Financial Policy Summary and Record of the Financial Policy Committee Meetings on 13 June and 4 July 2019

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This is the record of the Financial Policy Committee meetings held on 13 June and 4 July 2019.

It is also available on the Internet: https://www.bankofengland.co.uk/financial-stability-report/2019/july-2019

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 2 October 2019 and the record of that meeting will be published on 9 October.

Financial Policy Summary, July 2019

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

The resilience of the UK financial system to Brexit

The core of the UK financial system, including banks, dealers and insurance companies, is resilient to, and prepared for, the wide range of risks it could face, including a worst-case disorderly Brexit.

The perceived likelihood of a no-deal Brexit has increased since the start of the year.

- Increased Brexit uncertainties have put additional downward pressure on UK forward interest rates and led to a decline in the sterling exchange rate and an underperformance of UK-focused equities. In markets that are particularly dependent on foreign investors – notably commercial real estate and leveraged lending - investment into the UK was much weaker in 2019 Q1 than in recent years.

The UK banking system remains strong enough to continue to lend through the wide range of UK economic and financial shocks that could be associated with Brexit.

- Actions by businesses and authorities since November have resulted in some improvement in the preparedness of the UK economy for a no-deal Brexit. However, material risks of economic disruption remain.

- The FPC continues to judge that its 2018 stress test of major UK banks was sufficiently severe to encompass the wide range of UK economic and financial shocks that could be associated with Brexit. Overall, the stress scenario was more severe than the global financial crisis.

- Major UK banks demonstrated their resilience to that stress scenario. Since the stress test they have maintained Tier 1 capital levels of around 17% of risk-weighted assets – more than three times higher than before the global financial crisis.

The FPC is maintaining the UK countercyclical capital buffer rate at 1%.

- The underlying vulnerabilities (excluding Brexit) that can amplify economic shocks have not changed materially since November and remain at a standard level overall in the UK. Despite continued signs of strong risk appetite from creditors and lenders, total UK private non-financial sector credit growth has not been rapid and debt servicing burdens remain low.

- The FPC stands ready to move the UK countercyclical capital buffer (CCyB) rate in either direction as economic conditions and the overall risk environment evolve. If a major economic stress were to materialise, the FPC is prepared to cut the UK CCyB rate, as it did in July 2016. In the absence of such a stress, the FPC remains vigilant to developments, particularly in the domestic credit environment.

Most risks to UK financial stability from disruption to cross-border financial services in a no-deal Brexit have been mitigated.

- Extensive legislative and other preparations made by UK authorities and firms ahead of March will apply at the end of October. UK households and businesses will be able to use existing and new services from EU financial institutions.

- UK-based firms have made further preparations to be able to serve EU clients since the extension in March. It is important that they continue to do so to reduce further the risks of disruption.

- However, in the absence of further action by EU authorities, some disruption to cross-border financial services is possible. Although such disruption would primarily affect EU households and businesses, it could amplify volatility and spill back to the UK in ways that cannot be fully anticipated or mitigated.

Financial stability is not the same as market stability. Significant volatility and asset price changes are to be expected in a disorderly Brexit.

- In a disorderly Brexit, a range of UK asset prices – including the sterling exchange rate, equities, corporate and government debt and bank funding costs – would be expected to adjust sharply, tightening financial conditions for UK households and businesses.

- With over £1 trillion of high-quality liquid assets, major UK banks are able to meet their maturing obligations for many months without accessing wholesale funding or foreign exchange markets. As a further prudent precaution, the Bank of England maintains operations to lend in all major currencies on a weekly basis.

Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

<u>**Global risks**</u>

The risks to the global outlook have increased during the first half of the year.

- Rising trade tensions have resulted in declining business confidence and pose material downside risks to global output growth.

The impact of these risks would be amplified by continued material underlying vulnerabilities.

- Credit growth in China continues to outpace nominal income growth and debt is more than 200% of GDP. Some emerging market economies with large current account deficits or high levels of debt denominated in foreign currencies remain vulnerable to renewed capital outflows.

- In global financial markets, risk-free interest rates have fallen markedly and are consistent with more pessimistic expectations of economic growth. In contrast, measures of compensation for credit risk in corporate bond and loan markets appear to factor in a relatively benign economic outlook.

- US corporate debt is above pre-crisis levels as a share of GDP and, in part reflecting rapid growth of leveraged lending, the share of debt owed by highly leveraged US companies has reached pre-crisis levels of above 40%.

The core of the UK banking system remains resilient to these global risks.

- Major UK banks were subjected to a severe scenario for the global economy in the 2018 stress test that reflected these underlying vulnerabilities. World GDP contracted by 2.4% over the first year of that scenario and Chinese GDP contracted by 1.2%. Banks were assumed to lose more than 10% of their exposures to large non-investment grade US and UK companies. Major UK banks showed they were resilient to that scenario.

- This test on global exposures was of a severity that encompassed a worst-case scenario for global trade tensions. All implemented and contemplated tariff measures, combined with a severe business confidence shock and a sharp tightening in global financial conditions, could slow global GDP growth materially but would be unlikely to cause the outright fall in global output that banks were tested against.

- Even if a protectionist-driven global slowdown were to spill over to the UK at the same time as a worst-case disorderly Brexit, the FPC judges that the core UK banking system would be strong enough to absorb, rather than amplify, the resulting economic shocks.

<u>The future of finance</u>

The FPC welcomes the recent van Steenis review on the Future of Finance and the Bank's response.

Payments are currently a focal point for innovation. Consistent with its mandate, the FPC will aim to ensure that systemically important payment systems support financial stability, while allowing competition and innovation in payments to thrive. To do this, the FPC will:

- Assess developments in the scope and nature of regulation for payments and other innovative financial services to ensure the approach reflects their systemic importance.

- Assess risks to the UK financial system associated with the use of tokens and other assets used to facilitate new payment options and appropriate safeguards for their use to maintain financial stability and the supply of finance to the economy.

- Review the Bank's proposals on the appropriate level of access to its payments infrastructure and balance sheet in order to ensure that access supports fully the stability and resilience of the system while also allowing innovation in payments.

In the 2021 biennial exploratory scenario, the Bank will stress test the UK financial system's resilience to the physical and transition risks of climate change.   It will gather views on the design of the exercise and, as a first step, will publish a discussion paper in Autumn 2019.

- Financial stability risks from climate change arise both from the physical risks associated with the increased frequency of extreme weather events and from the transition to a carbon-neutral economy.

- This exercise will integrate climate scenarios with macroeconomic and financial system models. It will motivate firms to address data gaps and to develop cutting-edge risk management consistent with a range of possible climate pathways: ranging from early and orderly to late and disruptive.

- The discussion paper will cover issues such as the coverage of the test, the nature of scenarios considered, the appropriate time horizon and disclosure of results. This will allow the Bank to develop the scenarios in consultation with risk specialists from across the financial sector, climate scientists, other industry experts, and other informed stakeholder groups.

<u>Tackling vulnerabilities in open-ended funds</u>

Open-ended investment funds globally play an increasing and important role in the provision of finance. The FPC continues to judge that the mismatch between redemption terms and the liquidity of some funds' assets has the potential to become a systemic issue.

- Many funds offer daily redemptions while investing in assets that can take weeks or months to sell in an orderly way. They offer redeeming investors a price linked to the market price of the funds' assets despite having a redemption period much shorter than would be needed to realise those market prices, particularly in stress.

- This can create an incentive for investors to redeem when they expect others to do so. This self-reinforcing dynamic can lead to so many investors rushing to redeem that funds have no choice but to suspend all redemptions. Furthermore, fear of possible suspension reinforces the incentive to redeem.

- In 2015, the FPC highlighted vulnerabilities associated with funds' liquidity mismatch. These go beyond any single market or fund type. Large-scale redemptions from funds could test markets' ability to absorb asset sales, amplifying price moves, transmitting stress to other parts of the financial system, and disrupting the availability of finance in the real economy. Although to date these vulnerabilities have not created financial instability, they could do so under severe stress and are likely to become more important if more funds expand into less liquid assets.

The Bank and the FCA will together assess how funds' redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks without compromising the supply of productive finance.

- This is a global issue. For that reason the FPC supported the Financial Stability Board's 2017 recommendation that funds' assets and investment strategies should be consistent with their redemption terms. However, subsequent work by the International Organization of Securities Commissions did not prescribe how this should be achieved.

- Although funds are not permitted in general to favour one group of investors over another, there are no well-defined requirements for how this should be done. The Bank and FCA review will examine the costs and benefits of aligning redemption terms, including pricing and notice periods, with the typical time it takes to realise market prices for funds' assets in normal and stressed market conditions.

- The review will also assess the effectiveness of measures that are already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions.

<u>The transition away from Libor</u>

The continued reliance of global financial markets on Libor poses risks to financial stability that can be reduced only through a transition to alternative benchmark rates by end-2021.

There is no justification for firms continuing to increase their exposures to Libor. The pace of market participants' transition efforts now needs to accelerate and the FPC will monitor progress closely.

- The smoothest transition will be one in which market participants: cease new issuance of Libor-linked contracts; identify all existing contracts without appropriate fallback clauses and rectify this to the greatest extent possible; and actively reduce legacy exposures by negotiating their transition to new rates.

- It is not in firms' own interests to have a large stock of legacy contracts that will become subject to significant legal uncertainty beyond 2021. There are advantages to renegotiating contracts to refer to alternative reference rates well in advance of end-2021.

- Well-managed firms are expected to lead the transition. All firms that responded to the PRA's and FCA's *Dear CEO* letter have now appointed a Senior Manager accountable for overseeing the transition.

<u>Exploring the UK financial system's response to a severe liquidity stress</u>

In 2019, the Bank will conduct a biennial exploratory exercise to explore the implications of a severe and broad-based liquidity stress affecting major UK banks simultaneously.

- This exercise will not set new liquidity standards for banks. Banks hold regulatory liquidity buffers that the FPC expects to be used in a stress.

- The exercise will explore how the reactions of banks and authorities to the stress would shape its impact on the broader financial system and the UK economy. It will help to guide the PRA's approach to supervision and the Bank's provision of liquidity in stressed conditions.

- The Bank intends to publish the results of the exploratory exercise in mid-2020.

Record of the Financial Policy Committee meetings held on 13 June and 4 July 2019

1. The Committee met on 4 July 2019 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. To do so, 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 resilient to, and prepared for, 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.

2. The Committee also met on 13 June 2019 to discuss aspects of the Bank's response to the Future of Finance report, published on 20 June. In particular, the Committee considered the case for running a Biennial Exploratory Scenario (BES) in 2021 to explore the financial stability risks associated with climate change.

The resilience of the UK financial system to Brexit

3. Since the referendum on the UK's membership of the European Union (EU) in 2016, the FPC and other authorities had identified financial stability risks that could arise from Brexit and worked to ensure they were addressed. The FPC had published its regular assessments in its Financial Stability Reports (FSRs), and in Statements, Policy Summaries and Records of its meetings.

4. The Committee reviewed developments since its meeting in February when it had judged that the core banking system was strong enough to withstand the economic shocks that would accompany a worst-case disorderly Brexit.

5. In April 2019, the UK and the European Council agreed to extend the UK's membership of the EU until 31 October 2019, or earlier should the Withdrawal Agreement be ratified by both the EU and the UK before then.

6. **The perceived likelihood of a no-deal Brexit had increased since the start of the year**. This had put additional downward pressure on UK forward interest rates and led to a decline in the sterling exchange rate and an underperformance of UK-focused equities. In markets that were particularly dependent on foreign investors – notably commercial real estate and leveraged lending – investment into the UK was much weaker in 2019 Q1 than in recent years.

7. Actions by businesses and authorities since November had resulted in some improvement in the preparedness of the UK economy for a no-deal Brexit. However, material risks of economic disruption remained.

8. As a result **the FPC continued to judge that its 2018 stress test of major UK banks was sufficiently severe to encompass the wide range of UK economic and financial shocks that could be associated with Brexit.** In the 2018 stress-test scenario, UK GDP fell by 4.7%, the UK unemployment rate rose to 9.5%, UK residential property prices fell by 33% and UK commercial real estate prices fell by 40%. The scenario also included a sudden loss of overseas investor appetite for UK assets, a 27% fall in the sterling exchange rate index and Bank Rate rising to 4%.

Risk of disruption to cross-border financial services

9. The FPC updated its assessment of progress on its checklist of actions that would mitigate risks of disruption to financial services used by households and businesses to support their economic activity in the event of a no-deal Brexit (see Table 1).

10. As would be outlined in the July FSR, extensive legislative and other preparations made by UK authorities and firms ahead of March would apply at the end of October. UK households and businesses would be able to use existing and new services from EU financial institutions.

11. **The Committee continued to judge that most risks to UK financial stability from disruption to cross-border financial services in a no-deal Brexit had been mitigated.** UK-based firms had made further preparations to be able to serve EU clients since the extension in March. It was important that they continued to do so, to reduce further the risks of disruption. That would include making further progress – before the end of October – on the proportion of clients who had completed the necessary onboarding processes.

12. However, in the absence of further action by EU authorities, some disruption to cross-border financial services was possible. Although such disruption would primarily affect EU households and businesses, it could amplify volatility and spill back to the UK in ways that could not be fully anticipated or mitigated (Table 2).

Market volatility

13. **As the Committee had underlined previously, financial stability was not the same as market stability. Significant volatility and asset price changes were to be expected in a disorderly Brexit.** A range of UK asset prices – including the sterling exchange rate, equities, corporate and government debt and bank funding costs – would be expected to adjust sharply, tightening financial conditions for UK households and businesses.

14. However, the Committee recalled that markets had functioned effectively after the referendum in 2016. It also noted that major UK banks held over £1 trillion of high-quality liquid assets which would enable them to meet their maturing obligations for many months without accessing wholesale

funding or foreign exchange markets. And as a further prudent precaution, the Bank maintained operations to lend in all major currencies on a weekly basis.

The future prudential framework

15. **As the FPC had affirmed previously, irrespective of the particular form of the UK's future relationship with the EU, and 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 baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.**

Outlook for UK financial stability and UK Countercyclical Capital Buffer (CCyB) rate decision

16. The Committee reviewed financial system and economic developments in order to inform its overall judgement on the outlook for UK financial stability and its UK CCyB rate decision.

17. The FPC considered changes in the level of underlying vulnerabilities, which included measures of: household, corporate and public indebtedness; external imbalances; and valuation pressures in real estate and financial asset markets. These vulnerabilities determined the scale of future potential challenges the financial system could face in the event of an adverse shock and therefore drove the severity of stress scenarios against which the FPC tested the system.

18. Where the Committee identified specific shocks that could generate challenges for the financial system, it assessed whether those challenges were encompassed by the stress scenarios it had already tested against.

19. The Committee considered domestic and global developments in turn.

Domestic outlook

20. As would be outlined in the July FSR, growth in total UK private non-financial sector credit (excluding student loans) had not been rapid. It had decreased marginally to 3.7% in the year to 2019 Q1, broadly in line with nominal GDP growth of 3.5% over that period.

21. The Committee judged that modest credit growth reflected a balance of accommodative credit supply conditions and restrained credit demand. Domestic lender risk appetite remained strong, particularly in the mortgage market, where price and non-price terms had loosened in recent years as

competition had intensified. Despite that, borrower demand continued to be restrained, due in part to Brexit-related uncertainties.

22. The UK's credit to GDP gap, which measured the difference between the credit to GDP ratio and a simple statistical estimate of its long-term trend, remained significantly negative at -11.6 percentage points in 2019 Q1. This measure suggested a very low degree of underlying vulnerability but gave undue weight to the rapid build-up in credit prior to the global financial crisis, which had proven to be unsustainable. It had therefore been appropriate to put more weight on the growth rate of credit relative to incomes in recent years.

23. Debt servicing burdens remained low for both households and corporates supported by low interest rates. As would be set out in the July FSR, mortgage interest rates would have needed to increase by 200–300 basis points for the share of households with a mortgage debt-servicing ratio above 40% to rise to around its 1997-2006 average of 1.8%. The proportion of debt held by listed firms with interest coverage ratios below 3 also remained low by historical standards.

24. The UK's large current account deficit had widened by 1.1 percentage points to 5.6% in 2019 Q1. As would be outlined in the July FSR, the UK's reliance on foreign capital inflows made it vulnerable to a reduction in investor appetite for UK assets.

25. **Taking into account developments across the domestic credit environment, the FPC continued to judge that the underlying vulnerabilities (excluding Brexit) that could amplify economic shocks had not changed materially since November and remained at a standard level overall in the UK.**

Global outlook

26. The Committee assessed global vulnerabilities, which could affect UK financial stability directly through UK banks' exposures to vulnerable economies; indirectly by financial contagion through UK banks' exposures to other affected banks; and through macroeconomic spillovers to the UK economy.

27. In China, the Committee judged that financial vulnerabilities remained elevated. Credit growth continued to outpace nominal income growth and debt was more than 200% of GDP. Some emerging market economies with large current account deficits or high levels of debt denominated in foreign currencies remained vulnerable to renewed capital outflows.

28. In the euro area, one prominent vulnerability remained the sustainability of Italian government debt, which stood at over 130% of GDP, about a quarter of which was held by Italian banks (excluding their insurance arms).

29. The Committee judged that US corporate sector vulnerabilities remained material. US corporate debt was above pre-crisis levels as a share of GDP and, in part reflecting rapid growth of leveraged lending, the share of debt owed by highly leveraged US companies had reached pre-crisis levels of above 40%.

30. In global financial markets, risk-free interest rates had fallen markedly and were consistent with more pessimistic expectations of economic growth. For example, $13 trillion of global investment-grade debt was now trading at negative yields. In contrast, measures of compensation for credit risk in corporate bond and loan markets appeared to factor in a relatively benign economic outlook. Associated asset prices were vulnerable to a repricing, whether through an increase in long-term interest rates or an adjustment in credit spreads to reflect more pessimistic growth expectations, or both.

31. **Taking into account developments worldwide, the FPC continued to judge that underlying global vulnerabilities remained at a material level overall.**

32. **The risks to the global outlook had increased during the first half of the year. Rising trade tensions had resulted in declining business confidence and posed material downside risks to global output growth. The impact of these risks would be amplified by continued material underlying vulnerabilities.**

33. The FPC judged that the likelihood of a highly adverse scenario in which trade tensions became far more pervasive, persistent and damaging than previously expected had risen since its February 2019 meeting. In light of that, the Committee assessed whether a worst-case protectionist-driven global slowdown was encompassed within the global scenario in its 2018 stress test. Traditional trade models suggested that the direct effects on global GDP of the tariff measures that had been implemented to date were likely to be small[1]. The additional tariffs threatened by the US on China and on auto imports more generally would, however, increase that effect substantially. In the event that all of those measures were implemented, accompanied by retaliatory measures, the peak impact on the level of world PPP-weighted GDP over a three-year period could increase to around 0.8pp.

34. In a trade scenario of this kind, a significant accompanying hit to business confidence could approximately double the impact on world GDP. The Committee also discussed that in a highly adverse trade scenario, there was an increased probability that global financial conditions could tighten, which would weigh further on business confidence and increase the downside risks to global

[1] Governor Mark Carney had set out the potential impact of tariff measures and potential adverse scenarios in which they intensified in a speech on 2nd July 2019 to the Local Government Association Annual Conference and Exhibition 2019, Bournemouth": *Sea Change*.

growth. Taken together, the imposition of all implemented and contemplated tariff measures, combined with a severe business confidence shock and a sharp tightening in global financial conditions, could therefore slow global GDP growth materially, potentially detracting over 2 percentage points from cumulative growth over a three-year period. Even an impact of this magnitude however, would be insufficient to cause an outright fall in global output, which was expected to grow at around 3½ % per year in the coming years.

35. In light of its assessment of a highly adverse trade scenario, the Committee noted that the major UK banks had been subjected to a severe scenario for the global economy in the 2018 stress test that reflected the underlying global vulnerabilities. That scenario had included outright falls in PPP-weighted world GDP of 2.4% and in Chinese GDP of 1.2% during the first year of the stress scenario. These represented substantial shocks to the path of GDP, particularly noting that, in the absence of stress, the baseline paths would have seen annual growth in world and Chinese GDP of around 3½% and over 6% respectively. Major UK banks had demonstrated their resilience to that stress scenario. The FPC judged that this test on global exposures was of a severity that encompassed a worst-case scenario for global trade tensions.

Banking system resilience and UK CCyB rate decision

36. The FPC reviewed the level of banking system resilience and hence its ability to withstand the potential challenges posed by the overall risk environment.

37. As would be set out in the July FSR, the major UK banks had maintained Tier 1 capital levels of around 17% of risk-weighted assets since the 2018 stress test – more than three times higher than before the global financial crisis. Asset quality had also remained stable.

38. The Committee therefore judged that the results of the 2018 stress test remained a comprehensive test of the resilience of the UK banking system. The 2018 stress tests had demonstrated that the UK banking system was resilient to deep simultaneous recessions in the UK and global economies that were more severe overall than the global financial crisis. As the Committee had set out above, it judged that the stress test of major UK banks was sufficiently severe to encompass the wide range of UK economic and financial shocks that could be associated with Brexit and that the test on global exposures was of a severity that encompassed a worst-case scenario for global trade tensions.

39. The Committee also judged that, even if a protectionist-driven global slowdown were to spill over to the UK at the same time as a worst-case disorderly Brexit, the core UK banking system would be strong enough to absorb, rather than amplify, the resulting economic shocks and to continue to serve UK households and businesses.

40. **In light of this assessment, and its earlier judgement that the size of underlying vulnerabilities were broadly unchanged on the quarter, the FPC decided to maintain the UK CCyB rate at 1% in 2019 Q2.**

41. The FPC reiterated that it was prepared to cut the UK CCyB rate, as it had done in July 2016, were a major economic stress to materialise. This would enable banks to use the released buffer to absorb up to £11 billion of losses, which might otherwise lead them to restrict lending. Given losses of that scale, a cut in the UK CCyB rate to zero could preserve banks' capacity to lend to UK households and businesses by around £250 billion. This compared to around £75 billion of net lending in the past year.

42. In the absence of economic stress, the FPC would remain vigilant to developments in the level of underlying vulnerabilities, particularly in the domestic credit environment. Were Brexit uncertainty to fade, and lending conditions to remain accommodative, credit demand could rebound significantly and by more than economic growth, leading to an increase in the riskiness of banks' exposures. Given current accommodative lending conditions, that could require a timely policy response to ensure resilience.

43. Consequently, the Committee confirmed that it stood ready to move the UK CCyB rate in either direction as economic conditions and the overall risk environment evolved.

Resilience of market-based finance

44. The FPC had a statutory responsibility to identify, monitor and take action in relation to financial stability risk across the UK financial system. The FPC considered financial stability risks from banks as well as beyond the core banking sector. As would be outlined in the July FSR, market-based finance had become more important since the crisis. It accounted for around half of financial sector assets and all of the net increase in debt finance to UK non-financial businesses since 2008.

Open-ended funds

45. The FPC discussed the potential UK financial stability risks from open-ended funds. Open-ended investment funds globally played an increasing and important role in the provision of finance. The FPC's in-depth assessment of open-ended funds in 2015 had highlighted the vulnerabilities associated with liquidity mismatch in funds that offered short-term redemptions while investing in longer-dated and potentially illiquid assets. Such funds now held more than $30 trillion of global assets

46. As the Committee had discussed on a number of occasions, liquidity mismatch raised the possibility of fire sales of assets in the face of large-scale redemptions. The Committee noted that while fund managers had a range of tools to manage liquidity, including the ability to suspend redemptions from the fund, these were not always sufficient to eliminate the risks arising from large redemptions. This had been illustrated in the period around the referendum in 2016, with UK commercial real estate funds seeing significant redemptions and some funds suspending redemptions.

47. The Financial Conduct Authority (FCA) briefed the FPC that, in the event of a disorderly Brexit, some open-ended commercial real estate (CRE) funds could be suspended, as they were after the referendum. Many offered daily redemptions while investing in assets that typically took weeks or months to sell in an orderly way. On its own, this was unlikely to give rise to financial instability.

48. The Committee agreed that disclosure of this briefing could act to raise the probability of the risks of suspension being triggered in the event of Brexit. The Committee therefore agreed that it was against the public interest to publish its discussion of this briefing in the Record of its meeting and decided to defer publication, under Section 9U of the Bank of England Act 1998. It would review this text after Brexit had occurred.[2]

49. It was important that investors did not have unrealistic expectations about the liquidity of open-ended funds and understood the liquidity tools that could be used. Many funds offered daily redemptions while investing in assets that could take weeks or months to sell in an orderly way. They offered redeeming investors a price linked to the market price of the funds' assets despite having a redemption period much shorter than would be needed to realise those market prices, particularly in stress.

50. This could create an incentive for investors to redeem when they expected others to do so. This self-reinforcing dynamic could lead to so many investors rushing to redeem that funds had no choice but to suspend all redemptions. Furthermore, fear of possible suspension reinforced the incentive to redeem. Such risks could be further exacerbated if the use of suspension or other liquidity management tools by one fund led to concerns about the liquidity of other open-ended funds.

51. The FPC also discussed the importance of accurately assessing the relevant liquidity of different assets. The liquidity of an asset in stressed market conditions could be impaired relative to normal conditions.

[2] The text in this and the preceding paragraph was omitted from the version of the Record that was initially published on 11 July 2019. The Committee agreed at its 11 March 2021 meeting to publish this text, for the reasons set out in the Record of that meeting.

52. While the Committee's recent discussions on open-ended funds had focused on the risks associated with commercial real estate funds, vulnerabilities associated with funds' liquidity mismatch went beyond any single market or fund type. Corporate bond funds had faced significant outflows during the period of financial market volatility at the end of 2018. Similarly, open-ended leveraged loan funds had seen a significant proportion of their investments redeemed as leveraged loan prices had fallen in global markets in December 2018. The suspension of LF Woodford Equity Income Fund in June, while not systemic in nature, illustrated potential liquidity mismatch in an equity UCITS fund.

53. All of those considerations underscored the importance of addressing the structural misalignment between redemption terms and the time needed to realise the market prices of funds' assets. Large-scale redemptions from funds could test markets' ability to absorb asset sales, amplifying price moves, transmitting stress to other parts of the financial system, and disrupting the availability of finance in the real economy. The Committee continued to judge that the mismatch between redemption terms and the liquidity of some funds' assets had the potential to become a systemic issue. Although to date these vulnerabilities had not created financial instability, they could do so under severe stress and were likely to become more important if more funds expanded into less liquid assets.

54. Given the potential vulnerabilities and the global nature of asset management, the FPC continued to support the Financial Stability Board's (FSB) 2017 recommendation that funds' assets and investment strategies should be consistent with their redemption terms. However, subsequent work by the International Organization of Securities Commissions (IOSCO), while endorsing the recommendation, did not prescribe how this should be achieved. Implementation was left to national authorities and the funds themselves.

55. Although funds were not permitted in general to favour one group of investors over another, there were no well-defined requirements for how this should be done. The FPC therefore welcomed the Financial Conduct Authority (FCA) and the Bank's intention to assess together how funds' redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks without compromising the supply of productive finance. As would be set out in the July FSR, the review would examine the costs and benefits of aligning redemption terms, including pricing and notice periods, with the typical time it took to realise market prices for funds' assets in normal and stressed market conditions. The review would also assess the effectiveness of measures that were already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions. The FPC would review progress and provide an update in due course.

Annual review of risks beyond banking

56. Since 2014, the FPC had augmented its rolling programme of in-depth assessments on specific activities outside of the core banking sector with an overall annual review. Where vulnerabilities were identified, the FPC assessed whether these would be addressed by domestic or international workstreams, or whether further work was needed. Ultimately, if deemed necessary, the FPC, in line with its objectives, had a power to make Recommendations to HM Treasury on the scope of regulated activities and on the allocation of regulatory responsibilities between relevant authorities.

57. As part of its 2019 review, the FPC considered the progress against its policy conclusions from past in-depth assessments.

58. Many of those were reliant on international policy initiatives and, as would be set out in the July FSR, progress had been mixed. The FPC noted welcome progress in some areas where international policy measures had been agreed, such as changes to leverage ratio standards in order to minimise their impact on liquidity in key dealer-intermediated markets. There were other areas, though, where international progress had been lagging.

59. The FPC focused its discussion on areas where domestic action might be able to compensate for the lack of international progress, and in particular on measures of leverage in investment funds. As set out in the November 2018 FSR, the FPC considered that in order to monitor the potential financial stability risks from fund leverage supervisors needed information on funds' use of borrowing and derivatives, potential losses and potential liquidity demands. The proposals set out in the IOSCO consultation paper on operationalising the FSB recommendation in this area left considerable discretion to national regulators and so it was unlikely that a globally consistent set of measures would be implemented. The FPC agreed that it might be beneficial to consider domestic collection of these types of measures, and noted that its previous work on the appropriate measures could be used as a basis for that.

60. Similarly, there had been little progress on aggregating trade repository data across countries to provide authorities with a global view of derivatives markets as had been recommended by the G20 as part of its post-crisis reform programme. There had also been no progress on reforms to the risk margin element of Solvency II for insurers.

Updates on FPC's close monitoring list

61. To understand changes to the non-bank financial system and any implications for the resilience of market based finance or financial infrastructure providers, the FPC monitored closely activities that were evolving or growing rapidly. In keeping with this approach, at its July meeting, the Committee reviewed two of the areas it had previously identified as requiring close monitoring: exchange traded-funds (ETFs) and fast markets. The Committee would return to financial technology (FinTech) and the provision of cloud services to the financial sector in the second half of 2019.

62. The FPC agreed to continue to monitor fast markets closely, and in particular the risks posed by 'flash episodes', where asset prices moved very sharply and by more than was warranted by economic fundamentals, before typically retracing those moves shortly afterwards. Such episodes had not yet had financial stability consequences, but there remained a risk that they became significantly more frequent or had greater impacts on market participants, particularly in less regulated markets, such as spot foreign exchange markets. As would be set out in the July FSR, there were other potential risks from the reliance of many Principal Trading Firms, which provided short-term liquidity in these markets, on a small number of banks to provide clearing services. The Committee judged, however, that this did not currently appear to pose a significant risk to UK financial stability.

63. The Committee reviewed staff analysis of developments in ETFs. The Committee observed that around one-third of ETFs by value were invested in assets other than highly liquid developed economy equities. However, ETFs were different to open-ended funds because they could be traded on secondary markets. In a stress this meant that, although they could trade at a discount, the underlying assets should not be subject to direct fire sale pressure to the same extent. The FPC therefore judged that the majority of ETFs did not appear currently to present material financial stability risks but would keep the risks in this sector under review as part of its regular annual assessment.

Review of regulatory perimeter

64. Overall, the FPC agreed that it was not necessary to recommend any changes to the regulatory perimeter at this stage.

Developments in financial market infrastructure

65. As part of its 2019 review of risks beyond the core banking sector, the FPC also discussed recent developments in financial market infrastructure providers (FMIs). Banks and other financial services firms relied upon financial market infrastructure to ensure the provision of financial services.

It was vital, therefore, that FMIs maintained the highest standards of resilience and that the regulatory authorities had the appropriate tools to identify and mitigate potential risks to the critical services provided by FMIs.

66. **The FPC welcomed the recent van Steenis review on the Future of Finance and the Bank's response.**

67. The Committee observed that payments were currently a focal point for innovation and welcomed the Bank's announcement that it would fully engage with HM Treasury's review of the payments landscape to support choice, competition and resilience and to ensure that regulation and infrastructure kept pace with innovation.

68. The FPC also supported the Bank's intention to consult on the appropriate level of access to the Bank's payments infrastructure and balance sheet, including necessary safeguards.

69. **Consistent with its mandate, the FPC would aim to ensure that systemically important payment systems supported financial stability, while allowing competition and innovation in payments to thrive. To do this, the FPC would:**

- Assess developments in the scope and nature of regulation for payments and other innovative financial services to ensure the approach reflected their systemic importance.

- Assess risks to the UK financial system associated with the use of tokens and other assets used to facilitate new payment options and appropriate safeguards for their use to maintain financial stability and the supply of finance to the economy.

- Review the Bank's proposals on the appropriate level of access to its payments infrastructure and balance sheet in order to ensure that access supported fully the stability and resilience of the system while also allowing innovation in payments.

70. As would be outlined in the July FSR, payments systems supervised by the Bank were replacing or upgrading the IT infrastructure used to process and settle payments. As well as allowing such payments systems to adapt more flexibly to developments in the wider payments industry, this should help to improve operational resilience. It was important to ensure, however, that robust plans were in place to mitigate the risks associated with transitioning to the new IT infrastructure.

71. As agreed in April 2017, the FPC received a report on the Bank's supervision of CHAPS and on the work done by the Bank as CHAPS operator to strengthen end-to-end risk management of the

CHAPS system, including implementing revised governance arrangements and a new risk management framework.

72. The FPC also discussed the risks arising from regulatory uncertainty for central counterparties (CCPs) operating across borders. While the risk to UK CCPs' ability to continue providing clearing services in the EU in the event of a no-deal Brexit had been removed until at least March 2020, elements of the changes to EU legislation on CCPs yet to be agreed created a new source of uncertainty that would need to be resolved prior to them being granted permanent recognition. Effective supervisory cooperation was necessary to ensure that internationally active CCPs were subject to clear, certain and coordinated regulatory requirements and actions which, for example, did not conflict or overlap.

73. The FPC underlined the importance of FMIs' governance arrangements and risk culture reflecting fully the vital services they provided to the financial system and economy. The FPC noted that there was a strong case for extending the Senior Managers and Certification Regime to FMIs. This would help the Bank to ensure that individuals in key influence positions within FMIs had suitable skills, experience and understanding of the systemic importance of FMIs.

The transition away from Libor

74. The FPC had been monitoring the risks that Libor might become unavailable since 2013. **In June 2018, the FPC had agreed that the continued reliance of global financial markets on Libor posed risks to financial stability that could be reduced only through a transition to alternative benchmark rates by end-2021.**

75. The Committee was briefed on recent developments regarding markets' reliance on Libor, the financial stability risks that continued reliance on Libor could give rise to, and the actions that market participants would need to take to ensure a smooth transition. The full details of this would be set out in the July FSR.

76. The scale of risks was highest in derivative markets, due to the high notional value of outstanding contracts. But the FPC would also continue monitoring material risks in loans and other cash markets.

77. Important steps towards building liquidity in new benchmark rates were being taken. In derivative markets, the proportion of cleared sterling swaps referencing SONIA had reached over 45% during the first half of 2019. However, the stock of cleared sterling Libor swap contracts maturing beyond 2021 continued to increase.

78. Progress in cash markets was more mixed. For example, in loan markets, Libor-linked lending remained normal practice. There had been more progress in bond markets where SONIA-linked notes were quickly being established as the market standard for new issues. The Committee noted that some market participants might wait for new forward-looking term benchmark rates before switching to alternative benchmark rates. From a financial stability perspective, it was beneficial to encourage the use of (compounded) overnight benchmark rates where possible, as the underlying overnight rate itself would always be the most robust benchmark and was already available for use. But the FSB had recognised that there was a role for term benchmarks in some cases. For sterling, three benchmark administrators had confirmed that they were working on the development of such term benchmarks. Completing this work could help accelerate the transition away from Libor. It would be important to ensure these rates were robust and compliant with IOSCO principles and the EU Benchmarks Regulation.

79. There were now some encouraging precedents for replacing references to Libor in existing contracts that matured after 2021. These actions by individual market participants needed to become much more widely adopted and replicated across the market.

80. **The Committee agreed that there was no justification for firms continuing to increase their exposures to Libor. The pace of market participants' transition efforts now needed to accelerate and the FPC would monitor progress closely.**

81. The FPC noted that it was not in firms' own interest to have a large stock of legacy contracts that would become subject to significant legal uncertainty beyond 2021.

82. Members observed that well-managed firms were expected to lead the transition. All firms that had responded to the PRA's and FCA's *Dear CEO* letter had now appointed a Senior Manager accountable for overseeing the transition. The FPC welcomed the fact that the PRA and the FCA had indicated that firms should plan based on the likely cessation of LIBOR at end-2021.

83. The Committee noted the fact that, even with sufficient levels of effort by market participants to accelerate the transition, there might be a stock of legacy contracts remaining after 2021.

84. In order to manage and mitigate any risks associated with this, it was important for authorities to consider a broad range of solutions, including the possibility of addressing the financial stability risks that these outstanding contracts could pose when Libor was discontinued by way of legislative options.

85. It was not clear to the Committee at this point if such a comprehensive legislative solution could be devised across all the necessary jurisdictions globally.

86. If market participants put undue reliance on the possibility of such a legislative solution being devised, this could reduce their incentives to transition to new reference rates in time, ahead of 2021, and could precipitate the financial stability risks that authorities were seeking to mitigate. The Committee therefore agreed that it was against the public interest to publish its discussion of any possibility of addressing the financial stability risks associated with outstanding legacy contracts remaining after 2021 by way of a legislative option in the Record of its meeting, and decided to defer publication, under Section 9U of the Bank of England Act 1998. It was not possible to agree now the date at which this text would be published, but the Committee would keep this under review.[3]

The 2019 and 2021 biennial exploratory scenarios (BES)

87. Under the Bank's approach to stress testing, the Bank would run exploratory scenarios alongside the annual cyclical scenarios in 2019 and 2021. The BES was a flexible tool which helped to explore risks not covered by the Bank's Annual Cyclical Scenario (ACS), including longer-term challenges to banks' business models.

2019 BES

88. At its July meeting, the FPC discussed the key elements of the scenario for the 2019 BES. It noted that using a BES to explore the financial systems' response to a liquidity stress would be a natural extension of the Committee's existing work on bank capital. The Committee had also considered exploratory scenarios that focused on bank solvency, but judged that a liquidity scenario would provide particularly useful new insights into how the system would operate under stress.

89. The Committee observed that the exploratory scenario would not set new liquidity standards for banks, or reconsider the appropriate calibration of individual banks' existing regulatory liquidity guidance. As the FPC had previously underlined, banks held regulatory liquidity buffers that the Committee expected to be used in a stress, bringing liquidity coverage ratios below 100%.

90. Instead, the BES would explore how the reactions of banks and authorities to the stress would shape its impact on the broader financial system and the UK economy. It would help to guide the PRA's approach to supervision and the Bank's provision of liquidity in stressed conditions. It would also help to raise awareness of how the Bank's framework for liquidity provision would operate in a stress.

[3] The text in this and the three preceding paragraphs was omitted from the version of the Record that was initially published on 11 July June 2019. The Committee agreed at its 9 March 2022 meeting to publish this text, for the reasons set out in the Record of that meeting.

91. Some members observed that the likelihood of all major UK banks suffering a simultaneous liquidity stress was remote. But examining the implications of a severe liquidity stress affecting major UK banks concurrently would provide the Committee with a better understanding of what might increase stress in a tail-risk event. For example, the exercise would allow the Committee to assess banks' reliance on financial markets to generate liquidity from their assets, and the impact that asset sales could have on asset prices and on other banks holding the same assets.

92. **The FPC therefore agreed to use the 2019 BES to explore the implications of a severe and broad-based liquidity stress affecting major UK banks simultaneously.**

93. The Committee discussed the need to ensure that banks responses were realistic and coherent in aggregate and therefore decided to have two sequential rounds of submissions. This would provide insights into banks' decision-making processes. Running the exercise with two rounds was a significant innovation for the 2019 BES and would also allow the scenario to incorporate the Bank, FPC and PRA's responses, given banks' initial reactions.

94. If participating banks suffered significant deposit outflows, then absent any management actions, other deposit takers might see corresponding inflows. The FPC agreed that it was appropriate to assume the majority of these deposits would go to deposit takers not participating in the BES, as these institutions were assumed to be unaffected by the stress. A proportion of deposits might ultimately be passed back to banks participating in the BES. But if this was in the form of financial institution deposits with high expected roll-off rates, this would have little impact on banks' regulatory liquidity positions.

95. The FPC agreed that participating banks should be the same firms involved in the 2019 ACS. Participants would be asked to submit projections on a group basis, and on a UK ring-fenced and non-ring-fenced bank basis, where applicable.

96. Details of the scenario and its calibration would be set out in the July FSR, to help participants prepare for the exercise. Participants would receive more detail on the scenario guidelines and data templates in due course. The Bank intended to publish the results of the exploratory exercise in mid-2020.

2021 BES

97. The Committee considered the case for running a BES in 2021 to explore the financial stability risks associated with climate change.

98. Committee members agreed that climate change exemplified the type of risk for which the exploratory scenarios were intended.

99. The Committee noted that the Future of Finance report, which would be published on 20 June, would recommend that the Bank explore a new climate-risk scenario to explore transition readiness in a future BES.

100. The Committee also noted the potential benefits to the financial services industry in the UK, and beyond, of guidance on climate scenario analysis. As would be noted in the FSR, the PRA had recently published a Supervisory Statement[4] setting out how banks and insurers were expected to manage climate-related financial risks via governance, risk management, scenario analysis and disclosure. This intervention had been welcomed by industry.

101. The Committee was also made aware, and took note, of the HM Treasury announcement that the next remit and recommendations letter that the Chancellor would issue to the FPC would reflect the need for the Committee to consider the COP21 Paris agreement when advancing its objectives and discharging its duties.

102. As would be outlined in the FSR, financial stability risks from climate change arose both from: (i) the physical risks associated with the increased frequency of extreme weather events, increasing the losses financial institutions might face and making some risks uninsurable; and (ii) the transition to a carbon-neutral economy, which could potentially generate significant structural changes across all sectors of the economy and prompt the reassessment of a wide range of asset values.

103. Given that climate change would affect all parts of the financial system, and had the potential to generate important spillovers across sectors, the Committee agreed that there could be benefits to extending coverage of the climate BES beyond the banks that participated in the previous BES. As would be highlighted in the FSR, the Bank's 2019 market-wide insurance stress simulations included climate-related physical and transition risk scenarios. The Committee would consider the results of this exercise when designing the scenario and deciding which institutions would be covered.

104. The Committee agreed that, given the nature of the risks associated with climate change, and limited data and models on climate-related financial risks, there was merit in beginning an industry-wide consultation now to gather feedback on some of the key parameters and scenario design features well in advance of 2021. In view of the diverse nature of the risks, there were also pros and cons of examining more than one scenario in the BES and the consultation could usefully gather feedback on the practicalities of such an approach.

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[4] PRA Supervisory Statement 3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change, April 2019

105. **The Committee agreed that in the 2021 BES the Bank should stress test the UK financial system's resilience to the physical and transition risks of climate change.** This exercise would integrate climate scenarios with macroeconomic and financial system models. It would motivate firms to address data gaps and to develop cutting-edge risk management consistent with a range of possible climate pathways: ranging from early and orderly to late and disruptive.

106. **The Committee further agreed that the Bank should gather views on the design of the exercise and, as a first step, should publish a Discussion Paper in autumn 2019.** The Discussion Paper should seek feedback on issues such as the coverage of the test, the nature of scenarios considered, the appropriate time horizon and disclosure of results. This would allow the Bank to develop the scenarios in consultation with risk specialists from across the financial sector, climate scientists, other industry experts, and other informed stakeholder groups. The Committee agreed that this Discussion Paper should seek feedback on specific scenario design questions.

Regular / other reviews

Reciprocation of French macroprudential measure

107. The FPC considered the ESRB recommendation for relevant authorities to reciprocate a group-level large exposure limit of 5% in respect of the exposures of their systemically important banks to highly indebted French-resident non-financial corporations, imposed in France by the Haut Conseil de stabilité financière.

108. Reciprocation would be in line with the FPC's previously stated intention of reciprocating foreign non-CCyB macroprudential capital actions where appropriate, recognising both the likely benefits to UK financial stability and to maintain consistency with its approach to reciprocating foreign CCyB rates.

109. The FPC noted that while currently no UK banks met the materiality threshold set out by the ESRB, banks could do so in the future due to ordinary fluctuations of business. Reciprocation would ensure compliance with the ESRB regime. The FPC noted the measure, through targeting corporate indebtedness, was related to leveraged lending. The FPC had previously identified the rapid growth of leveraged lending globally as a risk to UK financial stability.

110. The FPC noted that HM Treasury (HMT) was ultimately responsible for the decision. The FPC would support any HMT decision to reciprocate the measure. Following the FPC's consideration of the measure, the HMT representative confirmed HMT's decision to reciprocate and that HMT would notify the ESRB of its decision.

Reciprocation of Swedish macroprudential measure

111. The FPC also considered the ESRB recommendation for relevant authorities to reciprocate a risk-weight floor imposed by the Swedish Finansinspektionen targeting Swedish mortgage exposures. The FPC decided no action was necessary at this time as no UK credit institution had material exposures to Swedish mortgages and further, all were a long way from the ESRB threshold. The Committee would keep this under review.

The following members of the Committee were present:

Mark Carney, Chair
Jon Cunliffe
Ben Broadbent*
Dave Ramsden
Sam Woods
Alex Brazier
Anil Kashyap
Donald Kohn
Elisabeth Stheeman
Martin Taylor*
Andrew Bailey, Chief Executive of the Financial Conduct Authority*
Charles Roxburgh attended as HM Treasury’s representative in a non-voting capacity

** Members attended 4 July Policy meeting but were unavoidably unable to attend on 13 June*

Table 1: Checklist of actions to avoid disruption to end-users of financial services during Brexit

This checklist reflects the risk of disruption to end-users, including households and companies, if barriers emerge to cross-border trade in financial services. The risk assessment takes account of progress made in mitigating any risks. It assesses risks of disruption to end users of financial services in the UK and, because the impact could spill back, also to end-users in the EU.[5]

Risks of disruption are categorised as low, medium or high. Arrows reflect developments since the FPC's previous checklist was published in the Financial Policy Summary in March 2019[6] since March. Blue text is news since then.

The checklist is not a comprehensive assessment of risks to economic activity arising from Brexit. It covers only the risks to activity that could stem from disruption to provision of cross-border financial services.

	Risk to UK	Risk to EU	
Most risks to financial stability that could arise from disruption to cross-border financial services in a no-deal Brexit have been mitigated.			
Ensure a UK legal and regulatory framework is in place			The passage of the EU (Withdrawal) Act 2018 and secondary legislation will, among other things, allow EU financial services companies to serve UK customers. Some secondary legislation is still required to implement the domestic state aid framework and to ensure EU legislation that begins to apply during the Brexit extension period can operate effectively (e.g. parts of the revised Capital Requirements Regulation).
OTC derivatives (cleared)			The UK government has legislated to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses. The European Commission has provided a temporary and conditional equivalence decision in respect of the UK's regulatory framework for UK CCPs. The European Securities and Markets Authority (ESMA) subsequently announced the recognition of the 3 UK CCPs until end-March 2020 in a no-deal scenario and agreed the cooperation arrangements to support this with the Bank. This will allow EU counterparties to continue clearing existing trades, and new trades, with UK CCPs. UK CCPs will require clarity over future recognition arrangements well ahead of the expiry of this recognition, in order to avoid the risk that contracts would need to be closed out by March 2020.
Insurance contracts			The UK government has legislated to ensure that the 16 million insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced after Brexit. UK insurance companies continue to make good progress in restructuring their business in order to service £61 billion of EU liabilities after Brexit. £56 billion of this liability is expected to be addressed by October 31 2019. Temporary regimes announced by EU states are expected to further reduce the residual 'at risk' liabilities by over 50%. Some EU countries are implementing national legislation to support affected policyholders. The European Insurance and Occupational Pensions Authority (EIOPA) published recommendations to national authorities supporting recognition or facilitation of UK insurance companies' continued servicing of EU contracts.

[5] In most cases, the impact on EU end-users will apply to the wider European Economic Area (EEA).
[6] Financial Policy Summary and Record, March 2019

Asset management			Cooperation agreements between the Financial Conduct Authority, ESMA and EU National Competent Authorities have been agreed. This enables EU asset managers to delegate the management of their assets to the UK after exit. The UK government has legislated for EU asset management firms to continue operating and marketing in the UK after exit. And to operate in the EU, the largest UK asset managers have completed their establishment of EU authorised management companies.
In the absence of actions by EU authorities, some risks remain. Although these issues primarily affect EU households and businesses, they can also be expected to amplify volatility and spill back to the UK.			
Banking services			The UK government has legislated to ensure that UK households and businesses can continue to be served by EU-based banks after Brexit. EU authorities have not taken similar action. As a result major UK-based banks are transferring their EU clients to subsidiaries in the EU so that they can keep providing services to them. All material subsidiaries are now authorised, fully operational and trading. Firms are making use of the extension of the UK's membership of the EU to continue building the capacity of their EU entities. On average, approximately half of clients of major UK-based banks have completed the necessary documentation to enter into derivatives trades facing the EU entities. The number of clients actively trading in the new entities is lower. Some operational risks therefore remain, including if many clients seek to migrate to the EU entities at the last minute. These could amplify any other disruption in the market.
OTC derivative contracts (uncleared)			Certain 'lifecycle'[7] events will not be able to be performed on cross-border derivative contracts after Brexit. This could affect £23 trillion of uncleared derivatives contracts between the EU and UK, of which £16 trillion matures after October 2019. This could compromise the ability of derivatives users to manage risks, and could therefore amplify any stress around the UK's exit from the EU. The UK government has legislated to ensure that EU banks can continue to perform lifecycle events on contracts they have with UK businesses. The European Commission does not intend to reciprocate for UK-based banks' contracts with EU businesses. Most EU states with material uncleared derivatives activity have implemented legislative measures which seek to address this risk at national level but the scope and effectiveness of these measures will vary between jurisdictions. Notably, particular uncertainty remains about the scope of current or proposed legislation in jurisdictions which account for approximately half of the notional value of outstanding contracts.
Personal data			The UK government has legislated to continue to allow the free flow of personal data from the UK to the EU. The European Commission has indicated that it does not intend to take similar action to ensure the free flow of personal data from the EU to the UK in a no deal scenario. While the action by the UK government will reduce disruption, both UK and EU households and businesses may be affected due to the two-way data transfers required to access certain financial services. Companies can add clauses into contracts in order to comply with the EU's cross-border personal data transfer rules. The majority of firms intend to rely on these clauses, but these are subject to some legal and operational risk. Firms are making use of the time provided by the extension of the UK's membership of the EU to

[7] These lifecycle events include amendments, compressions, rolling of contracts, or exercise of some options.

			continue to implement these clauses. An ongoing case before the Court of Justice of the EU (CJEU), judgement on which may now be passed soon after the UK's exit from the EU, could impact the validity of these clauses.
Implementation period to allow mitigating actions by firms			Financial institutions need time to complete any necessary restructuring of their operations and re-papering of contracts. In November, the European Council endorsed a Withdrawal Agreement that includes an implementation period. If ratified, such an implementation period would reduce all of the risks set out in the FPC's checklist.

Table 2: Other risks of disruption to financial services

These risks could cause some disruption to economic activity if they are not mitigated and the UK leaves the EU without an agreement or implementation period. The FPC judges their disruptive effect to be somewhat less than that of those issues in its checklist.

Actions have also been taken to address other potential risks to financial services which, although unlikely to cause financial stability risks with material economic effect, could have been disruptive	
Credit Rating Agencies (CRAs)	EU rules will prevent some banks and insurance companies in the EU from calculating prudential requirements using ratings issued by UK CRAs unless endorsed by an EU CRA. This will mainly affect banks and insurers calculating requirements under the standardised approach/formula. A co-operation agreement exists between ESMA and the FCA and UK CRAs have registered EU entities to endorse UK ratings. ESMA has assessed the legal and supervisory framework for UK CRAs and concluded it meets the conditions for endorsement. However, the decision to endorse ratings lies exclusively with the CRA. The FCA has also issued a statement on the EU legal and supervisory framework, allowing UK CRAs to endorse EU ratings into the UK.
Access to euro payment systems	The Single Euro Payments Area (SEPA) schemes are currently used by UK payment service providers (PSPs, including banks) to make lower value euro payments such as bank transfers between businesses, mortgage and salary payments on behalf of their customers. The European Payments Council (EPC) has confirmed that the UK will retain SEPA access in the event of a no-deal exit. UK firms will also need to maintain access to TARGET2 to use it to make high-value euro payments. UK banks intend to access TARGET2 through their EU branches or subsidiaries or correspondent relationships with other banks.
Settlement finality protection for financial market infrastructure	After the UK exits the EU, UK financial market infrastructure firms (FMIs) will no longer be protected under EU law against payments or transfers being revoked, or collateral being clawed back, in the event that an EEA member enters insolvency. EEA countries accounting for almost all the EEA members of UK FMIs have implemented national legislation intended to provide settlement finality protection in the event of insolvency of local firms using financial market infrastructure in non-EU countries. For countries where protections are not in place, UK FMIs can implement other mitigants, including seeking legal opinions to clarify the extent of protections in other jurisdictions or restructuring EEA members' participation to jurisdictions where protections are in place.
However, some issues remain which could restrict EU firms' ability to trade or invest in certain UK assets and vice versa, and increase the costs of doing so	

Ability of EEA firms to trade on UK trading venues	EU-listed or traded securities are traded heavily at UK venues which offer deep liquidity pools for a range of securities traded by UK and EU firms. The EU's Trading Obligations requires EU investment firms to trade EU-listed or traded shares, and some classes of OTC derivative, on EU trading venues (or venues in jurisdictions deemed equivalent by the EU). The UK will also have reciprocal trading obligations when it leaves the EU. Firms and venues are taking action to ensure they can trade securities and affected derivatives in both the EU and UK and other equivalent jurisdictions. However, the process of adjustment might pose operational risks. And it would fragment liquidity across jurisdictions and venues, which may particularly impact EU firms' trading given their reliance on UK liquidity pools. The EU and UK could deem each other's regulatory frameworks as equivalent, thereby mitigating risks of disruption. The FPC notes the recent expiration of the EU's equivalence determination for Switzerland's trading venues.
Increased prudential requirements	EU regulations subject EU banks' and insurance companies' non-EU exposures (which, after exit, will include their holdings of UK securities) to stricter capital and liquidity requirements, as well as imposing some restrictions on holdings of non-EU assets. UK legislation, which is aligned with EU rules, would similarly subject UK banks and insurance companies to stricter capital and liquidity requirements on non-UK exposures. Secondary legislation passed in the UK allows regulators to delay the impact for UK firms. The Bank expects to publish the final transitional direction ahead of the UK's withdrawal from the EU. .

ANNEX: PREVIOUS 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	At its meeting in July 2019, the FPC set the UK CCyB rate at 1%, unchanged from February. The UK has also reciprocated a number of foreign CCyB 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#ccyb
[2] https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-the-fpcs-recommendation-on-loan-to-income-ratios-in-mortgage-lending
[3] https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending