Bank of England

Financial Policy Summary and Record of the Financial Policy Committee meetings on 26 September and 5 October 2023

10 October 2023

This is the record of the Financial Policy Committee meetings held on 26 September and 5 October 2023.

It is also available on the Financial Policy Summary and Record page of our website: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2023/october-2023

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 His 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 21 November 2023 and the record of that meeting will be published on 6 December 2023.

Financial Policy Summary, 2023 Q3

The Financial Policy Committee (FPC) seeks to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face – so that the system is able to absorb rather than amplify shocks and serve UK households and businesses

The overall risk environment

The overall risk environment continues to be challenging and near-term global growth prospects remain subdued. Long-term interest rates, particularly in the US, have risen to materially higher levels. Some parts of the global banking system and financial markets remain vulnerable to stress from increased interest rates, and are subject to significant uncertainty, reflecting risks to the outlook for growth and inflation, and from geopolitical tensions.

Financial market developments

Since the July Financial Stability Report (FSR), risk-free interest rates in advanced economies have risen further, and market participants are now firmer in their expectations that many policy makers will need to maintain high rates for a prolonged period. 10-year US government bond yields have risen to around 4.75%, their highest level since 2007. Euro area and UK long-term interest rates have also risen. In the UK, market pricing implies a lower peak Bank Rate than had been anticipated at the time of the July FSR, reflecting downside news on inflation and the near-term outlook for growth.

Given the impact of higher interest rates, and uncertainties associated with inflation and growth, some risky asset valuations appear stretched. Stretched risky asset valuations increase the likelihood of a greater correction in prices if downside risks to growth materialise. This would have a direct impact on the cost and availability of finance for corporates globally, and would affect riskier borrowers in particular.

Further material increases in risk-free interest rates, or a significant re-appraisal of credit risk globally, could also be amplified by vulnerabilities elsewhere in the system of market-based finance, with a broader potential impact on financial stability.

Global vulnerabilities

Higher interest rates continue to weigh on the ability of households and businesses in advanced economies to service and refinance their debts. Some banks in a number of jurisdictions will have been impacted by recent increases in long-term interest rates.

Residential property prices have fallen and further falls are likely in many economies, and indicators suggest that CRE prices in many countries are decreasing significantly.

Longstanding vulnerabilities in the Chinese property market have crystallised further, and significant downside risks remain. Activity and prices have weakened in recent months and a number of developers have faced tightening financing conditions and liquidity pressures as sales have fallen. Chinese authorities have put in place measures to provide some support, aimed at limiting spillovers from losses being borne by creditors. A further deterioration in activity and prices could pose risks to the Chinese economy and its financial sector, which could impact the UK and other jurisdictions via trade or financial spillovers, including through disorderly asset price adjustments.

In common with mainland China, Hong Kong also has high private sector debt levels and elevated property prices, and UK banks' exposures to Hong Kong are larger than those to mainland China. At present, however, there are limited signs of stress in Hong Kong property markets and there is greater security and seniority on Hong Kong exposures relative to Chinese exposures. Nevertheless, despite differences between the risk profiles of the two property sectors, should current challenges in China's property sector lead to a significant downturn in the broader Chinese economy, spillovers to Hong Kong's property market could be material.

The 2022/23 Annual Cyclical Scenario (ACS) stress test indicated that major UK banks were resilient to the direct effects of a severe downturn in mainland China and Hong Kong, including a very large shock to property prices in both markets. **The FPC will continue to monitor closely developments in these property markets, and the potential for spillovers to UK financial stability.**

Markets reacted in an orderly manner to the announcement by the Bank of Japan in July that it would conduct its yield curve control policy with greater flexibility. However, there is a risk that further policy changes could trigger larger or more volatile price adjustments, for example if they led to reallocations of government bond holdings across jurisdictions, or some Japanese banks incurring losses on their domestic government bond holdings.

UK household and corporate debt vulnerabilities

In the UK, household finances remain under pressure, and the full impact of higher interest rates has not yet passed through to all borrowers. The share of households with high debt servicing ratios – after accounting for the higher cost of living – is rising, and is expected to continue to do so through 2024. But the FPC continues to judge that it is likely to stay below the historic peak reached in 2007. In part, this reflects the FPC's mortgage market measures, introduced in 2014 – including its loan to income flow limit on lending to borrowers with high loan to income ratios at or above 4.5 – and the FCA's

responsible lending requirements, which have limited the build-up of household indebtedness.

Owner-occupier arrears are low in historical terms, though there has been a modest increase. Some borrowers facing higher interest rates have taken out mortgages with longer-terms, and a small number have moved to interest only. There has, for example, been a notable increase in the proportion of borrowers taking out mortgages with 35 year or above terms, although this remains a small share of total mortgages. Such lending will be bound by FCA responsible lending rules requiring lenders to take account of future changes to income and expenditure, such as the borrower retiring, where that is expected to happen during the mortgage term.

UK banks remain in a strong position to support borrowers should they face difficulties servicing their debts.

Buy-to-let mortgagors are experiencing increases in mortgage interest payments in addition to some structural factors likely to put pressure on incomes from residential property. This could lead some landlords to sell, putting downward pressure on house prices, although net sales by landlords have not been significant so far. Buy-to-let landlords may seek to continue to pass on higher costs to renters, adding to other cost of living pressures.

There is evidence that some households are increasing the use of consumer credit in response to cost of living pressures and higher debt servicing costs, which could lead to greater debt vulnerability for households in the near-term.

A significant rise in unemployment would increase the likelihood of UK household debt vulnerabilities crystallising. UK unemployment remains low by historical standards at 4.3%, although employment indicators are generally softening with subdued economic activity.

Overall, the UK corporate sector is expected to remain broadly resilient to higher interest rates and weak growth. However, the full impact of higher financing costs has not yet passed through to all corporate borrowers, and will be felt unevenly, with some smaller or highly leveraged UK firms under pressure. Corporate insolvency rates have continued to rise, albeit from very low levels.

Larger corporates were in a stronger position going into this period of rising interest rates relative to previous tightening cycles. The bulk of outstanding fixed-rate UK corporate debt matures in or after 2025. As a result, refinancing needs for larger firms are likely to be limited in the near-term, and firms have some time to adjust their business plans, which should help to limit risks associated with re-financing and higher debt servicing costs.

The UK CRE sector continues to face a number of challenges, both from higher interest rates and structural factors. CRE prices in the UK have reacted more quickly to market developments, having fallen further than in some other jurisdictions, such as the US and

Europe. UK banks have reduced their exposures to UK CRE over recent years, and arrears on their exposures are still low by historical standards.

UK banking sector resilience

The UK banking system is well capitalised, supported by strong recent profitability, and has high levels of liquidity.

There is a wide range of business models amongst smaller and medium-sized UK banks, some of which are specialised in particular activities or serve particular sectors. A more challenging environment can affect these business models in different ways.

The FPC continues to judge that the UK banking system is resilient to the current economic outlook and has the ability to support households and businesses even if economic and financial conditions were to be substantially worse than expected.

Expected increases in credit losses related to the challenges facing UK households and corporates are well within the levels of losses projected in the 2022/23 ACS stress test. The ACS indicated that major UK banks could withstand a severe macroeconomic downturn whilst continuing to support UK households and businesses.

Forward looking indicators of UK banks' asset quality remain relatively stable overall, though arrears have started to increase from historically very low levels and are expected to rise further. Recent weakness in lending appears to reflect weaker demand and previous tightening in banks' risk appetite. The FPC continues to judge that the tightening in UK credit conditions has reflected changes to the macroeconomic outlook rather than defensive actions by banks to protect their capital positions.

The UK countercyclical capital buffer rate decision

In light of its assessment of financial vulnerabilities and the resilience of the UK banking system, **the FPC has decided to maintain the UK CCyB rate at 2%.** The FPC will continue to monitor developments closely and stands ready to vary the UK CCyB rate, in either direction, in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment.

Stress testing

To support the FPC's and Prudential Regulation Authority's (PRA) monitoring and assessment of the resilience of the UK banking system to potential downside risks, the Bank intends to run a desk-based stress test exercise, rather than an ACS, in 2024. The desk-based exercise will use Bank models and expertise to test the resilience of the UK banking system. A key benefit of a desk-based exercise will be to allow for that resilience to

be tested to more than one adverse macroeconomic scenario. The Bank currently intends to return to a concurrent exercise involving firm submissions of stressed projections in 2025.

The Bank will also take stock of, and update, its framework for concurrent bank stress testing in 2024, drawing on lessons learnt from its first decade of concurrent stress testing.

Alongside the desk-based stress test exercise, the Bank is currently carrying out a system-wide exploratory scenario (SWES), launched in June, which aims to improve understanding of the behaviours of banks and non-bank financial institutions in stressed financial market conditions. The participating firms in this exercise are representative of markets that are core to UK financial stability. The initial stress scenario will be published in 2023 Q4.

The resilience of market-based finance

Vulnerabilities in market-based finance (MBF) remain. The FPC judges that the scale of these is broadly unchanged since the July FSR. Should such vulnerabilities crystallise in the context of sharp movements in asset prices, they could amplify any tightening in credit conditions, and so affect households and businesses.

Hedge funds continue to maintain material leveraged positions in US Treasuries, including in the cash-futures basis trades that had contributed to dysfunction in the US Treasury market in March 2020. **The FPC will continue to monitor risks to core market functioning and broader financial stability posed by leveraged trades in government bond markets,** and welcomes the PRA's recent '**Dear CRO**' letter following the PRA's thematic review of regulated banks' liquid fixed income financing businesses.

A **Financial Stability in Focus** released today sets out the FPC's approach to identifying, assessing, monitoring and mitigating vulnerabilities in MBF. As the FPC has previously stated, there is an urgent need to address these vulnerabilities. Market-based finance comprises a broad and complex universe of very different firms and business models connected by a range of financial market infrastructures, both within and between jurisdictions. Policy work to reduce vulnerabilities and improve resilience therefore needs to happen at an international level and involve a range of regulatory authorities. Alongside **international policy work led by the Financial Stability Board, the UK authorities are also working to reduce vulnerabilities domestically where it is effective and practical.**

The FPC's resilience framework for liability-driven investment (LDI) funds introduced in 2023 Q1 has been functioning broadly as intended in an environment of higher market interest rates. Funds have maintained overall levels of resilience consistent with the minimum levels recommended and have initiated recapitalisation at higher levels of resilience than previously, although there remain some areas for improvement. It is important that work

to put in place a monitoring and enforcement framework for pooled funds by the FCA and relevant international regulators continues.

The Bank is continuing to work with other UK authorities to improve the resilience of money market funds (MMFs). The UK authorities will publish a consultation paper on MMF regulation later this year. Significantly more liquid assets than currently required is likely to be the most effective way to increase MMF resilience and so reduce risks to financial stability, since higher levels of liquidity increase the range of stresses MMFs are resilient to. **Bank staff analysis suggests that weekly liquid asset levels in the region of 50-60% of assets would give a high level of assurance that sterling denominated MMFs would be resilient to severe but plausible stresses.**

Record of the Financial Policy Committee on 26 September 2023 and 5 October 2023

1. The Committee met on 26 September and 5 October 2023 to agree its view on the outlook for UK financial stability and, on that basis, 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. The FPC seeks to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face – so that the system is able to absorb rather than amplify shocks and serve UK households and businesses.

The overall risk environment

2. The FPC judged that the overall risk environment continued to be challenging and near-term global growth prospects remained subdued. Long-term interest rates, particularly in the US, had risen to materially higher levels. Some parts of the global banking system and financial markets remained vulnerable to stress from increased interest rates, and were subject to significant uncertainty, reflecting risks to the outlook for growth and inflation, and from geopolitical tensions.

Financial market developments

3. Since the July 2023 Financial Stability Report (FSR), risk-free interest rates in advanced economies had risen further. The FPC noted that market participants were now firmer in their expectations that many policymakers would need to maintain high rates for a prolonged period. But the FPC highlighted that there had been some evidence of divergence in expectations for the outlook in advanced economies, in particular in light of market participants' views on the relative robustness of the United States economy as compared to the UK and the Euro-area.

4. Long-term interest rates had increased sharply – particularly in the US, where 10-year government bond yields had increased by around 90 basis point since the July FSR and were around 4.75%; their highest level since 2007. US government bond yields had also risen at the short end, albeit to a lesser extent. The FPC noted that these adjustments had so far been orderly and largely reflected rising term premia, with US real interest rates rising to around 2.5%, their highest levels since 2008. Long-term Euro-area and UK government bond yields had also increased although the increases were smaller than in the US overall. In contrast, UK shorter-dated government bond yields had decreased, with two-year yields falling by around 35 basis points. This reflected shifts to the expected path of Bank Rate, as data releases indicated some evidence of reduced UK inflation persistence and emerging signs of slowing economy activity. Market expectations of peak UK Bank Rate had fallen to 5.4% from 6.2% at the time of the July FSR.

5. Risky asset prices had fallen somewhat since the July FSR. The risk premia on many advanced economy risky assets were around or above the middle of their historical distributions, although credit spreads for US Dollar-denominated high-yield and investment-grade bonds were more compressed than their Euro or Sterling equivalents. And some measures of US equity risk premia remained well within the lower quartile of their historical distribution, driven primarily by the continued strength in the US tech sector. The Committee judged that better than expected economic activity in the US had played some part in the relative compression of US risk premia, as compared to other advanced economies.

6. The FPC judged that given the impact of higher interest rates, and uncertainties associated with inflation and growth, some risky asset valuations appeared stretched. In particular, the FPC noted that a deterioration in the global economic outlook, further increases in risk-free interest rates, or further interest rate volatility could lead to sharp reductions in asset prices and further tightening in financial conditions for households and businesses. This included further sharp increases in US government bond yields, with any resulting volatility potentially spilling over to UK and global markets. The FPC noted that any such moves could be amplified by vulnerabilities in the system of market-based finance.

7. The Committee observed that despite recent rates volatility, core markets had so far continued to function well including during some material adjustments in rates markets. While there had been some reduction in liquidity in gilt markets throughout the summer due to seasonal factors, liquidity had returned in September. But the FPC noted that in the current environment conditions could deteriorate quickly, especially if market volatility increased further.

8. The FPC also noted that market perceptions of credit risk in advanced economies were currently subdued despite uncertainty around growth and the high interest rate environment. Default rates on riskier credit had risen in 2023, especially for leveraged loans. But baseline forecasts from rating agencies indicated only small further increases going forward, to levels well below those seen during the global financial crisis (GFC) or the Covid pandemic. This could be attributed to relatively robust economic performance in advanced economies, especially the US, lower refinancing needs of corporates due to large volume of issuances in 2020/2021, and actions taken by issuers to alleviate short term funding pressures. But the Committee judged that default rates could rise further beyond current market expectations should risks of weaker economic growth, further material increases in risk-free rates and increased inflation persistence, as well as geopolitical risks, materialise.

9. The FPC noted that should such risks crystallise, a reduction in investor risk appetite could further impact riskier borrowers in advanced economies already facing a significant tightening in financial conditions. For example, year-to-date high-yield corporate bond and leveraged loan issuances in major currencies were around 30-60% below their 2018-2022 averages at this point in the year. And private markets, which had in recent years substituted

some of the public market funding, had started to show signs of slowing down, which could exacerbate the tightening of credit conditions facing riskier borrowers.

Global vulnerabilities

10. The FPC noted that geopolitical tensions, including Russia's illegal invasion of Ukraine and tensions between the US and China, could increase the likelihood of global vulnerabilities crystallising and could particularly affect the UK's internationally focused banks.

11. High interest rates in advanced economies continued to dampen global GDP growth. Headline inflation had continued to fall in recent months in advanced economies, largely reflecting lower energy prices, but services inflation remained high, and was a large and growing contributor to overall inflation. Global growth was expected to remain subdued in the near-term.

12. High interest rates also continued to weigh on the ability of households and businesses in advanced economies to service and refinance their debts. Riskier corporate borrowing in financial markets, such as private credit and leveraged lending, appeared particularly vulnerable. Stress in the leveraged loan market, for example due to a worsening macroeconomic outlook, could cause a rapid reassessment of risks by investors, potentially resulting in sharp revaluations and fire sales. The 2022/23 Annual Cyclical Scenario (ACS) stress test captured the risks to major UK banks from leveraged lending.

13. While the global banking system had been resilient following the stresses earlier this year, some banks in a number of jurisdictions would have been impacted by recent increases in long-term interest rates, and remained exposed to property markets, including commercial real estate (CRE). More comprehensive measures of CRE prices tended to be heavily lagged but faster-moving indicators, while less robust, suggested that US and euro area CRE prices were decreasing significantly. Residential property prices had also fallen and further falls were likely in many economies, with high interest rates on new or variable rate mortgages leading to falls in residential property prices as affordability – and hence demand – declined. In the US, a number of banks had been downgraded by credit rating agencies. However, deposits held by smaller US banks had continued to recover since the July FSR. Around half of the decline seen in February and March 2023 had unwound by the end of August. The US authorities had also published proposals for the implementation of Basel III, which had been estimated to lead to a material increase in capital requirements for both mid-size and larger institutions and the Federal Deposit Insurance Corporation (FDIC) had outlined proposals to strengthen the resolution framework. The banking sector stresses in March demonstrated how contagion could spread within jurisdictions and across borders via financial market pricing, affecting banks' funding costs and share prices.

14. Longstanding vulnerabilities in the Chinese property market had crystallised further after a short-lived stabilisation, and significant downside risks remained. Activity and prices in the property market had weakened in recent months. New floor space sold each month in China had fallen by nearly a half from 2021 H1 levels, and real estate investment by nearly a fifth to August year-on-year. A number of property developers had faced tightening financing conditions and liquidity pressures as sales had fallen. Several developers had missed bond payments or defaulted in recent months, and spreads on offshore bonds had increased since the July FSR. In light of these developments, the Chinese authorities had put in place measures to provide some support, aimed at limiting spillovers from losses being borne by creditors, against the backdrop of a longer-term strategy to reduce speculation in the sector. The Committee judged a further deterioration in activity and prices could pose risks to the Chinese economy and its financial sector, which could impact the UK and other jurisdictions via trade or financial spillovers, including through disorderly asset price adjustments.

15. Some UK banks had material exposures to Hong Kong as well as mainland China. In common with mainland China, Hong Kong also had high private sector debt levels and elevated property prices, and UK banks' exposures to Hong Kong were larger than those to mainland China. At present, however, there were limited signs of stress in Hong Kong property markets and there was greater security and seniority on Hong Kong exposures relative to Chinese exposures. Nevertheless, despite differences between the risk profiles of the two property sectors, should current challenges in mainland China's property sector lead to a significant downturn in the broader Chinese economy, spillovers to Hong Kong’s property market could be material. The 2022/23 ACS indicated that major UK banks were resilient to the direct effects of a severe downturn in mainland China and Hong Kong, including a very large shock to property prices in both markets. The FPC would continue to monitor closely developments in these property markets, and the potential for spillovers to UK financial stability.

16. Markets reacted in an orderly manner to the announcement by the Bank of Japan in July that it would conduct its yield curve control policy with greater flexibility. However, there was a risk that further policy changes could trigger larger or more volatile price adjustments, for example if they led to reallocations of government bond holdings across jurisdictions, and to some Japanese banks incurring losses on their domestic government bond holdings.

UK economic outlook

17. The FPC noted that the Monetary Policy Committee (MPC) expected UK GDP to rise only slightly in 2023 Q3, compared with the 0.4% increase incorporated in the August **Monetary Policy Report** (MPR). Underlying growth was also likely to be weaker in the second half of 2023 than previously expected. The FPC noted that there remained considerable uncertainties around the medium-term outlook.

18. Twelve-month CPI inflation fell from 7.9% in June to 6.7% in August. The MPC expected UK CPI inflation to fall significantly further in the near term, reflecting lower annual energy inflation and further declines in food and core goods price inflation, although risks to inflation in the August MPR were skewed to the upside.

UK debt vulnerabilities

UK household resilience

19. Household finances remained under pressure from increased living costs and interest rates. Higher interest rates were expected to continue to impact more households as fixed rate mortgage deals expired and households refinanced, although average quoted mortgage rates had decreased slightly since July and some households will have had some time to prepare for higher mortgage payments. The FPC noted that while the aggregate debt to income ratio declined to 117% (excluding student loans) in 2023 Q2, the lowest level since 2003, the proportion of borrowers with high cost of living adjusted debt service ratios (COLA DSRs) had increased, primarily reflecting higher interest rates. COLA DSRs were expected to rise a little further, while remaining below GFC levels, to 2.5% by end-2024, as mortgagors refinanced onto higher rates. To reach the 2007 peak level (3.4%), it would require mortgage rates to be around three percentage points higher relative to current expectations, other things equal.

20. This lower projected peak in part reflected the FPC's mortgage market measures, introduced in 2014 – including its loan to income (LTI) flow limit on lending to borrowers with high loan to income ratios at or above 4.5 – and the FCA's responsible lending requirements, which had limited the build-up of household indebtedness. The FPC observed that the flow of high LTI mortgage lending as a share of new lending was around 5%, its lowest level since the introduction of the flow limit, and in aggregate the loan-to-value (LTV) profile of UK banks' mortgage portfolios was strong, reflecting a long period of house price growth and more prudent lending practices than those preceding previous downturns.

21. Leading house price indicators showed a modest decline through August, and house prices were expected to fall further over 2024. Mortgage approvals fell in August, reflecting the increase in mortgage rates over the last year, the squeeze on household incomes and a weak macroeconomic outlook.

22. Owner-occupier mortgage arrears (of 2.5% or more of the outstanding balance) rose slightly in 2023 Q2 but remained low in historical terms (less than 1% of outstanding owner-occupier mortgages). Robust capital and profitability, and strict regulatory conduct standards for lenders, overseen by the FCA, meant UK banks were both able and expected to offer forbearance and support to borrowers. Lenders representing approximately 90% of the mortgage market had also signed up to offer options agreed under the **Mortgage Charter**, for which take-up had so far been quite limited. Some owner-occupier mortgagors, who faced

higher interest rates and had recently refinanced, had extended their mortgage terms, and a small number had moved to interest only. The Committee noted that since 2021 Q1 the proportion of new mortgage lending with a term of 35 years or more had increased by 8 percentage points, to 12% by 2023 Q2, though this remained a small share of total mortgages. The FPC also noted that while longer mortgage terms and other forbearance measures could reduce pressures on borrowers in the short term, they could increase debt burdens over the longer term. Potential risks from such lengthening of debt burdens were mitigated somewhat by the FCA's responsible lending rules that required lenders to take account of future changes to income and expenditure, such as the borrower retiring, where this was expected to happen during the mortgage term.

23. Higher interest rates, together with some structural factors, were also putting pressure on profitability in the buy-to-let sector, which had led some landlords to sell or pass on higher costs to renters. Private rents in the UK rose by 5.5% in the 12 months to August 2023, compared with 5.3% in the 12 months to July. The FPC recognised that renter households tended to have lower incomes than homeowners (including relative to housing costs) and they were likely to have low savings. Higher costs relative to incomes could lead to an increased reliance on consumer credit, or difficulties paying off existing consumer credit or other types of debt. It could also increase vulnerability to future adverse shocks. The FPC noted that buy-to-let mortgage arrears (of 2.5% or more of the outstanding balance) increased in Q2 but from a low base, and remained below 1% of all buy-to-let mortgages outstanding.

24. There was survey evidence that some households were increasing their use of consumer credit in response to cost-of-living pressures and higher debt servicing costs, which could lead to greater debt vulnerability for households in the near-term. But the annual growth rate for all consumer credit was little changed at 7.6% in August. Within that, the annual growth rate for credit card borrowing was also little changed at 11.8%.

25. A significant rise in unemployment would increase the likelihood of UK household debt vulnerabilities crystallising. UK unemployment remained low by historical standards at 4.3%, although employment indicators were generally softening with subdued economic activity. In the August MPR, the MPC forecast the UK unemployment rate to rise to 4.8% in 2025 Q3 and remain there until 2026 Q3.

UK corporate resilience

26. The FPC judged that the UK corporate sector was likely to remain broadly resilient to higher interest rates and weak growth. In aggregate, firms had been repaying debt and earnings growth had been stronger than expected, such that in 2023 Q1, the amount of outstanding corporate debt relative to earnings had continued to fall since its recent pandemic-era peak. And the net debt-to-earnings ratio was at its lowest point in the last 20 years at around 120%.

27.The bulk of outstanding UK corporate debt was due to mature in or after 2025. That meant that refinancing needs, for larger firms in particular, were likely to be limited in the near-term, and firms had some time to adjust their business plans, which should help to limit any risks associated with re-financing and higher debt servicing costs. Nevertheless, higher financing costs were likely to put pressure on some smaller or highly leveraged firms.

28.The debt-weighted proportion of medium and large corporates with interest coverage ratios (ICRs) below 2.5 was projected to continue to increase throughout 2023 as debts refinanced at higher rates (assuming no further reduction in borrowing), although it was expected to remain some way below the peak of 65% reached in the early 2000s.

29.Large increases in the cost of borrowing and issuance could challenge corporate resilience and push down on investment and employment, should firms be unable to roll over or refinance existing debt or issue new finance as needed at an affordable price. That was especially the case for firms such as SMEs who would find it harder to access sources of finance beyond banks. SMEs constitute a relatively small share of bank exposures, some of which had been issued at low interest rates via government-guaranteed loan schemes. The FPC noted that while only 4.8% of government-guaranteed loans and 1% of commercial loans were in arrears, SMEs accounted for around 60% of UK employment.

30.The FPC noted that while corporate insolvency rates had risen in line with expectations and were likely to continue to rise, they remained low relative to their long-term average level of around 100 per 10,000 firms. The increase in insolvencies had been dominated by very small firms with limited debts. Nevertheless, the number of insolvencies of medium and large corporates had risen through 2023, also from very low levels.

31.The FPC noted that while market-based finance had the potential to diversify corporates' funding sources and improve the resilience of lending, an increased reliance on it could also introduce additional vulnerabilities as credit supply from these sources may be more cyclical. In particular, riskier borrowers could be more likely to experience difficulty in accessing credit in the event of unexpected shocks as they would likely find it difficult to access alternative markets.

32.The FPC further noted that vulnerabilities in UK commercial property markets remained. Higher interest rates and structural factors such as increased remote working had weighed on prices. Since their mid-2022 peak, UK CRE prices had reacted more quickly to market developments, having fallen by nearly 20% - further than in some jurisdictions, such as the US and Europe.

UK bank resilience

33.The FPC judged that the UK banking system was resilient to the current economic outlook and had the ability to support households and businesses even if economic and financial conditions were to be substantially worse than expected.

34.The UK banking system was well capitalised, supported by strong recent profitability, and had high levels of liquidity. The aggregate Common Equity Tier 1 (CET1) capital ratio for major UK banks was 14.7% in 2023 Q2. The aggregate CET1 capital ratio for smaller banks was 18.4% in the same period. The aggregate three-month rolling average Liquidity Coverage Ratio (LCR) remained well above requirements at 147% and 265% for major and smaller banks, respectively. The FPC noted that there was a wide range of business models amongst smaller and medium-sized UK banks, some of which were specialised in particular activities or served particular sectors. A more challenging environment could affect these business models in different ways.

35. The Committee noted that forward looking indicators of UK banks' asset quality remained relatively stable overall. Amongst banks' UK loan books, mortgage arrears had increased, albeit to what was still a low level historically, and were expected to rise further. Offsetting this, there had been an improvement in banks' forward-looking measures of unsecured retail and wholesale credit risk. Major UK banks' provision coverage remained broadly flat at 1.1% over the quarter, a little above pre-Covid levels.

36.However, the overall risk environment remained challenging as household and some corporate finances remained under pressure from rising interest rates, and some global risks continued to crystallise. Market measures of UK banks' future profitability, such as their average price to tangible book ratios, had remained subdued.

37.The Committee noted that defaults on leveraged lending had increased, although they remained well below the peaks observed during the GFC. Additionally, current levels of default in leveraged loan markets remained significantly less severe than those to which major UK banks had been tested as part of the 2022/23 ACS stress test.

38.As discussed above, risks had crystallised further in Chinese property markets. However, the decline in property prices in China and Hong Kong remained significantly less severe than those to which major UK banks had been tested as part of the 2022/23 ACS stress test. For example, the stress test included a 53% fall in Hong Kong CRE prices compared with the 6.5% fall observed since 2022 Q2.

39.The FPC discussed developments in bank funding markets in recent quarters. Aggregate deposit growth had declined, consistent with a slowing in lending growth. Within that, aggregate deposits at large banks had decreased while aggregate deposits at smaller banks had increased. There had been an increase in competition for deposits and savings, and interest rates on deposit accounts had increased. The FCA had introduced the Consumer Duty, which came into effect in July 2023 setting higher and clearer standards of consumer protection across financial services. Included in these rules was a focus on ensuring fair value and clearer and more proactive customer communications, which applied to all savings accounts.

40.Rates had increased relatively more for time deposits which, unlike sight deposits, could not be fully withdrawn at short notice without incurring a penalty. In turn, there had been a shift in deposit mix, with time deposits (including Individual Savings Accounts (ISAs)) increasing as a share of total household and private non-financial corporations (PNFC) deposits from 22.7% in May 2022 to 29.2% in July 2023. Longer-term deposits provided additional resilience to banks' liquidity.

41.There were further indications that increasing competition for deposits would see aggregate net interest margin (NIM) for the major UK banks stabilise at around current levels. Those levels were higher than recent years when Bank Rate had been close to the effective lower bound, and similar to levels seen before the GFC when Bank Rate was comparable to its current level.

42.The recent weakness in lending appeared to be the product of weaker demand and previous tightening in banks' risk appetite. There were no reports of a further tightening in risk appetite by banks in supervisory market intelligence and, since June 2023, mortgage product availability had increased while rates had declined. As such, the FPC judged the tightening in UK credit conditions reflected changes to the macroeconomic outlook rather than defensive actions by banks to protect their capital positions. The Committee would continue to monitor UK credit conditions for signs of an unwarranted tightening.

The UK countercyclical capital buffer rate

43.The FPC discussed its setting of the UK countercyclical capital buffer (CCyB) rate. The Committee reiterated that its principal aim in setting the CCyB rate was to help ensure that the UK banking system was better able to absorb shocks without an unwarranted restriction in essential services, such as the supply of credit, to the UK real economy. The UK CCyB rate enables the capital requirements of the UK banking system to be adjusted to the changing scale of risk of losses on UK exposures over the course of the financial cycle. The approach therefore included an assessment of financial vulnerabilities and banks' capacity to absorb losses on their UK exposures, including their sensitivity to shocks.

44.In considering the appropriate setting of the UK CCyB rate this quarter, the FPC discussed its judgements around underlying vulnerabilities that could amplify economic shocks. In aggregate, these vulnerabilities were broadly unchanged since the previous quarter, with several key indicators, including household debt-to-income and corporate gross debt to earnings around their long-term averages. However, underlying growth in the second half of 2023 was likely to be weaker than had been expected, and there remained considerable uncertainty around the economic outlook. Financial conditions remained tight, which would put pressure on debt serviceability and could bring greater risk to banks' resilience.

45.The subdued macroeconomic backdrop and the need for corporates to refinance at tighter conditions and higher rates meant that a tail of corporates remained under financial pressure. Increases in interest rates were still to pass through to majority of mortgagors, which could put pressure on household debt serviceability. In addition, the FPC noted that market expectations were for interest rates to remain high, which would put continued financial pressures on households and corporates. Nevertheless, projections of increases in the share of UK households with high mortgage cost-of-living adjusted DSRs, and the share of corporates with high ICRs, were similar to those projected last quarter.

46.Given this context, a number of views were discussed on the appropriate setting for the UK CCyB rate. Some members suggested that there might be a case for increasing the UK CCyB rate. The uncertain environment could mean that severe outcomes would be more likely, and building resilience against that possibility would be less costly if it started earlier, while bank earnings were strong. But, as noted above, vulnerabilities and the economic environment were little changed on the quarter.

47.The FPC also considered whether there was a case for releasing the CCyB. There was some evidence of vulnerabilities starting to crystallise, although arrears and insolvencies remained at historically low levels. In addition, the FPC judged that credit conditions were broadly unchanged since Q2, and that the tightening to date reflected increased credit risk rather than defensive actions by banks to protect their capital positions; and so it agreed that there were limited arguments in favour of decreasing the UK CCyB rate.

48.The FPC observed that UK banks' resilience was supported by continued robust profitability, relatively strong asset quality and strong capital positions. And the results of the 2022/23 ACS indicated that the major UK banks were resilient to a severe stress scenario. Given the major UK banks' strong capital positions, the FPC judged that the UK banking system was in a position to continue to meet credit demand from creditworthy households and businesses. Maintaining a neutral setting of the UK CCyB rate in the region of 2% would help to ensure that banks continued to have capacity to absorb unexpected future shocks without restricting lending in a counterproductive way. The FPC would continue to monitor UK credit conditions for signs of tightening that were not warranted by changes in the macroeconomic outlook.

49.In view of these considerations, the FPC decided to maintain the UK CCyB rate at 2%.

50.The FPC recognised the continued uncertain environment and reiterated that it would continue to monitor the situation closely and stood ready to vary the UK CCyB rate - in either direction - in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment. Consistent with the **FPC's updated CCyB Policy Statement** published in July, if vulnerabilities that could amplify future economic shocks increased to an elevated level, so as to pose greater risks to banks' resilience, the FPC would be prepared to raise the UK CCyB rate above 2%. This would ensure that banks

had an additional cushion of capital with which to absorb potential losses, enhancing their resilience and helping to ensure the stable provision of financial services. In contrast, if conditions deteriorated by significantly more than currently expected, in a manner that might otherwise lead banks to restrict lending primarily to defend their capital ratios, the FPC would be prepared to cut the CCyB rate as necessary. This would enable banks to use the released buffer to absorb losses and so be able to support lending.

Stress testing plans in 2024

51.The results of the 2022/23 ACS stress test, published in July 2023, indicated that the UK banking system would be able to withstand a severe stress scenario that incorporated persistently higher advanced economy inflation, increasing global interest rates, and deep simultaneous recessions in the UK and global economies, with materially higher unemployment and sharp falls in asset prices.

52.Since the Bank began concurrent stress testing for banks in 2014, it had undertaken a range of stress tests of the banking system to severe economic and financial scenarios, adapting its approach as appropriate. These had included exercises involving firm submissions such as ACS stress tests – in which the macroeconomic scenario had been calibrated to include severe but plausible events in the long-run context of UK and global macroeconomic performance – and a Solvency Stress Test to assess banks' resilience to a very severe intensification of the macroeconomic shock arising from the Covid pandemic. In 2020, the Bank undertook and published the results of two desk-based stress tests, including a reverse stress test, which used Bank models and expertise to test the resilience of the UK banking system to adverse macroeconomic scenarios associated with the pandemic without submissions of stressed projections from banks.

53.To support the FPC's and Prudential Regulation Authority's (PRA) monitoring and assessment of the resilience of the UK banking system to potential downside risks, the FPC and Prudential Regulation Committee (PRC) had agreed that the Bank would run a desk-based stress test exercise in 2024. A key benefit of a desk-based exercise was that resilience could be tested to more than one adverse macroeconomic scenario.

54.The exercise would provide a view on the resilience of the UK banking system based on updated starting balance sheet data from banks. The outcome of the desk-based test would be used to inform the FPC's judgements about the ability of the banking system to support the economy through stress and support the PRA's ongoing supervisory work. The aggregate results would be communicated publicly.

55.Alongside the desk-based stress test exercise, the FPC would continue to assess the resilience of the UK banking system as part of its regular monitoring work. This would continue to be informed, in part, by the PRA's microprudential supervision of individual banks.

56.Alongside the desk-based stress test exercise, the Bank was carrying out a system-wide exploratory scenario (SWES), launched in June 2023, which aimed to improve understanding of the behaviours of banks and non-bank financial institutions in stressed financial market conditions. The participating firms in this exercise were representative of markets that are core to UK financial stability. The initial stress scenario would be published in 2023 Q4.

57.The Bank would also take stock of and update its framework for concurrent bank stress testing in 2024, drawing on lessons learned from its first decade of concurrent stress testing, and so continue to support the FPC and PRC in meeting their objectives. Subject to the stocktake, in 2025 the Bank intended to return to a concurrent exercise involving firm submissions of stressed projections.

58.As part of this stocktake, the Bank would assess whether the coverage of banks in its concurrent stress testing of the banking system remained appropriate. To provide clarity while the stocktake was ongoing, the FPC and PRC agreed not to extend participation in the 2025 concurrent exercise.

Market-based finance resilience

Recent developments

59.The FPC judged that vulnerabilities in certain parts of the system of market-based finance (MBF) remained, with the scale of these vulnerabilities broadly unchanged since the July FSR. The FPC observed that should such vulnerabilities crystallise in the context of volatility or sharp movements in asset prices, they could amplify any tightening in credit conditions, and so affect households and businesses.

60.The FPC noted that hedge funds continued to maintain material leveraged positions in US Treasuries and related futures, including in cash-futures basis trades that had contributed to dysfunction in the US Treasury market in March 2020. The Committee observed that hedge fund short positions in US Treasury futures were at around USD 700 billion notional and somewhat above levels seen in 2019 and 2020, driven primarily by asset manager long futures positioning. If these markets were to move sharply, deleveraging of these positions could further amplify stress. The FPC observed that similar positioning did not appear to be an inherent feature of cash gilt and related futures markets. The FPC would continue to monitor risks to core market functioning and broader financial stability posed by leveraged trades in government bond markets, including the extent to which these changes in hedge fund US Treasury futures positions were driven by basis trades.

61.The FPC noted that the PRA had recently completed a thematic review of regulated banks' liquid fixed income financing businesses. The review found a number of shortcomings in firms' counterparty risk management processes and margining arrangements that should be remediated. Some of these findings were drawn directly from lessons learned following the gilt market stress event, but others were broader themes. Many of these counterparty risk

management shortcomings were consistent with findings the PRA had previously made in relation to cash prime brokerage and synthetic equity financing following the default of Archegos.

62.The FPC was briefed on the **Dear CRO** letter the PRA sent to firms setting out the findings of this review, and the PRA's expectations of practices that firms should incorporate into their risk management of these activities. The FPC supported this work to strengthen banks' risk management practices, as part of the broader domestic and international work being undertaken to strengthen the resilience of market-based finance.

The FPC's approach to assessing risks from market-based finance

63.The FPC noted that the system of MBF had grown substantially in recent years and had become increasingly important to the UK and global economies. Between the start of the GFC and the end of 2020, the non-bank financial system had more than doubled in size, compared to banking sector growth of around 60%. As a result, non-banks now accounted for around half of the total assets making up the global financial system.

64.Given its importance to the UK economy and UK financial stability, it was vital that MBF was resilient, so it could absorb, and not amplify, economic shocks. The FPC judged it important that vulnerabilities which could pose risks to financial stability were monitored closely and actions were taken to enhance resilience.

65.As set out in the **Financial Stability in Focus** (FSIF) report, published alongside the Record, the Committee had an established approach to identifying, assessing, monitoring and mitigating risks in MBF which it regularly reviewed and developed, where necessary, to keep pace with the evolving shape of the financial system. The approach outlined in the FSIF supported the FPC's medium-term priority to further improve risk identification in, and the functioning and resilience of, MBF.

66. This approach had been underpinned by a framework that considered vulnerabilities within the system of MBF, and the transmission channels through which these vulnerabilities could have an impact on financial stability and subsequently on the real economy. In doing so, the FPC had drawn on a range of data and information sources, including regular monitoring, horizon scanning, available regulatory and commercial data, as well as domestic and international intelligence.

67.The output from this framework enabled the FPC to prioritise risks and how it planned to mitigate them.

68.The global, complex and highly interconnected nature of MBF created a range of practical challenges for macroprudential authorities globally, including material gaps in the data available to assess financial stability risks in the system. Work to reduce these gaps was ongoing but further effort was needed internationally and domestically to enhance data

gathering for monitoring and transparency, and to explore potential enhancements to cross border supervisory cooperation and data sharing. Additionally, the complex interactions within MBF and the wider financial system meant that vulnerabilities that were ostensibly small could turn out to have a large impact in stress.

69. As such, the FPC recognised that it was not realistic to expect that all risks could be identified in advance, and noted that it had not attempted to predict specific shocks that might occur. The FPC instead focused on understanding vulnerabilities and their potential impact on UK financial stability, and on building resilience to a range of possible shocks.

70. With regards to MBF resilience, the Committee judged that it was first and foremost market participants' responsibility to manage the risks they faced, overseen by relevant sectoral regulators. But the collective actions of participants in response to shocks could transmit stress and disrupt financial services to the real economy, even when individual actions seemed rational.

71. Resilience standards, and macroprudential policy more generally, aimed to prevent such disruption, and the FPC judged it had a responsibility to drive policy, internationally and domestically, to support the stability of the UK financial system. The FPC recognised that the need to increase the resilience of MBF through the implementation of policy responses by international and domestic regulators was vital and urgent. The high degree of interconnectedness and cross-border activity associated with MBF meant that global risks were most effectively addressed through internationally co-ordinated reforms, and the Bank and FPC would continue to support strongly the FSB's international work programme to increase the resilience of MBF. The FPC also worked to reduce vulnerabilities domestically where it was effective and practical.

72. At the same time, the Committee recognised that it would be neither feasible nor credible to build resilience to insure against every possible eventuality. There was therefore a role for global central banks to ensure their toolkits are developed to be able to respond effectively in exceptional stresses.

73. The Committee therefore agreed that resilience standards for MBF should be developed in coordination with work to enhance central bank tools to respond in stress, in order to ensure that public backstops did not end up substituting for a failure to achieve the appropriate level of private insurance.

The resilience of liability-driven investment funds

74. The FPC judged that its resilience framework for liability-driven investment (LDI) funds introduced in 2023 Q1 had been functioning broadly as intended in an environment of higher market interest rates. The Committee noted that risks to LDI funds arose not from the level of interest rates per se, but from rapid changes to those levels: in September 2022 the impact

on LDI funds of the unprecedented speed and scale of moves in gilt yields had created a material risk to financial stability. Since the introduction of the resilience framework, funds had maintained overall levels of resilience consistent with the minimum levels recommended, and had initiated recapitalisation at higher levels of resilience than previously.

75.The FPC judged that while LDI funds were resilient in aggregate, there remained some areas for improvement for some funds to implement fully the relevant guidance. Some LDI managers' recapitalisation had been observed to be slower than the expected five days. Funds also needed to ensure that their management buffers and triggers took into account the length of time they needed to recapitalise. The FPC noted it was important that LDI managers took action to address these issues.

76.The FPC reiterated the importance of continued work to put in place a monitoring and enforcement framework for pooled funds by the FCA and relevant international regulators.

Resilience of money market funds

77.The FPC discussed money market funds (MMFs) in the context of a consultation paper on MMF regulation that the UK authorities would publish later this year, following the **discussion paper** issued in May 2022. The FPC welcomed the UK authorities' commitment to consult on strengthening the resilience of MMFs. Increasing the resilience of MMFs was necessary to reduce systemic risk in the UK and global financial system.

78.As set in out in the Record of the Committee's meeting in March 2023, MMFs should be able to withstand severe but plausible levels of investor outflows without amplifying stress and increasing risks to financial stability. MMFs should be resilient to outflows at least as large as those seen in the dash for cash and LDI stress events, when central bank actions also helped to limit outflows. Such central bank interventions increased risks to public funds and should not be relied upon.

79.The FPC judged that significantly more shorter-maturing assets than currently required was likely to be the most effective way to increase MMF resilience and so reduce risks to financial stability. Higher liquidity would increase the range of stresses to which MMFs were resilient.

80. Bank staff analysis suggested that weekly liquid asset levels in the region of 50-60% of assets would give a high level of assurance that sterling denominated MMFs would be resilient to severe but plausible stresses. These issues would be explored in the forthcoming consultation paper.

81.The analysis built in assumptions around contagion given the failure of a single fund or funds could lead to wider concerns or confidence effects in the sector more widely. This could exacerbate outflows, and increase the stress on other funds. The modelling focussed on weekly liquid asset requirements to assess the ability of MMFs to withstand stresses over

extended periods, and to ensure that funds have a stream of maturing assets to generate liquidity without having to resort to asset sales.

82. Alongside weekly maturing assets, MMF resilience also appears to depend on other factors. The staff analysis showed that daily liquid assets of 15% or greater would be sufficient to meet the largest daily redemption seen by sterling MMFs in the dash for cash in March 2020, and greater levels of weekly liquid assets would ensure daily liquid assets levels were replenished in stress. MMFs are also currently permitted to include as weekly liquidity assets certain assets with a maturity up to 190 days that are issued or guaranteed by governments and other public bodies, up to of 17.5% of total fund assets. Some of these assets can still be difficult to sell in a stress, and MMFs may not be able to raise as much liquidity as anticipated. In determining minimum weekly liquid assets, staff analysis took a prudent approach and did not assume that these assets, or any others, could be sold to meet redemptions. The FPC noted that the consultation paper would explore stakeholder views on the appropriate balance of these factors for ensuring resilience.

83. To address vulnerabilities in the global MMF sector, a robust and coherent package of international reforms needed to be implemented. The best way of doing that was by working collaboratively across jurisdictions to ensure that reforms globally meet the Financial Stability Board's (FSB) objectives and strengthen the resilience of the global financial system. International cooperation had enhanced the resilience of the banking sector following the GFC and UK authorities were now actively contributing to international work on tackling vulnerabilities, reducing risks, and raising standards in non-bank financial institutions. The FPC noted that the FSB was currently undertaking a stocktake of progress by member jurisdictions in adopting reforms to enhance MMF resilience.

84. The combined impact of both international and UK policies would determine the nature and extent of systemic risk posed by MMFs. The FPC noted that the US Securities and Exchange Commission had recently adopted rules for MMFs which, among other reforms, increased daily and weekly liquid asset requirements to 25% and 50% respectively. The Financial Stability Board's reform programme required all authorities to take action to address financial stability risks from MMFs. As set out in the May 2022 discussion paper, UK authorities would need to be confident that MMFs that undertake liquidity transformation, primarily in sterling, face sufficiently robust regulatory requirements if they are to market to UK investors, and if risks to financial stability were to be addressed.

Systemic stablecoins

85. The FPC had previously set out two expectations for the regulation of stablecoins that had the potential to become widely used as a means of payment. First, that payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Firms in stablecoin-based systemic payment chains that are critical to their functioning should be regulated accordingly. Second, that stablecoins used in systemic

payment chains as money-like instruments should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

86.The FPC had also judged that a systemic stablecoin issued by a non-bank without a resolution regime and deposit guarantee scheme could meet its expectations, provided the Bank applied a regulatory framework designed to mitigate risks to financial stability.

87.The FPC noted the Bank's intention to publish a Discussion Paper exploring the proposed regulatory model for systemic stablecoins shortly. This would be published alongside related publications from the FCA on the regime for non-systemic stablecoin issuers and custodians; the PRA on risks that arise for deposit-takers from innovations in new forms of digital money and money-like instruments; and HMT on the new regulatory regime for fiat-backed stablecoins.

88.The FPC welcomed the forthcoming publications. It judged that the proposed regulatory model for systemic stablecoins being explored by the Bank would meet the expectations set out above. It would therefore provide the foundations for a UK regulatory framework that minimised financial stability risks arising from, and ensured public confidence in, systemic stablecoins that had the potential to become widely used as a means of payment.

Resolution framework

89.The FPC supported work that the Bank was undertaking, in co-ordination with HM Treasury, that sought to ensure that for small banks, which were not required to hold additional resources to meet the minimum requirement for own funds and eligible liabilities (MREL), there were resolution options that improved continuity of access to deposits and so outcomes for depositors.

90.The FPC noted that this work was exploring supplementing the existing resolution framework in a way that reduced risks to financial stability. This included establishing a mechanism where the cost of resolution for small banks sought to minimise risks to public funds.

2023 review of the FPC’s Leverage Ratio Direction

91. In line with its statutory obligations, the FPC reviewed its Direction and Recommendation to the PRA over the leverage ratio. The Direction had been issued in October 2022 following an annual review of FPC’s 2021 Direction to the PRA over the UK leverage ratio framework. The Recommendation was issued in October 2021.

92.The FPC continued to consider a leverage ratio to be an essential part of the framework for capital requirements for the UK banking system, and judged that the aspects of the leverage ratio set out in the 2022 Direction remained appropriate. The FPC judged that the

UK leverage ratio framework continued to advance the FPC's primary objective, in ways that as far as possible were effective in also achieving the FPC's secondary objective.

93. Having regard to the interaction between monetary and macroprudential policy, the Committee confirmed the appropriateness of continuing to exclude central bank claims from the leverage ratio, and of not recalibrating the minimum to reflect an increase in reserves since 2016. The FPC would keep this under review in future reviews of the leverage ratio framework.

94. In 2021, the FPC issued a Recommendation to the PRA to specify that additional Tier 1 (AT1) capital should only count towards Tier 1 capital for the purposes of the leverage ratio requirement if the relevant capital instruments specify a trigger event that occurs when the CET1 capital ratio of the institution falls below a figure of not less than 7%. In line with its statutory obligations, the FPC reviewed this Recommendation, and confirmed that it remains appropriate. These measures continue to provide greater assurance that the AT1 instruments would convert to CET1 while a firm is still a going concern. The FPC continues to consider that capital used to meet the leverage ratio requirement and buffers should be sufficiently loss absorbing.

Review of Other Systemically Important Institutions (O-SII) buffer framework

95. Under UK legislation implementing the Other Systemically Important Institutions (O-SII) buffer, the FPC is required to review the framework used to guide the setting of the O-SII buffer rate at least every two years. The PRA applies the FPC framework to all ring-fenced banks and to large building societies that hold more than £25 billion in deposits and shares (excluding deferred shares).

96. The FPC reviewed the O-SII buffer framework in line with these requirements and decided that no changes to the framework were necessary at this time. The FPC had conducted a comprehensive review of the framework in 2021-22, as part of which the Committee decided to update the metric used to determine O-SII buffer rates from total assets to the UK leverage exposure measure (LEM) and to recalibrate the thresholds to prevent an overall tightening or loosening of the framework. The FPC noted that these changes would first come into effect for the PRA's 2023 setting of O-SII buffer rates.

97. The FPC would continue to monitor the evolution of firms' balance sheets against the revised O-SII buffer metric and thresholds. The Committee intended to assess in 2024 whether the current buffer thresholds continued to remain appropriate in the context of the intended aims of the framework.

The following members of the Committee were present at the 26 September and 5 October 2023 Policy meetings:

Andrew Bailey, Governor
Colette Bowe
Sarah Breeden
Ben Broadbent
Jon Cunliffe
Jon Hall
Randy Kroszner
Dave Ramsden
Nikhil Rathi
Elisabeth Stheeman
Carolyn Wilkins
Sam Woods

Gwyneth Nurse attended as the Treasury member in a non-voting capacity

On behalf of the Committee, the Chair thanked Sir Jon Cunliffe for his work on the FPC since his appointment as Deputy Governor in 2013. In particular, he noted Sir Jon's role in helping to strengthen the financial system over the past decade as well as his contribution to international financial stability issues.

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 on cryptoassets, including stablecoins, and that he would not receive the related papers.

- Under the same provisions, Sam Woods had previously notified the Committee of his wife's employment at the consulting firm, Flint Global. It had been announced on 13 February 2023 that his wife would lead a review of The Pensions Regulator. It was therefore agreed that Sam Woods would be recused from discussion of issues (and not receive papers) relating to The Pensions Regulator and – as a precaution given the connection – liability driven investment issues more broadly. The findings of the review of The Pensions Regulator were published in September 2023 and following this it was agreed that Mr Woods's recusal would fall away.

Annex: Financial Policy Committee policy decisions

Outstanding FPC Recommendations and Directions (as at the date of the FPC's meeting on 26 September 2023).

On 23 March 2023, the FPC made the recommendation (23/Q1/1) that:

- The severe but plausible stresses to which LDI funds should be resilient should account for historic volatility in gilt yields, and the potential for forced sales to amplify market stress and disrupt gilt market functioning. If LDI funds were not resilient to such a shock, their defensive actions could cause financial instability, tightening credit conditions for UK households and businesses. The FPC judged that that these factors meant that the size of the yield shock to which LDI funds should be resilient should be, at a minimum, around 250 basis points.
- Liquid assets held to ensure resilience in the event of such a shock should be unencumbered and immediately available. Fund managers should have scope to consider additional assets, which investors had authorised them to use to meet collateral demands. Managers should apply appropriate prudence in doing this, for example by applying suitable haircuts.
- This minimum level of resilience should be maintained in normal times but could be drawn down on in stress. Minimum resilience around this level would ensure that funds could absorb a severe but plausible historical stress and still have a remaining level of headroom necessary to operate during a period of recapitalisation. This approach was consistent with the regulatory approaches in place for some systemically important financial institutions, where their standards were designed to allow institutions to continue operating after withstanding a severe stress.
- Funds should take into account the nature of their exposures, including duration, leverage, and concentration of holdings, and the liquidity, duration, and convexity of collateral, in modelling their resilience to yield moves.
- Pension schemes using leveraged LDI should be expected to be able to deliver collateral to their LDI vehicles within five days. Funds and schemes unable to implement these operational standards should be required to be resilient to a larger shock, calibrated to their own operational timelines.
- LDI funds should maintain additional resilience over and above the minimum to manage day to day volatility in yields and account for other risks they might face, including operational risks, in order to be able to maintain the minimum level of resilience in normal times. The amount of additional liquidity held should be calibrated by funds according to their own assessments of their exposures and operational

capabilities and other regulatory requirements, as well as interest rate trends and levels of market volatility. While this additional liquidity was expected to vary between funds, when combined with the minimum resilience to yield shocks, overall resilience levels should be broadly consistent with those currently prevailing in current market conditions (i.e. 300-400 basis points). Liquid asset holdings might be safely reduced over time if fund managers were able to demonstrate increased resilience through operational improvements.

In addition, the FPC made the recommendation (23/Q1/2) that:

- TPR takes action as soon as possible to mitigate financial stability risks by specifying the minimum levels of resilience for the LDI funds and LDI mandates in which pension scheme trustees may invest. To ensure that they were able in practice to do this, it was important that trustees had a simple mechanism for monitoring, and LDI funds disclosing, levels of resilience in dynamic markets.
- TPR should have the ability to employ effective monitoring tools, and to enforce as appropriate in cases of non-compliance with this resilience level. The FPC asked TPR to report back on how it intended to implement the recommendation.
- TPR should have the remit to take into account financial stability considerations on a continuing basis. This might be achieved, for example, by including a requirement to have regard to financial stability in its objectives, which should be given equal weight alongside other factors to which TPR is required to have regard. The FPC noted that in order to achieve this, TPR would need appropriate capacity and capability.

Other FPC policy decisions which remain in place

The following text 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.

Countercyclical capital buffer rate

The FPC agreed to maintain the UK CCyB rate at 2% on 5 October 2023, unchanged from its 3 July 2023 Policy meeting. 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%.

Liability driven investment funds

On 28 November 2022, the FPC recommended (22/Q4/1) that regulatory action be taken by TPR, in coordination with the FCA and overseas regulators, to ensure LDI funds remain resilient to the higher level of interest rates that they can now withstand and defined benefit

[1] See the Financial Stability section of the Bank's website: www.bankofengland.co.uk/financial-stability.

pension scheme trustees and advisers ensure these levels were met in their LDI arrangements.

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]

Leverage Ratio

In September 2021, the FPC finalised its review of the UK leverage ratio framework, and issued a Direction and Recommendation to implement the outcome of the review as set out in its October 2021 Record.[4]

In line with its statutory obligations, the FPC completed its annual review of its Direction to PRA. The FPC revoked its existing Direction to the PRA in relation to the leverage ratio regime, and issued a new Direction on the same terms as in September 2021 with the addition of discretion for the PRA to set additional conditions to the central bank claims exclusion.

The full text of the FPC's new Direction to the PRA on the leverage ratio is set out in the Annex of the October 2022 Record[5] (see Annex), together with the original Recommendation (now implemented).

The PRA has published its approach to implementing this direction and recommendation.[6]

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2 See PRA Policy Statement PS9/14, 'Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending', October 2014: www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf.

3 See www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending.

4 https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021

5 https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2022/fpc-summary-and-record-october-2022.pdf

6 PS21/21 | CP14/21- The UK leverage ratio framework | Bank of England (https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/changes-to-the-uk-leverage-ratio-framework)