FINANCIAL STABILITY REPORT PRESS CONFERENCE

Wednesday 6 December 2023

Opening remarks by Andrew Bailey, Governor of the Bank of England

Welcome to the press conference for the December Financial Stability Report.

Before answering questions, I would like to highlight some key themes from the Report and the announcements and publications that we are releasing today:

- The first is our assessment of the conditions facing UK households and businesses. On balance, we judge that while the full effect of higher interest rates has yet to come through, so far borrowers on the whole and the financial system have been resilient to these changes.
- The second is our analysis of global developments. Since the July Report, a number of risks in China have continued to crystallise, and geopolitical risks have increased following the tragic events in the Middle East.
- The third is our judgements on the resilience of the UK banking system, including our decision on the countercyclical capital buffer. UK banks are well capitalised and have high levels of liquidity, and the FPC is maintaining the CCyB at its 2% neutral setting.
- Finally, I will conclude by updating you on our work on the resilience of market-based finance, including our system-wide exploratory stress test.

UK households and businesses

The overall risk environment remains challenging. Across advanced economies, the outlook for inflation and growth is uncertain.

Financial markets currently expect that central banks in the UK, US and euro area are at or near their peak interest rates. These rates are likely to need to remain at these levels for an extended period to bring inflation back to target on a sustained basis. Doing so in turn also supports our financial stability objective.

The full effect of higher interest rates has yet to come through. Therefore, we remain vigilant to financial stability risks that might arise. However, so far UK households and businesses as a whole have been resilient to the impact of higher and more volatile rates.

Focusing specifically on households, finances remain stretched by the high cost of living.

- As part of this effect, mortgage debt servicing burdens have risen and will likely continue to do so over the coming year.
- We have also seen an increase in arrears for borrowers. This applies to owner-occupier and buy-to-let mortgage arrears, as well as unsecured consumer credit.
- Some buy-to-let landlords have passed on these higher costs to renters.

However, in spite of this, arrears are low relative to historical averages. While we expect them to increase, mortgage arrears are likely to stay well below the 2008 peak. The overall household debt to income ratio has been falling in 2023 and is at its lowest level since 2003.

Turning to corporates, businesses remain under pressure given higher borrowing costs.

- Again, we have seen increases in arrears in some sectors over the past year, such as SME loans.
- In addition to SMEs, there are other pockets of riskier borrowers in the corporate sector where refinancing pressures could have a material impact, such as highly leveraged firms – particularly those reliant on market-based finance.

<u>However, we judge that the UK corporate sector as a whole has remained resilient to high interest rates and weak growth.</u> Strong earnings growth has driven a fall in the total corporate debt relative to earnings measure from its recent Covid peak to the lowest point in the last 20 years in Q2 this year.

Global outlook

<u>A key uncertainty in our assessment of the global outlook is around the path of the Chinese economy.</u> In the past few months, we have seen that some of the risks in the Chinese property market have continued to crystallise, and there are still downside risks.

- Real estate investment had fallen by around 17% in October relative to a year earlier, and total floor space sold was down by around a fifth.
- Chinese developers have continued to default in the face of falls in sales and tighter financial conditions, with particular concerns around Country Garden and Evergrande.
- Meanwhile the outlook for the mainland Chinese economy more broadly remains subdued.

While the Chinese authorities have put in place measures to support the property sector, if these trends spilled over to the rest of the economy, they could have a wider impact. A key channel which we observe closely is UK banks' exposures to both mainland China and particularly Hong Kong.

Our latest stress test showed that UK banks were resilient to a severe global recession that included very significant falls in real estate prices in mainland China and Hong Kong. However, we continue to monitor closely developments in this space.

<u>We have also seen an increase in geopolitical risks this year as a result of the tragic events in the Middle East.</u> The conflict in Gaza has increased uncertainty around the economic outlook, particularly with respect to energy prices. If these risks crystallised, this could impact both the macroeconomic outlook in the UK and globally, as well as increase financial market volatility.

UK banking system resilience

<u>Turning to our assessment of the UK banking system, we judge that it is well capitalised and has high levels of liquidity.</u>

This judgement also informs our assessment that if economic and financial conditions were materially to worsen for UK households and businesses, our banking system has the capacity to support them.

There are some forms of lending which are more exposed to credit losses as borrowing costs rise. These include loans to finance:

- Commercial real estate investments;
- Buy-to-let properties; and
- Highly leveraged lending to corporates, as well as to other lenders to the corporate sector.

In terms of wider trends around lending and profitability, we observe that:

- Overall lending remains subdued, reflecting reduced demand from borrowers as well as more caution from banks over the past two years.
- There is some evidence that net interest margins have peaked, however the aggregate profitability of the major UK banks is nevertheless expected to remain robust.
- We have also set out our views today on some of the wider trends affecting the banking system given changes to central bank balance sheets. Banks will need to factor these into their liquidity management and planning over the coming years.

Based on these developments, and the broader financial stability outlook, the FPC has decided for Q4 to maintain the UK CCyB rate at its neutral setting of 2%.

The resilience of market-based finance

I would finally like to say a few words about our approach to the risks posed by non-bank financial institutions. Since the last Financial Stability Report, we judge that vulnerabilities in some parts of the non-bank landscape have increased.

- First, funds which have been investing in riskier corporate borrowing have seen outflows. Riskier corporate borrowing in financial markets such as private credit and leveraged lending appear particularly vulnerable in the current environment.
- Second, there are now larger imbalances in the market for derivatives on US Government debt – a core asset in the global financial system. These imbalances involve the leveraged positions of asset managers and hedge funds, and they could result in significant market volatility in the event of a shock.

As we saw in episodes like the dash for cash and the LDI crisis, sharp movements in asset prices could lead to dysfunction in core markets and tighter credit conditions. The Financial Stability Board has an active work programme in place designed to tackle some of these risks, and we are also working to reduce UK vulnerabilities.

- First, we welcome the proposals to increase the resilience of UK-based money market funds, which have been published today.
- Second, we have released our scenario for the first system-wide exploratory stress test. This will draw together the behaviours of a broad range of financial institutions – both banks and non-banks – in a severe stress. It will explore how their actions might interact to amplify financial stability shocks.

Conclusion

In closing, our assessment is that while the overall risk environment has not materially changed since July, it remains challenging. The outlook for the economy is uncertain and there are new geopolitical risks.

While the system has so far been resilient to the impact of higher and more volatile interest rates, the full effect of these changes is yet to be felt – and we remain vigilant to them as they unfold.

I want to end on a personal note. Last week, very sadly Alistair Darling passed away. Alistair was an outstanding public servant in the very best sense of the term. He was wise, kind and had a wicked sense of humour.

As Chancellor, he was thrust into dealing with the consequences here of an accumulated loss of financial stability worldwide. He dealt with almost unimaginable situations in the most professional way. His example serves as a reminder of why preserving financial stability is so important.