesses were likely to need continuing support from the financial system as the economy recovered and as the Government's support measures unwound in coming months.

Support for the UK economy to weather economic disruption

8. The UK financial system had provided support to households and businesses to weather the economic disruption from the Covid pandemic, reflecting the resilience that had been built up since the global financial crisis, and the exceptional policy responses of the UK authorities.

Households

9. The FPC noted that households' uptake of financial support schemes had continued to fall. Around 80,000 mortgage payment deferrals remained in place as of end March 2021, compared to a peak of almost 2 million. This was expected to fall further. According to the ONS's Business Insights and Conditions Survey, the share of employees on furlough had fallen to 6% in early June 2021, the lowest reported level since the Coronavirus Job Retention Scheme (CJRS) began.

10. Household survey data indicated that the share of UK households with high debt-servicing burdens had increased slightly during the course of the pandemic, but remained significantly below the pre-global financial crisis level. In the March 2021 wave of the NMG survey, 1.4% of households

were spending more than 40% of their income on mortgage repayments, up from 0.9% in 2019 but materially below the 2.7% share in 2007.

11. The Committee agreed that the full effect of the pandemic on household finances would become clearer as the economy recovered and support for households unwound fully later in the year. If the economic outlook were to deteriorate some households may come under additional financial pressure.

12. House price growth and housing market activity during 2021 H1 had been at their highest levels in over a decade. After a period of muted price growth during the early stages of the pandemic, the UK House Price Index was around 9% higher than it was a year ago, despite a decrease in April. The FPC judged that high levels of activity were likely to reflect in part a temporary boost from the Stamp Duty holiday. They may also reflect structural factors, such as households seeking extra space or using savings accumulated during the pandemic. The outlook for the housing market was uncertain, but early signs from housing market indicators suggested some of the strength in demand could persist beyond the end of the Stamp Duty holiday.

13. The FPC noted that, alongside the recent high levels of activity, many lenders had started to re-enter the market for mortgages at higher loan-to-value (LTV) ratios, having withdrawn these products earlier in the pandemic. But the share of mortgages issued at higher LTV ratios remained low by recent standards. As a result, the share of outstanding mortgages with high LTV ratios had not risen and remained well below its pre-global financial crisis level.

14. Against that backdrop, the FPC's mortgage market Recommendations had been in place and aimed to limit any rapid build-up in aggregate indebtedness and in the share of highly indebted households. The share of new mortgages at loan-to-income ratios of 4.5 or higher was 10.4% in 2021 Q1, a marginal increase from 9.5% in 2020 Q1 but well below the FPC's 15% limit. The FPC's review of its mortgage market measures was underway and the Committee would report its conclusions later in the year.

Corporates

15. The FPC noted that support from the financial system and government had helped to keep UK business insolvencies relatively low since March 2020, and had helped to improve businesses' cash positions in aggregate. Net finance raised since March 2020 had totalled around £76 billion, materially higher than the average raised in previous years. Businesses' cash balances – an important indicator of resilience to shocks - had increased by around £132 billion (around 25%) since end-2019 and 48% of SMEs in February 2021 held at least one month's worth of turnover in cash compared to 39% the previous year.

16. The FPC considered that some businesses would face additional cash flow pressure as the economy recovered and as substantial repayments of VAT and rent arrears came due, government support such as the CJRS unwound, and repayments under the government loan schemes began. The FPC noted that this pressure could be particularly acute for businesses in sectors affected by additional public health restrictions, such as accommodation and food; businesses in sectors vulnerable to structural shifts associated with Covid; or for businesses that were already facing challenges to their business models prior the pandemic.

17. Given those additional pressures on cash flow and the planned end in September 2021 of the suspension of winding-up petitions, which had been in place throughout the pandemic, the FPC judged that insolvencies were likely to increase over the next 12 months, particularly in sectors most affected by restrictions on economic activity and among SMEs.

18. Overall, the FPC judged that UK corporate debt vulnerabilities had increased modestly. The increase in indebtedness had not been large in aggregate, but had been more substantial in some sectors and among SMEs. In aggregate corporate debt levels had increased by only 5% to £1.4 trillion from 2019 Q4 to 2020 Q4 and the majority of the increase had been accounted for by government-guaranteed SME loan schemes. UK corporates' aggregate interest payments as a proportion of earnings (an aggregate measure of the corporate debt burden) had not increased over 2020, and were at around historical lows, supported by the low interest rate environment and the initial interest-free period for government-guaranteed loans.

19. The FPC noted that there had been a sizeable tail of highly leveraged firms before the pandemic, that these firms may have seen their positions worsen, and that such companies with weak balance sheets were likely to be more vulnerable to increases in financing costs. The FPC noted that this was an issue to which they would return at future meetings, as the economy recovered and more detailed data became available.

The resilience of the UK banking system and the interim results of the 2021 Solvency Stress Test

20. The FPC discussed the resilience of the UK banking system, including its ability to withstand future shocks and continue to support households and businesses. The FPC also discussed the interim results of the 2021 Solvency Stress Test (SST).

21. Major UK banks' and building societies' ('banks') capital and liquidity positions remained strong. Their aggregate Common Equity Tier 1 (CET1) capital ratio was around 16% in 2021 Q1, over three times higher than at the start of the global financial crisis. Banks' liquidity coverage ratios (LCRs) continued comfortably to exceed regulatory guidelines.

22. The FPC noted that UK banks expected their impairments in 2021 to be materially lower than in 2020, reflecting the improved macroeconomic outlook, and that they continued to observe limited signs of asset quality deterioration in their existing lending portfolios. Similarly, analysts' expectations for banks' 2020-21 impairments had fallen from at least £45 billion last year to £30 billion.

23. These developments had supported an improvement in investors' views of the banking sector. The market capitalisation of banks was now around 80% higher relative to lows in September 2020, with the average price to book ratio (which measured the market value of shareholders' equity relative to the accounting value of that equity) now over 0.6. Credit default swap premia and senior unsecured debt spreads for UK banks remained low, at around their pre-Covid levels.

24. The FPC continued to note the possibility of adverse developments that could affect bank capital positions over coming quarters, such as a rise in unemployment and increased business insolvencies that could result in credit losses and a commensurate inflation in risk-weighted assets. In addition to these headwinds, the benefit from IFRS 9 transitional relief would taper away and relief on the existing stock of provisions might also decrease as some assets moved into default and became ineligible for it. The Prudential Regulation Authority (PRA) had also consulted on the restoration of the deduction of software intangible assets from CET1. As a result of these effects, banks' capital ratios may fall back somewhat, though would remain significantly above minimum requirements.

25. The scenario used for the 2021 SST had been designed to assess UK banks' end-2020 balance sheets against a severe path for the economy in 2021-25 on top of the economic shock associated with the Covid pandemic. It was broadly consistent with the 'double dip' scenario generated in the FPC's 'reverse stress test' of August 2020 and represented an intensification of the macroeconomic shocks seen in 2020. When combined with the economic shocks already seen in 2020, it implied a cumulative three-year loss (with respect to the pre-Covid baseline) of 37% of 2019 UK GDP.

26. The interim results of the SST showed the aggregate CET1 ratio of banks falling from 16.2% at end-2020 to a low-point of 10.4% in 2022, above the aggregate 'reference rate' of 7.7%.[1] This also applied when considered on a leverage ratio basis. The CET1 low-point was higher than those observed in the 2020 'reverse stress test' and the 2019 annual cyclical scenario (9.6% and 9.3% respectively).

[1] This aggregate 'reference rate', which comprised banks' minimum requirements and systemic buffers, had been adjusted to account for the impact of IFRS 9. Final reference rates would be published as part of the updated and final results due to be published in 2021 Q4. For further details of the approach to 'reference rates' see Key Elements of the 2021 stress test.

27. Downside risks remained. But the FPC continued to judge that the banking sector remained resilient to outcomes for the economy that were much more severe than the MPC's central forecast. This judgement was supported by the interim results of the 2021 SST.

28. The FPC supported the Prudential Regulation Committee's (PRC's) decision that extraordinary guardrails on shareholder distributions were no longer necessary, consistent with the return to the PRA's standard approach to capital-setting and shareholder distributions through 2021. The FPC judged that the interim results of the 2021 SST, together with the central outlook, were consistent with the PRC's decision.

29. The Committee also noted that the updated and final results of the 2021 SST, including bank-specific outcomes, would be published in 2021 Q4. Submissions from banks participating in the 2021 SST would continue to be analysed, including for non-credit risk areas. It was likely that the final aggregate results in 2021 Q4 would differ to a certain extent from those published in the *FSR*. This was because the stressed projections from participating banks that covered other risk areas were likely to expose bank-specific dynamics not captured by the aggregate desktop analysis.

The UK Countercyclical Capital Buffer rate decision

30. The FPC reiterated that its policy was to vary the UK Countercyclical Capital Buffer ('CCyB') rate in line with system-wide risks to the UK banking sector and to set the UK CCyB rate in the region of 2% when the risk environment was judged to be standard. This approach aimed to ensure that the buffer is large enough to create capacity for banks to lend through downturns.

31. The FPC had reduced the UK CCyB rate to 0% in March 2020 to support the ability of banks to extend credit to households and businesses at a challenging and highly uncertain time. The Committee continued to judge that it was in banks' collective interest to support viable households and businesses, and reinforced its expectation that banks' capital buffers could be used as necessary to support the economy.

32. Taking into account its discussion on the economy and the financial system, the FPC agreed that it was appropriate to maintain the UK CCyB rate at 0% in 2021 Q2.

33. The FPC continued to judge that it expected to maintain a UK CCyB rate of 0% until at least December 2021. Due to the usual 12-month implementation lag, any subsequent increase would not be expected to take effect until the end of 2022 at the earliest.

34. The Committee discussed both the timing and pace of return to a standard UK CCyB rate in the region of 2%. To inform its decision around when to increase the UK CCyB, the Committee would monitor a range of factors, including the evolution of the economic recovery, prevailing financial

conditions, and the outlook for banks' capital. The pace of return to a standard UK CCyB rate would depend on banks' ability to rebuild capital while continuing to support the UK economy, households and businesses.

Financial markets

35. The FPC observed that core financial markets had continued to function well and support the economic recovery. Market conditions had largely recovered from the dysfunction seen during the March 2020 market stress, with bid-offer spreads of government and corporate bonds settling at about pre-Covid levels.

36. The FPC judged that there was evidence of an increase in risk-taking in global financial markets. Risky asset prices had continued to increase since the December 2020 *FSR*, with major equity indices rising by around 15% on average. The FPC noted that this partly reflected the improved economic outlook, but might also reflect a 'search for yield' in a low interest rate environment, and higher risk-taking. Some asset valuations appeared elevated relative to historical norms, such as those for US equities and corporate bonds. Some metrics that compared asset valuations against economic fundamentals, such as the cyclically adjusted price to earnings ratio, were near record highs for US equities, but appeared less elevated in UK equity markets. And, as the FPC had stated previously, investment-grade corporate bond spreads looked compressed, particularly once adjusted for deterioration in credit quality and increase in duration.

37. Pre-Covid trends of strong issuance of riskier types of debt and loosening in underwriting standards, as set out in the December 2019 *FSR*, had continued. For example, a record 72% of new leveraged loans had weak maintenance covenants in 2021 Q2 compared to around 65% in 2020 Q1 and around 14% in 2007. The issuance of new collateralised loan obligations (CLOs) had also been strong in 2021, at around 135-150% relative to the levels seen over the past five years, while refinancing and resetting activity in the market had reached record highs. And the share of high-yield bonds within total corporate bond issuance was at the highest level seen over the previous decade. There was also evidence of some banks seeking to maintain higher exposure to risk in parts of their trading and securitisations businesses. These developments could increase potential losses in a future stress, and highly leveraged firms had also been shown to amplify economic downturns.

38. The increase in risk-taking had also manifested in the markets for certain cryptoassets. Bitcoin had experienced sharp price growth over the 12 months to April 2021. The price of Bitcoin had risen six-fold over that period, before falling sharply and losing around half of its value over the course of May. It had remained around these lower levels since then. In this instance, spillovers to broader financial markets were limited. However, there were signs of growing interest in cryptoassets and related services from institutional investors, banks and key payment system operators. The FPC

would continue to monitor developments in cryptoasset markets and, as highlighted in March 2018, would act to ensure the core of the UK financial system remained resilient if linkages between cryptoassets and systemically important financial institutions or markets were to grow significantly.

39. The FPC judged that the increase in risk-taking by financial market participants created a vulnerability to a sharp adjustment in risky asset prices. Sharp decreases in asset prices could amplify economic shocks by impairing businesses' ability to raise finance via bond and equity markets, as well as result in losses for banks' trading portfolios and reduce the value of collateral securing loans. The FPC discussed potential triggers for a sharp adjustment in risky asset prices, such as investors re-evaluating the prospects for growth and inflation and the future path of interest rates. Any such correction could be amplified by vulnerabilities in market-based finance, and risked tightening financial conditions for households and corporates.

40. The FPC re-iterated that the vulnerabilities in the system of market-based finance highlighted during March 2020 remained and could amplify any initial adjustment in asset prices, as set out in the July *FSR*. For example, there were mixed signals from the available data on leverage in the non-bank system. In the US the amount of securities purchased on margin by investors, mainly by hedge funds, had increased over the past 18 months to reach an all-time high, but remained moderate when measured relative to the size of the US equity market. And there continued to be liquidity mismatches in some open-ended funds. Assets under management in US and emerging market open-ended corporate bond funds were around 120% of their pre-Covid levels, albeit they were broadly flat in UK-focused funds, while the share of liquid assets held by corporate bond funds had decreased to below pre-Covid levels.

41. The FPC discussed the failure of the family office Archegos. While the failure was not a systemic issue, it had translated into material losses for certain banks and demonstrated the effects of leverage in the non-bank sector on other counterparties and markets. The incident presented important lessons to learn for risk management in banks' prime brokerage businesses. It also demonstrated the insufficient visibility of risks associated with non-bank leverage. As the FPC set out in the November 2018 *FSR*, the assessment of the systemic risks from non-bank leverage required information on potential losses and potential liquidity demands arising from the use of leverage. Whilst some progress had been made, the FPC continued to judge that data reported to the supervisors of non-banks, including hedge funds, did not include all the information needed to monitor these risks appropriately.

42. The combination of rising vulnerabilities associated with an increase in risk-taking in global financial markets, and continued structural vulnerabilities in the non-bank sector, highlighted the

importance of the work being done by the FPC and internationally, coordinated by the Financial Stability Board, to enhance the resilience of market-based finance.

Building the resilience of the financial system

The resilience of market-based finance

43. Market-based finance had grown substantially in recent years and had become increasingly important to the UK economy. Non-bank financial institutions accounted for around half of UK financial sector assets and all of the net increase in UK corporate debt since 2008 had come from market-based finance. The FPC had the responsibility to identify, monitor and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the whole of the UK financial system, and so had been assessing the risks from the non-bank financial sector regularly for many years, including annual reviews of its resilience since 2014. In the Chancellor's March 2020 letter on the FPC's remit[2], HM Treasury had asked the FPC for a detailed assessment of the oversight and mitigation of systemic risks from the non-bank financial sector. Preliminary analysis had been presented in the August 2020 *FSR*, focusing on the lessons learned from the March 2020 market stress.

44. At its June meeting, the Committee discussed the completion of its response to the request from HM Treasury, which would be set out in the July *FSR*, supported by a Bank report on assessing the resilience of market-based finance. The FPC judged that, given its importance to the UK economy as well as evidence of vulnerabilities, the resilience of market-based finance needed to be enhanced. During the March 2020 stress, existing vulnerabilities had amplified adjustments to risky asset prices and the need for a large redistribution of liquidity around the system had resulted in market dysfunction. This had even affected core advanced-economy government bond markets, and the impairments to markets had amplified the impact of the shock on the economy via tighter financial conditions. While central bank interventions were necessary and effective in backstopping market functioning, such actions carried risks, such as the risk that expectations of future support might increase risk-taking or moral hazard. The March 2020 stress had been exceptionally severe, but it was part of an increasing body of evidence in recent years that market-based finance had become more prone to liquidity shocks.

45. It was important that market-based finance was resilient to, and did not amplify, shocks. The FPC strongly supported the work, co-ordinated internationally by the Financial Stability Board (FSB),

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[2] See https://www.bankofengland.co.uk/-/media/boe/files/letter/2020/chancellor-letter-11032020-fpc.pdf?la=en&hash=29B4977F925DDF52FF9F4DB627F94B475C01F0C1.

to assess and, where necessary, remediate the underlying vulnerabilities associated with the March 2020 'dash for cash'. Such work was necessarily a global endeavour, reflecting the international nature of those markets and their interconnectedness. UK authorities, including the Bank, the FCA and HM Treasury, were engaged in the FSB work programme, and an update was due to be provided to the G20 in October.

46. The FPC noted its commitment to supporting the development of international approaches via the FSB work programme. It would also continue to undertake its own assessment of the resilience of market-based finance on a regular basis and, in light of the FSB's work, would consider whether there might be need for additional policy responses in the UK. The FPC was committed to the implementation of robust standards and maintaining a level of resilience that was at least as great as that required by international standards. The FPC judged that it would also be important to ensure that reforms to enhance the resilience of market-based finance increased the resilience of the system overall, and did not come at the cost of reduced resilience elsewhere in the system.

47. Building on its previous discussions of vulnerabilities in non-bank financial intermediation, to reduce the likelihood and impact of disruptions to market-based finance in the future, the FPC identified three areas of focus:

- Reducing the demand from the non-bank financial system for liquidity in stress: Following a negative economic shock, or under stressed conditions, investor appetite usually shifted from risky assets to safer, more liquid, assets. This could lead to an aggregate increase in the demand for liquidity; it was important that features of the financial system did not exacerbate this demand for liquidity.

- Ensuring the resilience of the supply of liquidity in stress: The non-bank financial system was always likely to need some additional liquidity in stress. It was important to ensure this need could be met in ways that avoided forced asset sales or disruption to market functioning.

- Potential additional central bank liquidity tools for market functioning: It was first and foremost for market participants to manage the liquidity risks they faced. However, it was not realistic or efficient to expect them to self-insure against every conceivable shock or stress. It was therefore also important to examine whether central banks had the appropriate facilities to provide liquidity to the whole of the financial system in stress in order to support market functioning without creating moral hazard – or whether any further tools were needed.

48. There were a number of vulnerabilities that could exacerbate the demand for liquidity in stress. These included: the mismatch between the liquidity of assets held in open-ended funds – including money market funds – and the redemption terms offered by those funds; the forced unwinding of leveraged positions by non-bank financial institutions; and the management of liquidity following increases in derivative margin calls.

49. The issues associated with liquidity mismatch in open-ended funds had been considered by a joint Bank and FCA review, the conclusions of which had also been discussed by the FPC at its June meeting (see below).

50. Money-market funds (MMFs) were a particular form of open-ended fund where many investors regarded their holdings as cash-like assets and generally redeemable on demand, but they were subject to the risk of losses because MMFs might not be able to make good on that expectation in all circumstances. The market stress in March 2020 had highlighted structural vulnerabilities in MMFs as they found their ability to generate additional liquidity constrained. To address vulnerabilities in the global MMF sector, a robust and coherent package of international reforms needed to be developed. As would be set out in the July *FSR*, there were a range of potential ways to address the liquidity mismatch in MMFs. Any reform package should also remove the cliff-edge effects introduced by liquidity thresholds related to the use of suspensions, gates and redemption fees. The FPC welcomed the publication by the FSB of a consultation paper, which set out policy proposals to enhance MMF resilience.

51. Leveraged investors such as hedge funds could also increase the demand for liquidity in a stress. Under such conditions, hedge funds' risk-management procedures might lead them to reduce their market positions as part of de-risking and/or de-leveraging. This could have a negative effect on market liquidity, as was observed in US Treasury markets in March 2020. While there was no evidence of widespread deleveraging by hedge funds in the gilt market during that episode, given both the important role of hedge funds in gilt repo markets and the ability for stress in US Treasury markets to spill over to gilt markets, it was important to address these issues. The FPC supported further international work, co-ordinated by the FSB, to understand the role of leveraged investors in government bond markets and to assess whether excessive leverage could be a cause for concern in future episodes of market dysfunction.

52. In March 2020, very large moves in asset prices had led margin calls on derivative contracts to increase significantly, adding to the demand for liquidity. The collection of margin was an important tool to reduce and mitigate the risk that the failure of one firm could have a severe impact on the rest of the financial system, which had been strengthened by reforms following the global financial crisis. However, some users of derivatives were more prepared than others for the increase

in margin. To meet the substantial liquidity demands, actions taken by non-bank financial institutions had collectively contributed to selling pressures in a number of markets as they sought to raise cash, including large withdrawals from MMFs. The FPC supported international work to assess whether there was more procyclicality in margin calls than was warranted, whether market participants were prepared for margin calls in stress, and any consequent need for policy in light of this, without compromising the benefits of the post-global financial crisis margining reforms.

53.	The FPC considered how the resilience of the supply of liquidity in stress could be enhanced. While dealers initially provided liquidity in core markets during the March 2020 market stress, they became constrained, in part due to regulatory factors and their own risk appetite. Higher capital and liquidity requirements introduced in the aftermath of the global financial crisis had been put in place to ensure that banks and dealers remained resilient during stresses, but there had been some evidence that dealers' capacity to intermediate in markets had been related to their proximity to regulatory thresholds, in particular with respect to leverage. Structural features of markets, such as the use of central clearing and the role of high-frequency market participants, were also important drivers of market capacity during the period of stress.

54.	The FPC judged that there would be value in exploring ways to enhance market intermediation capacity in a stress, without compromising dealer resilience. The Bank report on assessing the resilience of market-based finance would set out examples of how this could be achieved, such as the use of regulatory capital and liquidity buffers by banks in times of stress or potential changes to market structure.

55.	The FPC also considered it important to examine whether central banks should have additional facilities to provide liquidity to the wider financial system in stress, to support market functioning. In March 2020, traditional central bank tools to backstop liquidity via the banking sector had proved insufficient to calm conditions in the broader financial system. Asset purchases implemented under quantitative easing had been able to do so, which had supported both monetary and financial stability. But there could be scenarios in which monetary policy tools, such as quantitative easing, would not be appropriate to support market functioning given the monetary policy stance. In order for central banks to effectively deal with financial instability caused by market dysfunction, the FPC supported examining whether new tools were needed specifically for this purpose. Any tools would need to be both effective and minimise any incentives for excessive risk-taking in the future through appropriate pricing and accompanying regulatory requirements.

56.	As part of the work to assess the vulnerabilities in market-based finance, it would also be important to enhance data on the sector, internationally and domestically, so that regulators were better able to assess the resilience of the sector and risks to it. Data on the sector were much more fragmented relative to the banking sector and the global nature of these markets limited the line of sight any single regulator could acquire from its own domestic data. While the FPC had sought to overcome these issues, by drawing on analysis and insights from a broad range of datasets and indicators, there remained data gaps. International effort and cooperation would be essential to remediate most of those data gaps.

57. The FPC would continue to scan for potential vulnerabilities originating outside the core UK banking sector, and to monitor the growth of risks in the non-bank financial system. As part of this, the FPC would assess the suitability of the regulatory perimeter, in line with its remit.

Concluding the joint Bank-Financial Conduct Authority review of open-ended investment funds

58. As the FPC had noted previously, the mismatch between redemption terms and the liquidity of some funds' assets meant there was an incentive for investors to redeem ahead of others, particularly in a stress. This first-mover advantage had the potential to become a systemic risk by creating run dynamics. It could result in forced asset sales by funds, further amplifying asset price moves and, by testing markets' ability to absorb sales, contributing to dysfunction in markets of the sort observed in March 2020. This could impair the issuance of new securities and thereby disrupt the supply of credit to the real economy.

59. In July 2019, a joint review had been launched by the Bank and the FCA of how funds' redemption terms might be better aligned with the liquidity of their assets. In December 2019, the FPC had set out three key principles for fund design, relating to pricing adjustments, liquidity classification and notice periods or redemption frequency. The review had subsequently considered how these principles could be developed further, to support UK financial stability.

60. As part of the review, in March 2021, the FPC had also discussed the findings of a joint Bank and FCA survey of open-ended funds that provided insights on liquidity management during the period of market stress last year. The FPC's first principle was that liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a representative sample of those assets or the time period needed for a sale to avoid a material price discount. The survey had found that many fund managers appeared to have overestimated the liquidity of fund portfolios, even after the experience of the stressed period in March 2020. The FPC's second principle was that redeeming investors should receive a price for their units in the fund that reflected the discount needed to sell the required portion of a fund's assets in the specified redemption notice period. The FPC had judged that the survey indicated that use of swing pricing had been inconsistently applied across funds and, in many cases, even when deployed, the swing had been insufficient.

61. Informed by the results of the survey, the Bank and the FCA had developed a possible framework for how an effective liquidity classification for open-ended funds could be designed, and considerations for the calculation and use of swing pricing. A consistent and more realistic classification of funds' assets was an essential step to ensuring funds could address mismatches between asset liquidity and redemption terms. More consistent and complete swing pricing could be developed in order to better reflect the costs of exiting a fund and also to promote financial stability by reducing first mover advantage.

62. The FPC fully endorsed the conclusions of the joint Bank and FCA review into open-ended funds, including the proposed framework on liquidity classification and swing pricing, which further supported the FPC's first two principles on fund design. The FPC believed the conclusions of the review were an important contribution to the international work currently in train. Taken together, the FPC judged that these could reduce the risks arising from the liquidity mismatch in certain funds.

63. The Committee recognised that further technical work was needed to consider how these principles could be applied, and a number of operational changes would need to be addressed before any final policy was designed and implemented. But for assets that were not highly illiquid and infrequently traded, this was likely to be a more proportionate way to address liquidity mismatch than other options such as redemption notice periods.

64. The FPC emphasised the importance of addressing these issues internationally, given the global nature of asset management and of key markets. The effectiveness of domestic policy measures would depend in part on policies implemented in other jurisdictions. The FPC supported work led by the FSB and the International Organisation of Securities Commissions (IOSCO) on this topic.

65. The FPC's third principle for mitigating liquidity mismatch risks was that redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts beyond those captured in the price received by redeeming investors. This was particularly relevant for open-ended funds investing in inherently illiquid assets, such as property or infrastructure. The FPC supported the ongoing work of the industry working group – established by the Bank, HM Treasury and the FCA – which included developing a Long Term Asset Fund (LTAF) structure, and welcomed the FCA's consultation paper on this in May 2021. Given the nature of the investments permitted within an LTAF, the FCA did not expect any of these funds to offer daily dealing. More generally, the development of funds with longer notice periods could help to increase the supply of finance to the economy, in line with the FPC's secondary objective. The FPC recognised that there were operational, regulatory and demand-side barriers to investment in less liquid investments that would need to be addressed to allow successful development.

Libor

66. The Committee received an update on the transition away from Libor. Most new use of Libor was due to stop by the end of 2021. The FPC emphasised that market participants should use the most robust alternative benchmarks available in transitioning away from use of Libor to minimise future risks to financial stability.

67. The FPC discussed the risks posed by recently created credit sensitive rates such as those being used in some US dollar markets. The FPC viewed that these rates had the potential to reintroduce many of the financial stability risks associated with Libor, and as such judged that they were not robust or suitable for widespread use as a benchmark. The FPC welcomed recent remarks made by members at the US Financial Stability Oversight Council, warning that widespread use of these credit sensitive benchmarks may replicate many of Libor's shortcomings, and calling for the use of robust risk-free rates. These credit sensitive rates would not appear to be in compliance with the IOSCO Principles for Financial Benchmarks if their use became widespread.

68. The Committee welcomed progress made in sterling markets, where most use of Libor in new contracts had now ceased and been largely replaced by compounded SONIA. There had been significant adherence to the ISDA protocol for legacy Libor-linked derivatives contracts, but further progress was needed to reduce the stock of legacy contracts in cash markets. The FCA was also consulting on use of its new powers to implement a synthetic Libor rate for certain sterling and yen Libor settings to support the orderly wind down of contracts that could not transition. The Committee welcomed the proposed use of these powers as a means to help mitigate tail risks in the transition. The Committee also noted that any synthetic Libor would be time-limited, and emphasised the importance of continued efforts by firms to reduce the pool of contracts as far as possible by the end of the year and thereafter.

69. In August 2020, the Committee agreed to continue to defer publication of Record text discussing Libor transition risks from legacy contracts. It agreed that it would review this decision again in 2021 Q4, or earlier if there were material developments in proposed legislative solutions for the legacy stock of contracts.

70. In February 2021 the European Commission gained powers to designate a rate which would replace all references to a benchmark that will no longer be published 3, while in April 2021 UK powers were agreed by Parliament and NY state legislation was passed. Following these material developments in legislative solutions, at its June meeting, the Committee again reviewed whether to

[3] https://www.consilium.europa.eu/en/press/press-releases/2021/02/02/financial-benchmarks-council-adopts-new-rules-addressing-libor-cessation/

publish or continue to defer publication of its previous discussion of legislative solutions from the Q2 2020, Q3 2019 and Q2 2019 Records.

71. Given a number of further legislative steps were still under discussion in various jurisdictions, the Committee agreed that it remained against the public interest to publish its previous discussion of legislative solutions in the Record of its meeting. This is because doing so could precipitate the financial stability risks authorities were seeking to mitigate. Market participants could put undue reliance on the possibility of further legislative solutions being devised and this could reduce their incentives to transition to new reference rates in time, ahead of 2021.

72. The Committee decided to continue to defer publication, under Section 9U of the Bank of England Act 1998. It agreed that it would review again in 2022 Q1, once the key transition milestones at the end of 2021 had passed, or sooner if there are further material developments in proposed legislative solutions for the stock of legacy contracts.[4]

Critical third parties, including Cloud Service Providers

73. The FPC had previously highlighted that the market for cloud services was highly concentrated among a few Cloud Service Providers (CSPs), which could give rise to financial stability risks. Financial regulators globally had also noted the risks posed by concentration in the provision of certain third party services. For example, the FSB had published a Discussion Paper on regulatory and supervisory issues relating to outsourcing and third party relationships in November 2020.

74. The FPC noted that since the start of 2020, financial institutions had accelerated plans to scale up their reliance on CSPs and in future place vital services on the cloud. Although the Bank, FCA and PRA (collectively, UK financial authorities) had recently strengthened their regulation of UK financial institutions' operational resilience and third party risk management, the increasing reliance on a small number of CSPs and other critical third parties (CTPs) for vital services could increase financial stability risks in the absence of greater direct regulatory oversight of the resilience of the services they provided.

75. Consequently, the FPC viewed that additional policy measures, some potentially requiring legislative change, would be needed to mitigate financial stability risks from CTPs such as CSPs, including:

[4] The text in this and the three preceding paragraphs was omitted from the version of the Record that was initially published on 13 July 2021. The Committee agreed at its 9 March 2022 meeting to publish this text, for the reasons set out in the Record of that meeting.

- resilience standards for CTPs in respect of any critical services they provided to UK financial institutions, which should leverage the operational resilience framework recently introduced by the UK financial authorities; and

- resilience testing for CTPs based on the proposed standards and building on existing testing frameworks e.g. CBEST and SIMEX.

76. More work would be required between the Bank, FCA and HMT to define the nature of any future legislative changes that might be needed to support policy measures to mitigate financial stability risks from CTPs.

77. The FPC emphasised that any measures would need to be proportionate but sufficient to meet both macroprudential and microprudential objectives. These measures should also avoid being unduly restrictive in order not to be potentially counterproductive from an operational resilience perspective, such as requirements on UK financial institutions to only use CTPs in specific jurisdictions, or over where they can locate their data and information and communications technology (ICT) infrastructure.

78. The FPC noted that any additional policy measures that the UK financial authorities may introduce in the future in relation to CTPs would be necessarily restricted to those services that CTPs provided specifically to UK financial institutions and which could pose macroprudential and/or microprudential risks.

79. The FPC welcomed the engagement between the Bank, FCA and HMT on how to tackle these risks. The FPC recognised that, absent a cross-sectoral regulatory framework, and cross-border cooperation where appropriate, there were limits to the extent to which financial regulators alone could mitigate these risks effectively. In particular, the FPC supported the Bank's continued engagement with initiatives by the UK government to strengthen cross-sectoral oversight of third party service providers to multiple parts of the UK's critical infrastructure.

80. Given the cross-border nature of the risks posed by CTPs, the FPC also supported the Bank's continued engagement in international workstreams at the FSB and other bodies as well as with overseas financial regulators.

Climate Biennial Exploratory Scenario

81. Every two years, the Bank runs an exercise that explores the resilience of the UK financial system against potential risks beyond those covered in its annual solvency stress test. As previously decided by the FPC and PRC, in 2021 this biennial exploratory scenario (BES) would focus on the

potential risks related to climate change. This would support the FPC in assessing the risks posed by climate change to the UK financial system, and how the system might respond to those risks.

82. The 2021 Climate BES would explore the largest UK banks' and insurers' resilience to three different climate scenarios, testing different combinations of physical and transition risks over a 30 year period. Following a discussion, the Committee agreed the calibration of the three scenarios in the 2021 Climate BES by written procedure[5] ahead of its launch on 8 June 2021.

Bank of England Discussion Paper on new forms of digital money

83. On 7 June 2021, the Bank had published a discussion paper focused on new forms of digital money. The purpose of the discussion paper was to promote debate around issues that may arise in connection to retail-orientated stablecoins with a potential to become systemically important, as well as some issues around Central Bank Digital Currencies — an electronic form of central bank money that could be used by households and businesses to make payments.

84. The FPC had previously highlighted the rapid pace of innovation in payment systems, and that it viewed the ability to make payments safely and smoothly as critical to financial stability. The Committee had also previously considered the need for the regulatory system to adapt so the public could have similar confidence in new forms of digital money as in existing forms, allowing them to be widely used and trusted. In light of the development of new forms of digital currencies and their importance to UK financial stability, the Committee welcomed the publication of this discussion paper.

[5] The FPC written decision on the CBES took place prior to Carolyn Wilkins' start date on the Committee and therefore she was not eligible to take part. Carolyn was also not present for the Q2 FPC discussion on the CBES, and did not receive any related papers.

The UK-EU relationship

85. The UK authorities remained committed to mutual regulatory and supervisory co-operation with the EU authorities. Alongside co-operation with other regulatory authorities globally, this would continue to promote an open and resilient financial system to the benefit of all participants.

86. HMT and the European Commission had concluded technical discussions on the text of the Memorandum of Understanding (MoU) agreed in a Joint Declaration on Financial Services Regulatory Cooperation alongside the Trade and Cooperation Agreement. The MoU, once signed, would create the framework for structured regulatory cooperation in financial services between the UK and the EU.

87. On 28 June 2021, the European Commission had adopted data adequacy decisions for transfers of personal data to the UK, having found the UK's personal data protection regime "essentially equivalent" to that of the EU. This would allow for the ongoing free flow of personal data from the EU to the UK beyond the end of the temporary bridging mechanism for such transfers which would expire on 30 June 2021. The UK government had legislated to allow personal data flows from the UK to the EU ahead of the end of the transition period.

88. The FPC continued to monitor risks to its objectives that could arise from changes to the provision of cross-border financial services in the future. For example the potential for disruption when the EU's temporary equivalence and recognition determinations for UK central counterparties expire on 30 June 2022.

89. Consistent with its statutory responsibilities, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

90. The FPC would take note of the findings of the International Monetary Fund's Financial Sector Assessment Program (FSAP) review of the UK's financial sector. The FSAP would provide a robust independent assessment of standards in the UK.

The FPC's remit response

91. On 3 March 2021, the FPC had received from the Chancellor of the Exchequer a letter specifying the economic policy of HM Government and setting out HM Treasury's recommendations to the Committee under Sections 9D-9E of the Bank of England Act 1998. These recommendations relate to matters that the Committee should regard as relevant to its understanding of the Bank's

Financial Stability Objective and the Committee's responsibility in relation to the achievement of that Objective, the Committee's responsibilities in relation to support for the Government's economic policy, as well as matters to which the Committee should have regard in exercising its functions. The FPC agreed its response to this letter, which would be published alongside this Record.

Implications for the FPC from the Warsh review

92. In 2014, the Bank commissioned Kevin Warsh, former Governor of the US Federal Reserve, to undertake an evaluation of the MPC's transparency processes[6]. The MPC accepted all the recommendations in the review, and committed to several changes of its practices. The review also considered implications for the FPC and noted there were good reasons to pause before applying MPC transparency reforms to the FPC, not least that the field of macroprudential policy was at an earlier stage of development. It recommended that the Bank revisit this question within 5 years. Due to competing demands on the FPC's time, including Brexit and Covid, that review had been delayed until now.

93. In reviewing the implications of the Warsh review for the FPC, the Committee noted former Governor Warsh's comments that "[the] FPC appears reasonably well-served through existing accountability arrangements". For example, the Bank of England Act 1998 required the FPC to explain its policy decisions and deliberations, specifically through the publication of records of its meetings, which thereby played an important role in public accountability. The Committee also noted the efforts it had made over the years to improve effectiveness of its communications to make sure its messages reached its various audiences.

94. The FPC considered each of the Warsh recommendations in turn. The first recommendation was to publish the policy decision and rationale as soon as was practicable; and reduce the number of MPC policy meetings from twelve to eight. The FPC noted that since 2019 Q1 they had been publishing the FPC Record contemporaneously with the Financial Policy Summary and (in relevant quarters) the *FSR*. The FPC therefore agreed that the spirit of this recommendation was met through its existing accountability arrangements. Members considered that the current quarterly timetable struck an appropriate balance between timeliness and effectiveness, particularly since much of the data considered by the FPC was slower-moving.

95. The second recommendation required the MPC to enhance its minutes to better capture their Day 1 deliberations. Again, members felt that the FPC Record already captured the richness of FPC

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[6] https://www.bankofengland.co.uk/news/2014/december/boe-announces-measures-to-bolster-transparency-and-accountability

discussions and was already required to provide a summary of deliberations amongst members. They concluded that the current process captured the spirit of the recommendation.

96. Recommendation three asked the MPC to make transcripts of its Day 2 meetings public with publication deferral of five to ten years. The MPC agreed to do this after a period of eight years. The Committee noted the Warsh review's comment that such a practice might not be appropriate for the FPC given that "fully revealing the discussion that led to the identification of tail risks might not fully promote accountability and could cause unnecessary confusion in financial markets". The FPC also took the view that a different approach was warranted for the FPC, given the important differences in remit and decision-making between the Committees. Unlike the MPC, the FPC operated on a principle of consensus[7] with members standing behind collective decisions to achieve consensus wherever possible. The FPC agreed that the Record of its Policy meeting should continue to set out the deliberations considered in reaching the consensus.

97. Recommendation four requested that the Bank publish its key inputs to the MPC policy meeting alongside the Day 2 transcripts with an identical deferral period. The FPC was of the view that many of the risks considered by the FPC are tail-risks that often may still be 'live' many years after deliberation. This would be especially true of key financial stability risks such as a build-up in debt vulnerabilities, or weakness in bank profitability. Members were concerned that any public communication of internal debates around these risks could potentially prove destabilising. The FPC concluded that the publication of briefing papers should remain in line with the schedule for release through the Bank's Archive. Whilst members agreed that the FPC should be accountable for its decisions and acknowledged the importance of maintaining a historical record, they thought that these objectives were best served through other means, including via regular communication such as the *FSR*.

98. In reviewing the implications of the Warsh review, the FPC also looked at the current practices of some of its international peers[8]. The FPC were content that its existing transparency practices were equivalent or exceeded those of other macroprudential authorities.

99. The decisions on the implications of the Warsh review were taken by written decision on 28 June 2021.

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[7] Recognising the requirement imposed by paragraph 11 (4) of Schedule 2A of the Bank of England Act 1998

[8] European Systemic Risk Board, Financial Stability Oversight Council, Reserve Bank of New Zealand and the Bank of Canada

Review of the UK leverage ratio framework

100. In April 2015 the FPC had been granted powers to direct the PRA to set minimum leverage ratio requirements and buffers as part of its statutory responsibility for removing and reducing systemic risks. The FPC had published a policy statement to set out how it expected to calibrate and apply these powers on 1 July 2015.

101. The FPC continued to consider a leverage ratio, including an appropriate scope of the regime, to be an essential part of the framework of capital requirements for the UK banking system. In 2021 Q2, the Committee had conducted a comprehensive review of the UK leverage ratio framework in light of revised international standards, and its commitment to review its policy approach, and agreed a number of changes on which it was consulting.

102. The PRA had reviewed the leverage ratio framework concurrently, including to reflect international developments. The FPC and the PRC had coordinated closely on their reviews.

103. The FPC and PRC published a consultation document on 29 June 2021which outlined the changes that the FPC proposed to make to the framework, and the PRA's proposed approach to implementing these changes. The FPC welcomed the approach set out by the PRA.

The UK Leverage ratio

104. In July 2015, the FPC had directed the PRA to introduce a minimum leverage ratio capital requirement and buffers for major UK banks and building societies, which had been implemented in January 2016 by PRA rules and SS45/15. This had been designed to play a strong complementary role to the risk-weighted framework, introducing a 3% minimum leverage ratio requirement and leverage capital buffers. This framework had been implemented before the international approach to the leverage ratio framework was agreed. At the time, the FPC had announced it would review the framework in light of developing international standards.

105. In July 2016, the FPC had recommended that the PRA update the leverage ratio total exposure measure to exclude assets constituting claims on central banks, where they are matched by deposits, denominated in the same currency, and of identical or longer maturity – the PRA implemented that recommendation in 2016. This had been intended to ensure that the leverage ratio framework did not act as a barrier to the effective implementation of any monetary policy measures that lead to an increase in claims on central banks, and did not act as a disincentive for firms to use central bank liquidity facilities. The FPC had also subsequently recommended that the PRA recalibrate the minimum leverage ratio capital requirement for major UK banks and building societies

to 3.25%, in order to avoid an effective easing in the UK leverage ratio framework. The PRA had updated the framework so as to comply with that recommendation in 2017.

106. Internationally, the leverage ratio was a key element of the post-crisis regulatory reform agenda. The Basel Committee on Banking Supervision (BCBS) had finalised the final calibration of the leverage ratio internationally in 2017, which would become a binding minimum requirement in January 2023. In the EU, the Capital Requirements Regulation II had been finalised in 2019, becoming effective in June 2021. The FPC remained committed to the implementation of robust prudential standards in the UK.

107. Currently, the UK leverage ratio framework required major banks and building societies to satisfy a minimum Tier 1 leverage ratio of 3.25% on a measure of exposures that excluded qualifying central bank reserves. Mirroring the risk-weighted capital framework, three-quarters of this minimum requirement must be met with CET1 capital instruments. The remaining additional Tier 1 capital instruments must have a conversion trigger of at least 7% of risk-weighted CET1 capital in order to count towards the leverage ratio minimum requirement. The UK leverage ratio framework also included regulatory buffers that must be met only with CET1: an additional leverage ratio buffer for systemically important banks and a countercyclical leverage ratio buffer both scaled at 35% of their risk-weighted equivalents. The Committee continued to judge that these aspects of the leverage ratio remained appropriate.

108. The FPC considered that overall the existing UK leverage ratio framework delivered a level of resilience at least as great as that required by international standards. A key aspect was that the vast majority of the UK leverage requirement had to be met with the highest quality of capital. At the same time, the UK framework had elements the FPC considered to be of particular benefit to financial stability, such as the additional countercyclical leverage buffer, the leverage buffer for domestically systemically important firms, the exemption of deposit-matched central bank reserves, and the higher buffer usability achieved by relying on the PRA’s existing supervisory powers rather than mandatory distribution restrictions.

Scope of application of the leverage ratio

109. When the FPC had introduced the leverage ratio framework in 2015, it had stated it would expect to broaden the scope to include all PRA-regulated banks, building societies, and designated investment firms, subject to its review. In its 2016 ‘Framework for the systemic risk buffer’ publication, the FPC had expressed its intention to apply the leverage ratio to major UK banks and building societies at the level of Ring Fenced Banks (RFBs) sub-groups (where applicable). Subsequently, in 2018, the PRA had applied the leverage ratio framework to RFBs, within scope of the leverage ratio framework, with FPC support.

110. The FPC continued to consider that the leverage ratio should apply to the major UK banks and building societies and their RFBs. These firms accounted for the majority of UK banking assets, and their provision of critical financial services to the UK economy meant that the FPC believed their failure could pose material threats to domestic financial stability.

111. There were a number of other firms that were large, had complex business models, and were interconnected with the UK financial system. Some of these firms were important for financial market functioning because of their roles in the provision of liquidity and market making. As such, the FPC considered that their failure could also pose material threats to financial stability.

112. The FPC believed that these firms were unlikely to be captured by a direction covering major UK banks and building societies (which had large retail deposits) only. While they shared a number of qualitative features, the FPC considered that the simplest and most broadly shared feature was these firms' holdings of non-UK assets. The FPC therefore proposed to direct the PRA to extend the criteria for scope to include firms with significant non-UK assets. This was also consistent with the FPC's commitment to the implementation of robust prudential standards in the UK that would maintain a level of resilience that is at least as great as, or exceeds, that required by international baseline standards.

113. The FPC had considered whether to extend the scope of application to other firms than those with significant non-UK assets. In its considerations, the FPC noted that other smaller, domestic firms were subject to broadly the same risk-weighted and liquidity regulatory requirements as the major UK firms, derived from international standards. The FPC also noted that even where the requirements for these firms might be simplified, the PRA's objective was to maintain the safety and soundness of those firms.

114. The FPC considered that the individual failure of these firms was not likely to represent a systemic risk to UK financial stability. These firms did not significantly contribute to system-wide leverage. Subject to PRA implementation, the firms proposed in the coverage of the leverage ratio framework would already account for at least three-quarters of UK real economy lending and deposit taking. The FPC therefore judged that the systemic risk posed from the disruption to the continuity of the provision of services from these firms in a stress to not be high.

115. While the majority of these firms applied standardised regulatory risk weights, a small number of them had permission to use internal models. While these models present risks that could be mitigated by a leverage ratio requirement, the FPC considered that the other mitigants currently under consideration were in proportion to the risk posed by the use of internal models by those firms – in particular, the internationally agreed 'output floor' and the PRA's consultation on a mortgage risk weight floor. The FPC also welcomed the PRA's proposal to expect all firms that were not in scope of

the FPC's direction to manage their leverage risk so that their leverage ratio does not ordinarily fall below 3.25%.

116. The FPC also noted the PRA's consideration that these proposals advanced the PRA's secondary competition objective. Smaller firms would be more likely than larger firms to meet any additional requirements (including any MREL requirement) with higher-cost capital, as they tend to have more limited access to cheaper forms of capital. This additional capital funding cost could be a barrier to effective competition. Balancing these considerations, the FPC decided that it would be disproportionate to direct that the PRA extend a leverage ratio requirement for firms other than to those with significant non-UK assets. This was further supported by the FPC's cost benefit analysis, which suggested that a leverage ratio requirement for smaller firms may be proportionately costlier for them than for firms that the FPC proposed should be covered by the leverage ratio requirement. The FPC agreed to monitor the extent to which this judgement continued to hold in future reviews.

117. The FPC carefully designed its proposals in pursuit of its primary objective, in ways that as far as possible were effective in also achieving its secondary objective. Specifically, the FPC considered that the design and calibration of the leverage minimum and buffers provided a strong complementary leverage ratio which did not bind on most firms most of the time. In deciding the scope of the framework, the FPC considered both the benefits and costs of applying the leverage ratio to certain firm types. In determining the overall framework, and subject to its primary objective, the FPC also had regard to its secondary objective, and in particular how its proposed policy would impact competition and competitiveness.

Level of consolidation

118. The FPC has the power to direct the PRA to set leverage ratio requirements on a consolidated, sub-consolidated, and individual basis. In its 2015 implementation of the leverage ratio framework, the FPC had applied UK leverage ratio requirements at a consolidated level for UK groups, which the PRA subsequently extended to major ring-fenced banks at a sub-consolidated level, with FPC support. These levels of application would remain unchanged under the FPC's proposed direction.

119. The FPC recognised the benefits in aligning the leverage ratio with the risk-weighted approach in order for the leverage ratio to play a strong complementary role. This should also be simplest for firms to implement given it mirrored the existing level at which other regulatory requirements were applied. As such, the FPC recognised the general benefits of applying the leverage ratio at an individual level.

120. But the FPC recognised that, in some cases, firms' group structure could mean that applying the leverage ratio at an individual level might become disproportionately costly compared to applying it at a sub-consolidated level, where a relevant firm had a number of subsidiaries. The leverage ratio framework had been designed on an aggregate basis without reflecting the impact of group structure; and the FPC had previously stated its intention for the framework not to apply at the level of individual activities. Where such a cost was disproportionate, and the PRA considered sub-consolidation could prudently apply in light of its own objectives, the FPC considered that there would be a benefit to allowing sub-consolidation – particularly as it may avoid the combination of idiosyncratic group structures and the leverage ratio requirement adversely impacting the provision of liquidity in financial markets, which in turn could adversely impact financial stability.

121. Balancing these considerations, the FPC proposed to direct the PRA to apply the leverage ratio to these firms on an individual basis, but to let the PRA to exercise its judgement in line with its own statutory objectives to allow firms to apply for sub-consolidation where application at individual level may be deemed disproportionate, subject to strict prudential criteria set by the PRA. In exercising its discretion on the appropriate level of consolidation at which to implement the leverage measures, the FPC proposed to direct that the PRA should have regard to, among other things: the desirability of alignment between the levels of application of the leverage measures and measures under the risk-weighted capital framework; and the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

Powers available to the FPC: recommendation and direction

122. On Monday 14 June 2021 the Government had laid secondary legislation (the Bank of England Act 1998 (Macro-prudential Measures) (Amendment) Order 2021, or 'MPM Order 2021') to align the FPC's power of direction with changes made under the Financial Services Act 2021. HMT had previously consulted the FPC on its proposed amendments and their intention to make further minor consequential changes where necessary to reflect the passage of the Financial Services Act 2021.[9] If Parliament approved the MPM Order 2021, the FPC proposed to use its powers of direction and recommendation as would be set out in the Consultation Paper that was due to be published on 29 June 2021.[10]

[9] The FPC agreed with HM Treasury's proposed approach by written procedure on 31 March 2021
[10] The FPC agreed to propose the leverage measures by written procedure on June 22 2021

The following members of the Committee were present:

Andrew Bailey, Governor
Colette Bowe
Ben Broadbent
Jon Cunliffe
Jon Hall
Anil Kashyap
Dave Ramsden
Nikhil Rathi
Elisabeth Stheeman
Carolyn Wilkins
Sam Woods
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

In accordance with the relevant provisions of the Bank of England Act 1998, Jon Hall had notified the Committee of his shareholding at Guardtime (a blockchain based information security provider). It was agreed that he would recuse himself from discussions of the Bank of England discussion paper “New forms of digital money”, and that he would also not receive the related papers.

ANNEX: FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

The FPC has no Recommendations or Directions that have not already been implemented.

Other FPC policy decisions which remain in place

The table below sets out previous FPC decisions, which remain in force, on the setting of its policy tools. The calibration of these tools is kept under review.

Topic	Calibration
Countercyclical capital buffer rate	The FPC agreed to maintain the UK CCyB rate at 0% in June 2021, unchanged from March 2020. This rate is reviewed on a quarterly basis. The UK has also reciprocated a number of foreign CCyB rate decisions – for more details see the Bank of England website.[1] Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Mortgage loan to income ratios	In June 2014, the FPC made the following Recommendation (14/Q2/2): The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The Recommendation should be implemented as soon as is practicable. The PRA and the FCA have published their approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[2] and the FCA has issued general guidance.[3]
Mortgage affordability	At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates: When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product rate at origination). This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.

[1] https://www.bankofengland.co.uk/financial-stability
[2] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[3] https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending