Bank of England

Financial Policy Summary and record of the Financial Policy Committee meeting on 16 June 2022

05 July 2022

This is the record of the Financial Policy Committee meeting held on 16 June 2022.

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/2022/july-2022

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 30 September 2022 and the record of that meeting will be published on 12 October 2022.

Financial Policy Summary

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 economic outlook and UK financial stability

The economic outlook for the UK and globally has deteriorated materially. Following Russia's illegal invasion of Ukraine, global inflationary pressures have intensified sharply. This largely reflects steep rises in energy and other commodity prices that have exacerbated inflationary pressures arising from the pandemic, and further disruption of supply chains. Household real incomes and the profit margins of some businesses have fallen as a result. Global financial conditions have also tightened significantly, in part as central banks across the world have tightened monetary policy. Market interest rates and corporate bond spreads have risen sharply, reflecting expectations of further policy tightening in response to renewed risks of more persistent elevated inflation and increasing credit risk.

The outlook is subject to considerable uncertainty and there are a number of downside risks that could adversely affect UK financial stability. Developments related to the Russian invasion of Ukraine are a key factor that will affect both the global and UK outlooks, particularly if energy and food prices rise further. Stronger or more persistent inflationary pressures than currently expected might lead to: weaker economic growth globally; a further sharp tightening in global financial conditions; and the potential for further volatility and stress in financial markets. Tighter conditions would increase the pressures already facing households and businesses and the serviceability of public sector debt in some countries, including in the euro area. And risks remain in China around the re-emergence of vulnerabilities in the property sector and potential restrictions to contain further Covid outbreaks.

Financial markets and the resilience of market-based finance

Reflecting these developments in the economic outlook, global financial markets have been volatile in recent months. Risky asset prices have fallen markedly since the beginning of the year, and government bond yields have risen. Risk-taking in financial markets has also fallen globally, and measures of risk premia no longer appear compressed relative to historical levels. In addition, cryptoasset valuations have fallen sharply, exposing a number of vulnerabilities within cryptoasset markets, but not posing risks to financial stability overall. Given downside risks from additional supply shocks, faster-than-expected monetary policy tightening and slower-than-expected economic growth, risky asset prices remain vulnerable to further sharp adjustments.

Amid high volatility, liquidity conditions deteriorated even in usually highly liquid markets such as US Treasuries, gilts and interest rate futures. Core UK financial markets have remained functional, with participants able to execute trades, albeit at a higher cost. However conditions could continue to deteriorate, especially if market volatility increases further.

In the event of further shocks, impaired liquidity conditions could be amplified by the vulnerabilities in the system of market-based finance previously identified by the FPC. There is an important programme of work, co-ordinated by the Financial Stability Board (FSB), to understand and, where necessary, remediate the vulnerabilities exposed in the March 2020 'dash for cash', which is due to report its main findings and policy proposals in October. It is crucial that this work results in effective policy outcomes.

Increasing the resilience of Money Market Funds (MMFs) is an important step towards reducing the systemic risks that they pose to the UK and global financial system. In this context, and following agreement by FSB members to assess and address the vulnerabilities that MMFs pose in their jurisdictions, the FPC welcomes the recent publication of the joint UK authorities' Discussion Paper on Resilience of Money Market Funds.

UK bank resilience

The FPC judges that major UK banks have considerable capacity to support lending to households and businesses even with the deterioration in the economic outlook. In line with expectations, capital ratios declined in 2022 Q1 and are expected to fall back slightly over coming quarters. Nevertheless, major UK banks' capital and liquidity positions remain strong, and profitability has strengthened in aggregate.

Although downside risks will present headwinds, the FPC judges that UK banks have capacity to weather the impact of severe economic outcomes. In such scenarios, banks are likely to manage prudently their lending activity, commensurate with changes in credit quality in the real economy. Setting lending terms to reflect the new risk environment is appropriate. Restricting lending solely to defend capital ratios or capital buffers would be counterproductive and could prevent credit-worthy businesses and households from accessing funding. Such excessive tightening would harm the broader economy and ultimately the banks themselves.

Domestic debt vulnerabilities

Aggregate household debt relative to income has remained broadly flat in recent quarters, and there is little evidence of a deterioration in lending standards. However, the rise in living costs and interest rates will put increased pressure on UK household finances in coming months.

Despite this, the share of households with high debt-servicing ratios – those who are typically more likely to experience repayment difficulties – is not expected to increase substantially this year, in part because debt serviceability will be cushioned in the near term by fiscal support measures. This share is expected to increase above its historical average in 2023, as interest rate rises continue to pass through to households and unemployment rises, but it would remain significantly below the peaks seen ahead of the global financial crisis.

Debt-servicing remains affordable for most UK businesses. However, higher interest rates and input prices, weaker economic growth, and continued supply chain disruption are expected to weigh on corporate balance sheets. These effects will not fall evenly across businesses. Sectors with large exposures to energy or fuel prices (manufacturing and transport in particular) could face significant cost pressures. And the fall in household real incomes could reduce demand significantly in sectors such as non-essential household goods and services. While these pressures are likely to lead to some business failures, it would take large increases in borrowing costs or severe earnings shocks to impair businesses' debt-servicing ability in aggregate.

UK small and medium-sized enterprises (SMEs) have more debt than prior to the Covid pandemic, although the vast majority of this new debt was issued at relatively low rates, and the majority was fixed for six years or longer. Despite this, at least 70% of the current stock of outstanding SME debt is estimated to have been issued outside government loan schemes, and a large proportion of this debt is exposed to Bank Rate increases within a year. SME cash buffers are also lower than during the pandemic. SMEs make up a relatively small share of total corporate debt, and therefore pose limited direct risk to the UK financial sector in terms of bank losses, but represent a much larger share of employment.

The FPC continues to judge that major UK banks are resilient to domestic debt vulnerabilities.

Global debt vulnerabilities

Tighter financial conditions and reduced real incomes will weigh on debt affordability for households, businesses and governments in many countries, increasing the risks from global debt vulnerabilities. These pose risks to UK financial stability through economic and financial spillovers.

Higher interest rates and increases in the price of essential goods such as food and energy will make servicing debt more difficult for households in some countries, and emerging market economies in particular.

The FPC has previously highlighted vulnerabilities associated with riskier corporate borrowing, including in the United States. Weaker demand and higher interest rates will stretch debt affordability for a wider range of businesses. If interest rates were to increase in

line with market expectations, the share of listed US companies with low interest coverage ratios could increase significantly by the end of 2022, although it would remain below historical peaks.

Debt vulnerabilities in China remain elevated, particularly in the property market. The Chinese economy faces headwinds from continued Covid disruption, and a crystallisation of debt vulnerabilities would weigh further on activity.

A more severe downturn and tighter financial conditions could also put pressure on public sector debt in some countries, adding to the strains already caused by the pandemic. The FPC has previously highlighted vulnerabilities created by high public debt levels, including in Europe where yields on public sector debt in some countries have risen significantly during 2022.

The UK Countercyclical Capital Buffer (CCyB) rate decision

The FPC is increasing the UK Countercyclical Capital Buffer (CCyB) rate to 2%. This rate will come into effect on 5 July 2023, in line with the generally required 12-month implementation period. The FPC noted in December 2021 that since vulnerabilities that can amplify economic shocks had returned to pre-pandemic levels, and global and UK activity was expected soon to return to pre-pandemic levels, it was minded to return the UK CCyB rate to 2%, the level it was due to reach before the pandemic, in 2022 Q2. The global and UK economic outlook has deteriorated significantly since then, but domestic vulnerabilities that can amplify economic shocks remain broadly at their pre-pandemic level.

Given the considerable uncertainty around the outlook, the Committee will continue to monitor the situation closely and stands ready to vary the UK CCyB rate – in either direction – in line with the evolution of economic conditions, underlying vulnerabilities and the overall risk environment. In particular, if economic conditions deteriorate by significantly more than currently expected – in a manner that might otherwise lead banks to restrict lending – the FPC will be prepared to cut the UK CCyB rate as necessary.

The 2022 annual cyclical scenario

To support the FPC's monitoring and assessment of the resilience of banks to potential downside risks, the Bank will commence its annual cyclical scenario (ACS) stress test in September 2022, having been delayed in March in light of the Russian invasion of Ukraine and to help lenders focus on managing the associated market disruption. It will test the resilience of the UK banking system to deep simultaneous recessions in the UK and global economies, real income shocks, large falls in asset prices and higher global interest rates, as well as a separate stress of misconduct costs. Results will be published in Summer 2023.

Commodity market vulnerabilities

Commodity price volatility following the Russian invasion of Ukraine has further exacerbated price pressures facing households and businesses, and has had implications for the financial system. The sharp spike in gas and other prices following the invasion led to steep increases in margin requirements, essential for reducing counterparty credit risk, which created challenges for some market participants to raise the liquidity to meet them. Banks faced significant calls on revolving credit facilities from clients to fund higher margin requirements.

Despite the volatility, commodity and wider financial markets have continued to function, although the London Metal Exchange temporarily suspended trading in nickel contracts and cancelled trades between 8 and 15 March after a specific set of circumstances contributed to a sharp spike in prices.

Heightened uncertainty following the Russian invasion means there is a significant risk of further disruption in commodity markets. Further increases in volatility could increase the credit needs of the commodity sector for a given level of activity. Banks have sufficient capital to continue to meet these needs, although there is uncertainty over the amount of credit that will be supplied since it is subject to banks' judgements on risk management criteria and appetite.

The recent disruption has highlighted how vulnerabilities within commodity markets – and interconnections with the wider financial system – could propagate and amplify macroeconomic shocks.

Some of these are similar to vulnerabilities in the system of market-based finance. Due to opacity and lack of data in some markets, quantifying the size and scale of these fragilities and interconnections remains challenging, and addressing this globally should be a priority.

But some of these fragilities relate to physical markets, non-financial entities, or entities domiciled in other jurisdictions. Addressing them will thus require engagement from a broad range of financial and non-financial authorities, both domestic and global.

The FSB is undertaking in-depth analysis and assessment of vulnerabilities in commodity markets. Given the global nature of these markets, the FPC welcomes this work.

Record of the Financial Policy Committee on 16 June 2022

1. The Committee met on 16 June 2022 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. Its aim was to ensure the UK financial system was prepared for, and resilient to, the wide range of risks it could face – so that the system was able to absorb rather than amplify shocks, and serve UK households and businesses.

The economic outlook and UK financial stability

2. The FPC judged that the economic outlook for the UK and globally had deteriorated materially. Following Russia's illegal invasion of Ukraine, global inflationary pressures had intensified sharply. Global financial conditions had also tightened significantly, in part as central banks across the world had tightened monetary policy, and market interest rates and corporate bond spreads had risen sharply.

3. The Committee noted that the Monetary Policy Committee's (MPC's) central forecasts for UK and global economic activity as set out in the May 2022 *Monetary Policy Report (MPR)* were materially weaker than its previous projections. Higher inflation – particularly for commodities and tradable goods – was projected to reduce household real income substantially, lowering demand. UK GDP growth was forecast to slow sharply over the coming year. While there had been relatively little news in global and domestic economic data since the May *MPR*, there had been significant movements in financial markets, with large moves in major advanced economies' government bond yields and risky asset prices as participants adjusted their views on the economic outlook.

4. The economic outlook was subject to considerable uncertainty and there was a risk of further stress in financial markets. The FPC would continue to monitor risks to the outlook in order to protect UK financial stability.

5. There were a number of downside risks to the central outlook that could adversely affect UK financial stability. Developments related to the Russian invasion of Ukraine were a key factor that would affect both the global and UK outlooks, particularly if energy and food prices rose further. Stronger or more persistent inflationary pressures than currently expected might lead to: weaker economic growth globally; a further sharp tightening in global financial conditions; and the potential for further volatility and stress in financial markets. Tighter conditions would increase the pressures already facing households and businesses and the serviceability of public sector debt in some countries, including in the euro area. And risks

remained in China around the re-emergence of vulnerabilities in the property sector and potential restrictions to contain further Covid outbreaks.

6. In the UK, households' and corporates' finances were projected to become more stretched, due to the combined effects of rising inflation and interest rates. Household resilience would be cushioned in the near term by the Government's fiscal support measures, whereas the rise in interest rates was expected to increase the share of companies with a low Interest Coverage Ratio (ICR) – the ratio of earnings (before interest and tax) to interest expenses. UK small and medium-sized enterprises (SMEs) had more debt and lower cash buffers than they did before the Covid pandemic and were relatively more exposed to rising borrowing costs than larger corporates.

7. Although the global economic outlook had deteriorated materially, at present, the domestic financial sector remained resilient. Overall, the FPC assessed that UK banks had considerable capacity to support lending to households and businesses even with the deterioration in the economic outlook, and to weather the impact of severe economic outcomes.

Financial markets and the resilience of market-based finance

8. Financial markets globally, and in particular energy and broader commodity markets, had remained volatile amidst recent macroeconomic, monetary policy and geopolitical developments. Reflecting these developments, global financial conditions had tightened significantly, in part as central banks across the world had tightened monetary policy. Government bond yields had risen, with UK and US ten-year yields reaching their highest levels since 2014 and 2011 respectively. And risky asset prices had fallen markedly and were now materially below December 2021 *Financial Stability Report (FSR)* levels. For example, US equities were down c.19% and advanced economy high-yield corporate bond spreads had widened by 150-225 bps since the December *FSR*. The FPC judged that these moves reflected market participants adjusting interest rate and corporate creditworthiness expectations in the light of higher than expected inflation, related central bank actions, as well as heightened geopolitical and, more recently, recession risks. The FPC noted that the falls in risky asset prices had been largely orderly thus far.

9. The Committee judged that risk-taking in financial markets globally had fallen further since the December *FSR*. Measures of risk premia across financial markets no longer appeared compressed and most were around the middle of their historical distributions. However, the FPC highlighted that risky asset prices remained vulnerable to a further sharp adjustment in light of downside risks to the macroeconomic outlook, potential further inflation shocks and related monetary policy responses. The FPC also noted, however, that financial stability was not the same as market stability or the avoidance of any disruption to users of financial services. Significant market volatility was to be expected given the recent developments.

10. The Committee highlighted that lower risk appetite had also been reflected in reduced primary issuance. Primary credit markets remained open for most corporates, but bond issuance, especially by riskier firms, had been subdued. For example, year-to-date issuance in investment-grade bond and leveraged loan markets had been c. 20%-30% lower relative to the levels observed over the past five years, and around 60% lower for the riskier high yield bond markets. Market contacts had indicated that some smaller and less established high-yield corporates had struggled to access funding, with several deals being unsuccessful due to weak investor demand. The Committee highlighted that going forward, rising rates amidst a deteriorating economic outlook could increase concerns around corporate creditworthiness and pose challenges for some firms, especially lower-rated ones, in rolling over debt. The FPC noted that this pressure could be exacerbated if there was an increase in corporates downgraded from investment grade to high yield (so-called 'fallen angels'), forcing certain investors to sell downgraded securities into illiquid bond markets.

11. In line with the broader reduction in risk appetite, cryptoasset valuations had fallen sharply. In addition, investor confidence in the ability of certain so-called stablecoins to maintain their pegs, particularly those with no or riskier backing assets and lower transparency, had been weakened significantly. The FPC judged that while these events had not posed risks to financial stability overall, unless addressed, systemic risks would emerge if cryptoasset activity and its interconnectedness with the wider financial system continued to develop. This underscored the need for enhanced regulatory and law enforcement frameworks to address developments in cryptoasset markets and activities.

12. The FPC noted that amid high volatility, liquidity conditions had deteriorated, even in usually liquid markets such as US Treasuries, gilts and interest rates futures. For example, US Treasury market depth was two to three times lower than at the start of the year, and the bid-ask spreads on short-dated gilts were more than double the average level observed in 2021. The FPC also noted emerging signs of strain in other sovereign bond markets, and a continued rise in developed market interest rate volatility metrics.

13. The FPC judged that overall core UK financial markets – those essential to the smooth functioning of the UK financial system – had remained functional with participants able to execute trades, albeit at a higher cost. They noted that conditions could continue to deteriorate especially if market volatility increased further.

14. The FPC noted that pressures had also been observed in some parts of the system of market-based finance, as manifested in outflows from riskier corporate bond funds, as well as elevated levels of margin calls, especially in commodity derivatives markets. For example, US high yield and European corporate bond open-ended funds had seen outflows of around 9% of their assets under management since the start of the year. And in the week to 15 June, US high yield corporate bond open-ended funds had seen steep outflows comparable to the largest weekly outflow in March 2020. Additionally, UK central counterparties' (CCPs) initial margin requirements increased by up to £40 billion between February and April 2022

(encompassing the start of the Russian invasion), compared with around £60 billion over the same time period in 2020 (encompassing the start of the pandemic). Daily variation margin calls also spiked during the recent volatility: the largest aggregate daily variation margin call was £34 billion between February and April 2022, compared to £29 billion in the same period of 2020.

15. The Committee judged that given the current economic and geopolitical environment, risks of wider market disruption were elevated. It was noted that thus far there had not been signs of a widespread demand for cash that had manifested in forced sales of government bonds or an elevated demand for repo borrowing, such as the one that had led to disruption of those markets in March 2020. But the FPC highlighted that long standing vulnerabilities in market-based finance remained unaddressed and in the event of further shocks, impaired liquidity conditions could be amplified by those vulnerabilities in the system of market-based finance previously identified by the FPC. This included how potential forced asset sales by leveraged investors or funds investing in less liquid corporate bonds could interact with markets' limited capacity to absorb them, resulting in disruption in core funding markets and excessive tightening in financial conditions.

16. Given this context, the FPC highlighted the important programme of work, co-ordinated by the Financial Stability Board (FSB), to understand and, where necessary, remediate the vulnerabilities exposed in the March 2020 'dash for cash' which is due to report on its main findings and policy proposals in October. The FPC judged it crucial that this work resulted in effective policy outcomes. Absent an increase in the resilience of non-bank financial institutions, the financial stability risks associated with core market dysfunction could resurface during stress events. The FPC noted that the work planned by the FSB this year, including the FSB's effectiveness review of its 2017 asset management recommendations and the follow-up work contained in the consultation report[1] by the Basel Committee on Banking Supervision (BCBS), the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) on margining practices, represented important opportunities to develop policies to address some of those vulnerabilities.

17. On 23 May 2022, the Bank and the FCA, with the endorsement of HM Treasury, had published a discussion paper[2] on the Resilience of Money Market Funds (MMFs). This followed agreement by FSB members to assess and address the vulnerabilities that MMFs posed in their jurisdictions. The FPC welcomed the discussion paper and noted that increasing the resilience of MMFs was an important step towards reducing systemic risks posed to the UK and the global financial system. MMFs had faced severe liquidity pressures during the 'dash for cash' in March 2020. That shock had once again exposed underlying

---

1 https://www.bis.org/bcbs/publ/d526.htm

2 https://www.bankofengland.co.uk/paper/2022/money-market-fund-discussion-paper

vulnerabilities in MMFs that could have resulted in funds choosing to suspend redemptions. Widespread suspensions by MMFs could have had severe consequences for the financial system and real economy. With greater resilience, MMFs would, in future, be better able to withstand stressed market conditions without the need for central bank intervention.

18. The FPC discussed the relevance of its principles for fund design that had been published in December 2019 *FSR*[3] and in the Liquidity Management in UK open-ended funds report[4]. These principles established that there should be greater consistency between the liquidity of a fund's assets and its redemption terms. The FPC also noted that a significant proportion of the sterling MMFs used by UK investors were domiciled in the EU. Those MMFs were currently able to market to UK investors under a range of post-Brexit temporary regimes. The FPC noted that it was important to avoid opportunities for regulatory arbitrage and considered that funds that wanted to market to UK investors should do so on the same basis as UK funds. The FPC judged that the preferred way to avoid regulatory arbitrage was for international authorities to work together on establishing common high global standards, and noted that the UK authorities remained committed to mutual regulatory and supervisory co-operation with EU authorities.

UK bank resilience

19. The FPC discussed the resilience of the UK banking system, including its ability to withstand shocks and maintain credit supply to businesses and households. The FPC judged that the major UK banks' capital and liquidity positions remained strong. In line with expectations, capital ratios had declined in 2022 Q1 - the headline aggregate CET1 capital ratio was 14.5% in 2022 Q1 compared with 16.3% at the end of 2021. Shareholder distributions, alongside a range of expected regulatory developments, including changes to methodologies on risk-weighted assets and the treatment of intangible software assets for regulatory capital, had contributed to the decline.

20. The FPC noted that capital ratios of major UK banks were expected to fall back slightly over coming quarters, though banks were expected to maintain sufficient headroom to accommodate an increase in the UK Countercyclical Capital Buffer (CCyB) rate to 2%. Based on staff analysis, the FPC judged that major UK banks had considerable capacity to support lending to households and businesses even with the deterioration in the economic outlook.

21. The FPC noted that banks reported stronger profitability in Q1. Impairments remained below average pre-pandemic levels, despite the first positive impairment charge having been

[3] https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf
[4] https://www.bankofengland.co.uk/report/2021/liquidity-management-in-uk-open-ended-funds

registered since 2020 Q4. Looking forward, however, the FPC noted that asset quality was likely to deteriorate in view of the worsening macroeconomic outlook

22. Although downside risks would present headwinds, the FPC judged major UK banks had capacity to weather the impact of severe economic outcomes. In such scenarios, banks were likely to manage prudently their lending activity, commensurate with changes in credit quality in the real economy. Setting lending terms to reflect the new risk environment was appropriate. Restricting lending solely to defend capital ratios or capital buffers would be counterproductive and could prevent credit-worthy businesses and households from accessing funding. Such excessive tightening would harm the broader economy and ultimately the banks themselves.

23. The FPC would continue to monitor banking sector resilience, including as part of stress testing, and banks' risk appetite for lending.

Domestic debt vulnerabilities

24. The FPC judged that major UK banks were resilient to vulnerabilities in the UK household and corporate sectors. The Committee noted that higher inflation and rising interest rates would weigh on households making repayments on their debt. Rising interest rates would also increase debt-servicing costs for UK corporates and higher input costs and reduced demand from households would impact earnings for businesses. While challenges were expected for some individual businesses and households, in aggregate the shares of households and corporates with high debt-servicing burdens were projected to remain below historic peaks.

UK Household resilience

25. The FPC noted that UK house price inflation had been at around 10% in recent months, around the average level seen since June 2021. House price growth was expected to slow later in the year, with further slowing in 2023, driven by the deteriorating economic outlook and rising mortgage interest rates.

26. Despite high levels of house price inflation, there had continued to be little evidence of a deterioration in mortgage lending standards or a material increase in the number of highly indebted households. In 2022 Q1, the share of lending at a loan-to-income ratio of at least 4.5 was 10.1% and the share with a loan-to-value (LTV) ratio of at least 90% was 16.0%. These shares were at or slightly below their pre-pandemic levels. The ratio of aggregate household debt (excluding student loans) to income was 124% in 2021 Q4, little changed on the quarter and well below the pre-Global Financial Crisis (GFC) peak of 144%.

27. In March 2022, the share of households with high debt-servicing ratios (DSRs) had remained close to the historically low levels seen in recent years. The FPC considered a new cost of living adjusted DSR measure in assessing household resilience. This measure accounted for taxes and an estimate of essential spending, which enabled a better assessment of the combined impact from rising prices and interest rates. While survey

evidence suggested the share of households with high cost of living adjusted DSRs for mortgage debt may have increased slightly post-pandemic, it remained well below levels seen in the run-up to the GFC.

28. Pass-through of rises in interest rates and future inflation was expected to put pressure on households' finances. This pressure could make it more difficult for households to manage debt repayments, which could lead to sharp cuts to consumption and/or to defaults and losses for lenders. This was particularly relevant for lower-income households, who tended to spend a higher share of income on essential goods and services, and were more exposed to higher prices as a result. The pass-through of increases in interest rates to mortgage holders was expected to take time, as around 80% of the outstanding value of mortgages were on a fixed rate, up from around 30% in 2013.

29. The FPC noted uncertainty in projecting the shares of households with high cost of living adjusted DSRs for mortgage debt or consumer credit, but on balance, these were not expected to rise substantially in 2022. Consistent with the May *MPR* forecast, more expensive household essentials, higher interest rates and higher unemployment would increase the proportion households with high cost of living adjusted DSRs. The impact of these factors was likely to be mitigated to some extent by nominal earnings growth, the government support measures announced in May 2022, and the fact that most households had mortgages that were fixed in the near term. The precise impact of the relevant factors was difficult to quantify and the Committee judged that the outcome would depend on which households benefitted from earnings growth and the extent to which households had capacity to reduce essential spending.

30. The FPC noted that the share of households with high cost of living adjusted DSRs for mortgage debt and consumer credit was expected to increase in 2023, as interest rates continued to rise and pass-through to households, and unemployment increased slightly. Staff analysis suggested that shares could move above their historical averages in 2023, but would remain significantly below the peaks seen ahead of the GFC.

31. The FPC also noted that there were downside risks to the projections for household debt affordability. A further deterioration in the macroeconomic outlook resulting in a larger rise in unemployment, weaker real earnings growth, or a significant widening in credit spreads could lead to higher projections for the share of households with high cost of living adjusted DSRs.

UK Corporate resilience

32. The FPC noted that the operating environment for businesses was changing rapidly, and assessed that UK corporate debt vulnerabilities were likely to increase in the near term. The material deterioration in the economic outlook, combined with projections of higher interest rates increasing debt-servicing costs, would weigh on corporate balance sheets in the near term. While these pressures would likely lead to some business failures, it would take large increases in borrowing costs or severe earnings shocks to impair businesses' debt-servicing ability in aggregate. Staff had estimated the increase in businesses' funding rates that would be required to return the debt-weighted share of large UK businesses with ICRs below 2.5 to its historic high. Such estimates were highly uncertain and depended on a number of factors,

in particular the extent to which increases in funding rates pass through into the rates paid on their existing debt. Assuming that any increase in businesses' funding rates immediately applied to all of their debt – the highest degree of pass-through of funding rate rises into debt servicing payments – returning the debt-weighted share to its historic high would take an additional 200 basis point increase in businesses' funding rates by end-2022, on top of market expectations of a 150 basis point rise. It would entail funding rates increasing by a total of 450 basis points between end-2021 and end-2022. Assuming instead lower pass-through such that the funding rates increases were passed on only to floating rate debt, or debt that was at fixed rates for less than a year, returning the debt-weighted share to its historic high would take an additional increase in funding rates of 500 basis points (rather than the 200 basis points above). This would entail funding rates increasing by a total of 750 basis points between end-2021 and end-2022.

33. The FPC noted that pressures on corporate earnings would be felt most sharply by certain sectors. Sectors with large exposures to energy or fuel prices, such as air transport and some manufacturing subsectors could come under significant cost pressures. And the fall in household real incomes could reduce demand significantly in some sectors, such as non-essential household goods and services. In some cases, there could be an overlap between sectors most susceptible to rising interest rates and higher costs, and some of those sectors had already been affected by shifts in economic activity during the pandemic. Market intelligence also indicated that credit supply had started to tighten, particularly in vulnerable sectors such as retail, hospitality and manufacturing.

34. The FPC noted that SMEs had more debt than prior to the Covid pandemic, although the vast majority of this new debt was issued at relatively low rates, and the majority was fixed for six years or longer. Despite this, at least 70% of the current stock of outstanding SME debt was estimated to have been issued outside government loan schemes, and a large proportion of this debt was exposed to Bank Rate increases within a year. SMEs made up a relatively small share of total corporate debt, but a much larger share of employment. SMEs therefore posed limited direct risk to the UK financial sector in terms of bank losses. However, if many SMEs were to cease trading or significantly downsize, any subsequent fall in employment could be a source of stress to household balance sheets.

35. The FPC also noted that UK SMEs had lower cash buffers than during the Covid pandemic. Cash buffers were an important source of liquidity for SMEs, which tended to experience more restricted access to external finance. The share of SMEs with insufficient cash to cover 7 days of turnover had increased to 31% in February 2022, compared to 21% during the pandemic in June 2020. This share was 34% in 2019.

36. The FPC noted that cumulative insolvencies of UK corporates remained significantly below what might have been expected over the pandemic, although the level of insolvencies had increased in recent months. This reflected the phased withdrawal of temporary restrictions on insolvency proceedings during 2021 and early 2022. Insolvencies were likely to rise further during 2022 and the FPC would continue to monitor numbers of insolvencies on a quarterly basis.

Global debt vulnerabilities

37. The Committee discussed a range of global risks that could be relevant for UK financial stability. The Russian invasion of Ukraine had led to a material deterioration in the global outlook. In particular, sharp increases in the prices of energy and other commodities had exacerbated existing inflationary pressures arising from the pandemic, impacting upon real incomes. There had also been a sharp tightening in global financial conditions, in part as central banks in many countries had tightened monetary policy. These developments were weighing on debt affordability for households, businesses and governments, and had increased the risks from global debt vulnerabilities.

38. Higher interest rates, slower growth and increases in the price of essential goods, such as food and energy, would make servicing debt more difficult for households in many countries, in particular some emerging markets economies. Some households, for example in the United States (US), would be less exposed to increases in interest rates as their mortgage rates were fixed for long periods, but there could be pockets of distress for those most exposed to these shocks.

39. The FPC had previously highlighted vulnerabilities associated with leveraged corporate borrowing including in the US[5]. Weaker demand, higher energy prices, and higher interest rates would stretch debt affordability for a wide range of businesses, potentially posing material risks. Staff analysis considered the effects of increases in energy prices and revenues as projected in the May MPR, as well as market expectations for policy rates in 2022, on the share of large, listed businesses with ICRs below 2.5 in the US and the euro area. This suggested that, if interest rates increased in line with market expectations, the share of listed US companies with low ICRs could increase to around the levels seen in the GFC by the end of 2022, although it would remain below historical peaks. While market expectations of interest rate increases in the euro area were lower, euro area businesses were more exposed to increases in energy prices, particularly for gas. The share of euro area businesses with high ICRs would increase but remain below levels seen ahead of the GFC.

40. Globally, further supply shocks on key commodities, including energy, risked pushing up prices and reducing real incomes further. These shocks could come from greater geopolitical tensions, further supply disruptions from Covid-related restrictions, particularly in China, or other factors. In some countries, including in the US, domestic price pressures had also increased. If those pressures were to become stronger or more persistent, that might lead to a sharper tightening in global financial conditions, prompting a more pronounced downturn. Higher unemployment and weaker business prospects would increase the risks associated with debt vulnerabilities for households and businesses. That in turn could lead to losses for banks. Debt vulnerabilities in China remained elevated, particularly in the property market.

---

[5] https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021/financial-stability-in-focus

The Chinese economy faced headwinds from continued Covid disruption, and a crystallisation of debt vulnerabilities would weigh further on activity. A more pronounced downturn in the property sector could have significant economic consequences given the important role it played in the Chinese economy, accounting for around a quarter of Chinese GDP.

41. A more severe downturn and tighter financial conditions could also put pressure on public sector debt in some countries, adding to the strains already caused by the pandemic. So far only a few emerging market economies had fallen into financial distress, but a number of other countries remained vulnerable to a further tightening in global financial conditions. The IMF projections suggested that interest payments on government debt for major non-China emerging market economies would increase significantly in 2022 relative to government revenue.

42. Amongst advanced economies, public sector debt positions varied significantly. Some euro area countries had seen yields on public sector debt rise particularly sharply. For example, Italian 5-10 year government bond yields had increased by around 105 basis points over the previous month. The European Central Bank had announced it would apply flexibility in the reinvestment of its pandemic response asset purchases and accelerate work on an anti-fragmentation instrument to preserve the functioning of the monetary policy transmission mechanism. The FPC had previously highlighted vulnerabilities created by high public debt levels in the euro area, including interlinkages between banks and sovereigns. These global debt vulnerabilities posed a material risk to UK financial stability through economic and financial spillovers.

43. The crystallisation of risks associated with global debt vulnerabilities could affect UK financial stability through a number of channels, either directly through UK banks' foreign exposures, or indirectly through the impact on UK trade and financial conditions.

Building the resilience of the financial system

The UK Countercyclical Capital Buffer rate

44. The FPC discussed its setting of the UK Countercyclical Capital Buffer (CCyB) rate. In line with its communications in the December 2019 Record, the Committee reiterated that its policy was to vary the UK CCyB rate in line with system-wide risks to the UK banking sector and to set the UK CCyB rate in the region of 2% when vulnerabilities that could amplify economic shocks were judged to be at a 'standard' level. This approach aimed to ensure that the buffer was large enough to create capacity for banks to absorb shocks so that they were able to lend through downturns.

45. In considering the appropriate setting for the UK CCyB rate, the FPC discussed its judgements around the economic outlook and underlying vulnerabilities that could amplify

economic shocks. The FPC noted that, since the November 2021 *MPR*, global and UK activity had returned to pre-pandemic levels and the economic impact of Omicron had been limited and of short duration. However, during this time, the UK and world economic outlook had deteriorated materially, as global inflationary pressures had intensified sharply, including following Russia's invasion of Ukraine. Financial conditions had also tightened, particularly as central banks across the world had tightened monetary policy, and market interest rates had risen sharply. These developments were likely to impact the outlook for UK financial stability. In addition, the FPC judged that while domestic debt vulnerabilities had increased since the December 2021 *FSR,* they remained at a standard level overall. Global debt vulnerabilities, which could spill over to the UK, remained material.

46. The Committee noted that major UK banks' capital positions remained strong and that their profitability in aggregate had increased further in Q1. Major UK banks' aggregate common equity Tier 1 (CET) capital ratios were expected to fall back slightly over coming quarters, though they were expected to maintain sufficient headroom to accommodate an increase in the UK CCyB rate to 2%.

47. In view of these assessments of underlying vulnerabilities and bank resilience, and as it had communicated in December 2021 and March 2022, the Committee agreed to increase the UK CCyB rate from 1% to 2%, with binding effect from 5 July 2023, in line with the generally required 12-month implementation period[6].

48. Noting the uncertainty around the economic outlook, the Committee 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 conditions, underlying vulnerabilities and the overall risk environment. If economic conditions deteriorated by significantly more than currently expected, in a manner that might otherwise lead banks to restrict lending, the FPC would be prepared to cut the UK CCyB rate as necessary. This would enable banks to use the released buffer to absorb losses and provisions – which, all else equal, would now be recognised earlier in a stress under International Financial Reporting Standard 9 (IFRS 9) – and so be able to support lending.

Stress testing the UK banking system: the 2022 annual cyclical scenario (ACS)

49. To support the FPC's monitoring and assessment of the resilience of banks to potential downside risks, the Bank would commence its annual cyclical scenario (ACS) stress test in September 2022, which had been delayed in March in light of the Russian invasion of Ukraine and to help lenders focus on managing the associated market disruption. The ACS would test the resilience of the UK banking system to deep simultaneous recessions in the UK and global economies, real income shocks, large falls in asset prices and higher global

[6] See **here** for details of the FPC's approach to setting the CCyB and the CCyB core indicators.

interest rates, as well as a separate stress of misconduct costs. The results of the ACS would be published in summer 2023.

Vulnerabilities from a commodities market shock

50. In March 2022, the FPC had noted that commodity markets had experienced significant volatility including since the Russian invasion of Ukraine, with commodity prices rising sharply. At its June 2022 meeting, the Committee assessed the potential linkages between financial commodity markets and the broader financial system, as well as the vulnerabilities in commodities markets that could be exposed by further shocks to commodity prices. Further detail on these interlinkages was set out in the July 2022 *FSR.* The key transmission channels to the core financial system were identified as being via risks to: i) systemically important institutions; ii) the function of market-based finance; and iii) the provision of critical services including market infrastructure. Alongside this, the FPC considered the impacts on the economy more generally, including household and corporate debt vulnerabilities, as well as the impact on inflation and supply chains, which had already contributed to significant adjustments in asset prices, growth and revised expectations for monetary policy globally. The FPC noted the potential for the response of the financial system to amplify the impact of commodities shocks onto the real economy.

51. Commodity prices had risen in late 2021, reflecting both the recovery in demand as the effects of the Covid pandemic had begun to recede, and supply constraints. Price volatility had increased sharply following the Russian invasion of Ukraine, particularly for those commodities that Russia and Ukraine were significant producers of, such as gas, oil and metals, and some agricultural commodities. The increase in commodity volatility had numerous implications for commodity markets and the broader financial system. Steep increases in margin requirements, essential for reducing counterparty credit risk, had created liquidity challenges for some market participants. And banks had seen significant drawing on revolving credit facilities to fund margin requirements and had experienced increased exposure to other credit and counterparty risks, including from intermediating in the OTC derivatives markets.

52. Despite this volatility, the financial system had remained resilient so far. Commodity markets had continued to function, although the London Metal Exchange had temporarily suspended trading in nickel contracts and cancelled trades between 8 and 15 March 2022 after a specific set of circumstances contributed to a sharp spike in prices.

53. Heightened uncertainty following the Russian invasion meant that there was a significant risk of further disruption in commodity markets. Further increases in volatility could increase the credit needs of the commodity sector for a given level of activity. Banks had sufficient capital to continue to meet these needs, although there was uncertainty over the amount of credit that would be supplied since it was subject to banks' judgements on risk management criteria and risk appetite. Any reduction in position size and liquidity would make the price

discovery process harder, particularly for long dated commodity contracts. The FPC noted that commodity market volatility had not itself caused disruption in core financial markets, although a confluence of geopolitical and economic risks had led to some significant adjustments in asset prices and reductions in market liquidity across a range of markets recently. Nonetheless the interlinkages between financial and physical commodities markets had the potential to amplify stress in the real economy through further inflationary pressures in commodity prices creating additional credit stress for households and corporates and further impact on other markets.

54. The recent disruption had highlighted how vulnerabilities within commodity markets - and interconnections with the wider financial system - could propagate and amplify macroeconomic shocks. These included: i) the presence of some highly leveraged participants in commodity markets; ii) the liquidity mismatch at the centre of some participants' business models; iii) the fact that commodity markets tended to be concentrated among a few large, highly interconnected participants, meaning shocks could propagate quickly; and iv) the lack of transparency. Due to opacity, fragmentation of reporting and lack of data in some markets, quantifying the size and scale of these fragilities and interconnections remained challenging, and addressing this globally should be a priority. The FPC noted that some of these vulnerabilities were similar to the vulnerabilities previously identified in market based finance, such as leverage, opacity, concentration, and resilience to liquidity stress.

55. The Committee judged that it was important to distinguish between fragilities related to activities taking place in the regulated financial system, such as trading on exchanges, central clearing and activities of financial institutions, from those pertaining to trading in physical commodities, which sit outside of the regulated financial system. Some of these fragilities related to physical markets, non-financial entities, or entities domiciled in other jurisdictions, and addressing these would require engagement from a broad range of financial and non-financial authorities, both domestic and global.

56. Data transparency remained a key issue that needed to be addressed to be able to quantify fragilities in both physical and financial markets. Commodities markets were global, and fragmentation of data reporting across the various relevant authorities and jurisdictions, meant that individual authorities only had a partial view of the risks. There were also gaps in coverage, for example: the granularity of underlyings reported was limited in some markets; some physically-settled OTC transactions were not reportable to trade repositories; and some non-financial counterparty transactions could fall out of scope of reporting obligations under UK European Market Infrastructure Regulation (EMIR), or other equivalent rules elsewhere.

57. The FSB was undertaking in-depth analysis and assessment of vulnerabilities in commodity markets. Given the global nature of these markets, the FPC welcomed this work. The Committee stressed the importance of continued monitoring of the sector, and its links to

global vulnerabilities and the real economy. It would outline in the July 2022 *FSR* the improvements that could be made to current data reporting to allow monitoring of these markets. The FPC would continue to monitor signs of stress building up in commodity markets and would engage with other authorities as necessary to seek to ensure the resilience of the UK financial system to such a stress.

The FPC's Mortgage market recommendations

58. The FPC had, since June 2014, recommended a limit of 15% on the proportion of new mortgages extended at or above 4.5 times a borrower's income (known as the loan to income flow limit). Building on FCA rules, the FPC had also recommended that lenders assess whether borrowers could meet their mortgage payments if their mortgage interest rate switched to the contractual reversion rate and increased by 3 percentage points (known as the affordability test).

59. The FPC had carried out regular reviews of these Recommendations. In its latest review, based on analytical work published in the December 2021 *FSR*[7], the Committee had announced that it intended to consult on withdrawing the affordability test Recommendation. The FPC had concluded that, on current evidence, the LTI flow limit, without the FPC's affordability test Recommendation, but alongside the wider assessment of affordability required by the Financial Conduct Authority's (FCA's) Mortgage Conduct of Business (MCOB) responsible lending rules[8], ought to deliver the appropriate level of resilience to the UK financial system, but in a simpler, more predictable and more proportionate way.

60. In its February 2022 Consultation Paper[9] the FPC had sought views on its proposal to withdraw the affordability test Recommendation and on the potential impact this might have on the mortgage and housing markets. The consultation closed on 6 May and the majority of responses including all those from trade bodies were supportive of the proposal. The consultation feedback did not provide any evidence to suggest that removing the affordability test would have a significant impact on the mortgage or housing markets.

61. Following this consultation, the FPC decided to withdraw the affordability test Recommendation with effect from 1 August 2022. The FPC discussed options (both shorter and longer) for the timing of when the withdrawal of the affordability test Recommendation would come into effect based on the responses to the consultation. The FPC judged that a notice period of six weeks appropriately balanced the desirability of giving lenders notice ahead of the change in policy and the desirability of minimising the risk of borrowers delaying

---

[7] https://www.bankofengland.co.uk/financial-stability-report/2021/december-2021
[8] https://www.handbook.fca.org.uk/handbook/MCOB/11/6.html
[9] https://www.bankofengland.co.uk/paper/2022/withdrawal-of-the-fpcs-affordability-test-recommendation

purchases due to uncertainty about how reversion rates and the stress rate might move in future. An effective withdrawal date of 1 August 2022 was agreed by the Committee.

62. The FPC noted that the withdrawal of the affordability test Recommendation would not place any requirement on lenders to take action. It would be up to individual lenders as to whether they wished to make any changes to their own appropriately prudent lending practices and the timing of any changes after the withdrawal date. The FPC noted that this might lead to more variation in the interest rate stress applied to stress borrowers' affordability. The full details of the FPC's decision and its response to the consultation feedback would be set out in a Consultation Response subsequently published on 20 June 2022[10].

63. The consultation also received feedback on issues outside of the scope of the consultation. This feedback was not relevant to the specific proposal and so was not factored into the FPC's decision on the withdrawal of the affordability test Recommendation. However, the FPC was grateful for the feedback received and would keep it under consideration as part of its regular reviews of its mortgage market measures.

Other Systemically Important Institutions (OSII) buffer framework[11]

64. Following a review of the Other Systemically Important Institutions (O-SII) buffer framework in 2021 Q3, the FPC had decided to consult on a proposal to amend its framework. The consultation had closed on 15 February 2022.

65. The FPC had considered the responses to the consultation carefully and decided to amend its framework, as follows:

- Change the metric used to determine O-SII buffer rates from total assets to the UK leverage exposure measure[12].

- Recalibrate the thresholds used to determine O-SII buffer rates to prevent an overall tightening or loosening of the framework relative to its pre-Covid level.

[10] https://www.bankofengland.co.uk/news/2022/june/financial-policy-committee-confirms-withdrawal-of-mortgage-market-affordability-test
[11] The FPC made the decisions for this topic by written procedure.
[12] In light of the responses to the consultation, the FPC had decided that O-SII buffer rates should be determined based on firms' average of the quarter-end leverage exposure measure over the year.

66. The FPC's judgements relating to the responses to the consultation had been published in a FPC Response paper[13]. The FPC had also published an updated O-SII buffer framework to reflect the results of its review and consultation[14].

Resolvability Assessment Framework (RAF)

67. The FPC welcomed the publication[15] of the Bank's first assessment of the eight major UK banks' preparations for resolution under the Resolvability Assessment Framework (RAF).

68. The FPC noted that the published findings set out the progress made on resolvability since the GFC of 2007-08, when the UK did not have a regime to enable resolving banks without the use of public money. The UK now had a robust resolution regime. In addition, the Bank's assessment of resolvability showed that even if a major UK bank were to require resolution, customers would be able to keep accessing their accounts and business services as normal. Banks' losses and the costs of recapitalisation would be paid for by shareholders and investors, not taxpayers, overcoming the 'too big to fail' problem.

69. The Bank's assessment of resolvability had reflected the position at a point in time and the Bank had noted that maintaining a robust resolution regime would involve the authorities and banks responding as the financial system and regulatory landscape evolved. The FPC therefore also welcomed the approach by the Bank, as resolution authority, and the PRA, to make resolvability a continuing obligation for banks, which would include addressing the actions identified as part of the Bank's assessment, and require them to publish their own summaries of their preparations for resolution. The FPC noted that the Bank would repeat its assessment of the major UK banks in 2024 and every two years thereafter.

Climate Biennial Exploratory Scenario[16] (CBES)

70. The FPC welcomed the publication of the Bank's 2021 Climate BES results[17], which explored the largest UK banks' and insurers' resilience to a range of plausible climate scenarios, testing different combinations of physical and transition risks over a 30-year period.

71. The FPC judged that climate change, and the transition to net zero, created risks for businesses and households globally, and so for the financial system. The Committee noted

[13] https://www.bankofengland.co.uk/paper/2022/an-fpc-response-amendments-to-the-fpcs-framework-for-the-o-sii-buffer
[14] https://www.bankofengland.co.uk/-/media/boe/files/paper/2016/the-financial-policy-committees-framework-for-the-systemic-risk-buffer.pdf
[15] https://www.bankofengland.co.uk/financial-stability/resolution/resolvability-assessment-framework/resolvability-assessment-of-major-uk-banks-2022
[16] The FPC made the decisions for this topic by written procedure.
[17] https://www.bankofengland.co.uk/news/2022/may/boe-publishes-results-of-the-2021-biennial-exploratory-scenario-financial-risks-from-climate-change

that climate risks captured in the CBES scenarios were likely to create a drag on the profitability of UK banks and insurers. Firms' submissions suggested that overall costs would be lowest with early, well-managed action to reduce greenhouse gas emissions and therefore limit climate change.

72. In line with the Bank's objective to protect and enhance the stability of the UK financial system, the Bank and FPC would continue to work on this important topic. This would include working with banks and insurers to improve climate risk management, and support wider work to develop standards and frameworks for net zero transition. The FPC would also monitor any risks to the financial system as a result of possible large-scale withdrawals of credit from particular sectors. More broadly, the Committee noted the PRA's Climate Change Adaptation Report[18], published in October 2021, which stated that further work was required to identify whether changes in the design, use or calibration of the regulatory capital framework were needed to ensure resilience against the consequences of climate change.

The FPC's secondary objective and the Government's energy security strategy

73. On 7 April 2022, the FPC had received from the Chancellor a letter[19] setting out an additional recommendation in relation to the Government's energy security strategy. The letter recommended that where practical and relevant, the Committee should have regard to the Government's energy security strategy and the important role that the financial system will play in supporting the UK's energy security - including through investment in transitional hydrocarbons like gas - as part of the UK's pathway to net zero. This additional recommendation was supplemental to the recommendations set out in the HM Treasury's March 2021 remit and recommendations letter to the FPC.

74. The FPC agreed that they would, as required by statute, provide a formal written response to the recommendation when appropriate, in the usual way, as part of its response to the annual remit and recommendations letter.

Nature risks

75. In the Chancellor's March 2021 remit and recommendations letter to the FPC[20], HM Treasury had asked the FPC to consider the potential relevance of other environmental risks (in addition to those posed by climate change) to its primary objective.

---

[18] https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021

[19] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1067016/Recommendations_for_the_Financial_Policy_Committee_April_2022_final.pdf

[20] https://www.bankofengland.co.uk/-/media/boe/files/letter/2021/march/fpc-remit-and-recommendations-letter-2021.pdf

76. The FPC discussed that there was growing global attention on the potential for broader nature loss and degradation to cause financial risks (for example, in the NGFS-INSPIRE March 2022 report[21]), albeit the collective understanding of how nature-related risks could give rise to financial risks was in its infancy globally.

77. The FPC agreed that the Bank should seek to build its understanding of how these risks might arise and their potential materiality for UK financial firms and so the UK financial system.

Liquid asset usability

78. The FPC discussed that during the Covid stress, despite UK banks experiencing a relatively limited liquidity stress, there was still evidence of banks taking or considering taking defensive actions to support their Liquidity Coverage Ratios (LCRs). An over-reluctance to use high quality liquid assets (HQLA) in periods of unusual liquidity pressures could result in banks taking unnecessary liquidity-raising actions that could have adverse impacts on the wider economy and financial system.

79. The FPC welcomed the Bank and PRA's discussion paper[22] on liquid asset usability that was published in March 2022, as a way to continue to improve understanding of the issues around HQLA usability and to contribute to the ongoing work by the Basel Committee on Banking Supervision (BCBS) on the evaluation of Basel III reforms.

[21] https://www.ngfs.net/sites/default/files/medias/documents/statement_on_nature_related_financial_risks_-_final.pdf

[22] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/march/prudential-liquidity-framework-supporting-liquid-asset-usability

The following members of the Committee were present:

Andrew Bailey, Governor
Colette Bowe
Sarah Breeden
Ben Broadbent
Jon Cunliffe
Jon Hall
Anil Kashyap
Dave Ramsden
Elisabeth Stheeman
Carolyn Wilkins
Sam Woods

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

Nikhil Rathi was unavoidably unable to attend on 16 June. He communicated his views to the Governor beforehand.

As permitted under the Bank of England Act 1998, Anne Glover was present for the first hour[23] of the meeting the 16 June in her role as a member of Court.

In accordance with the relevant provisions of the Bank of England Act 1998, Carolyn Wilkins had notified the Committee of her Non-Executive Directorship of Intact Financial Corporation (including holding company of Royal Sun Alliance Group). It was agreed that she would recuse herself from discussions on insurance firms, which for this round included the Climate BES, and that she would not receive the related papers.

[23] This covered discussion of the outlook for UK financial stability and global debt vulnerabilities.

Annex: Financial Policy Committee policy decisions

Outstanding FPC Recommendations and Directions (as at the date of the FPC's meeting on 16 June 2022)

The FPC has no Recommendations or Directions that have not already been implemented. However, the withdrawal of the mortgage affordability test recommendation that was agreed on 16 June 2022 will come into effect on 1 August 2022 (see below).

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 increase the UK CCyB rate from 1% to 2% on 16 June 2022, with binding effect from 5 July 2023. 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.[24] 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.

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

The PRA and the FCA have published their approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[25] and the FCA has issued general guidance.[26]

Mortgage affordability

At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability test 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.

At its meeting on 16 June 2022, FPC withdrew the affordability test Recommendation, with effect from 1 August. The FPC judged that the LTI flow limit Recommendation, in tandem with the FCA's affordability testing under its Mortgage Conduct of Business framework, ought to deliver the appropriate level of resilience to the UK financial system, but in a simpler, more predictable and more proportionate way.

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**[27] (see Annex).

---

[25] 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**.
[26] See **www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending**.
[27] https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2021/october-2021.pdf

The PRA has published its approach to implementing this Direction and Recommendation[28].

[28] https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/changes-to-the-uk-leverage-ratio-framework