Financial Stability Report Press Conference

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Kate Ferguson, The Sun: You say that currently you're in a position to cushion the economic shocks. I wondered, how bad would inflation have to get or how much worse would the economy have to get for us to be looking at a situation where people are defaulting on their mortgages and it gets a lot worse for everyday households? Secondly, if I may, in your report, you talk about 1 in 3 SMEs not having enough cash-flow to see them through 7 days. Can you talk a little bit about that? How big a problem is that for that sector of the economy? How worried are you about SMEs and what SMEs are we talking about?

Andrew Bailey: Let me start off. I'm sure Jon and Sam will want to come in, and they're very good and important questions. Obviously, we'll take households and SMEs separately. I think a key point to make on households is that there are a number of factors which do have the right sort of what I might call buffering and protection effects. I've said this before and I said I wasn't going to say anything about monetary policy, and don't take this as any comment on what's going to happen but it's an important comment on the inflation we're seeing. It is important and it is, I'm afraid, very unfortunate, but because it's concentrated in what I call the essential goods that people consume, obviously particularly in energy and food, it therefore effects low-income households more severely because, quite naturally, their consumption is more weighted towards those essential goods. We're very cognisant of that. Now, the measures the government's announced on energy are very welcome in this respect because they are targeted at low-income households and I think that is absolutely the right thing to do, first of all. Secondly, we have taken a number of steps, as the FPC, over the years to ensure that the vulnerability of households who have problems is more manageable, I would particularly mention here the mortgage measures that we've taken. The so-called low to income flow limit is important for that because it does act to, if you like, put a cap on the number of households that are exposed.

There has been a growth also in the proportion of fixed-rate mortgages in the market and that too will have, obviously, an effect in terms of buffering, immediate effects. Those things are important. There is also, and Jon may want to come and talk about this, there's quite a helpful chart, well 2 charts actually, in the report and I'll leave Jon to talk about those. On SMEs just briefly for me and then I'll hand over. You're right to highlight SMEs because, in the report, we do highlight a difference between, if you like, the resilience of larger firms and SMEs. What I would say is the report does point out that more SME borrowing has been done at fixed rates, and that will obviously help to buffer. Then I'd come back to the general point I make, and this is very important, that the banking system is now more resilient. It has the capacity to support SMEs through difficult periods in ways that we didn't see during the financial crisis. Jon, I'll hand over to you.

Jon Cunliffe: Yes. I think I'd say the proportion of households who could get into real stress on their repayments, it's normally when repayments are about 40% of your income, is a

number we always watch very carefully and we always look to see what interest rate increases will be needed to take that share back to historically high levels, levels we've seen in the past, 2.7% was the highest we saw before the financial crisis. Of course, households now are facing a cost of living squeeze and they're facing higher interest rates. What we've done, and that's the charts the Governor referred to in the FSR, which are worth looking at, what we've done is we've tried to calculate, we've put the cost of living squeeze and the interest rates, I'm not going to tell you where Bank of England interest rates are going to go, you wouldn't expect me to, but the interest rates that the market is expecting. We put the market interest rates in and we put in the cost of living squeeze. What's going to happen to that number of households that get into, basically, debt service as a high proportion of their income, both for mortgages and for consumer credit. I think, as the Governor said, the impact this year is not expected to be great. In part, that's because of the government's action, which is cushioning the impact on lower income households, and in part because a lot of mortgages, the majority of mortgages, now are fixed rate for 2 to 5 years. Mortgage rate increases come through more slowly. We expect that to rise next year but we don't expect it to go back to some of the historically high levels we saw before the financial crisis.

Of course, there's great uncertainty about what will happen, for example, to energy costs, which is dependent on what happens following Russia's invasion of Ukraine but as it stands now, on the basis of the Monetary Policy Committee's forecasts on market interest rates, we don't see that share rising that much this year. We see it rising further next year. That's about debt distress, that's not to lose the point that, for many households, particularly those at the lower end of the income bracket, with few savings, the cost of living squeeze is going to exert more pressure.

Andrew Bailey: The charts are on page 21, by the way, for reference.

Ben Martin, The Times: Can I ask what lessons and insights have the bank learnt so far from its review into what happened at the LME earlier this year?

Andrew Bailey: Obviously, on the LME, there are, as you know, 2 reviews going on. 1 is in our area of responsibility, which is the clearing house, and the other one is the FCA's. I think the thing that I would point to initially, and again, Jon may want to come in as well, is that 1 of the things the LME has already done, and I think this is a very important thing to do, is that it has required more transparency in the OTC, over-the-counter, positioning in its markets. I think 1 thing that's clear from that incident is that to judge and to risk-manage in a market like that, where you've both got OTC trading and on-exchange trading, you have to see the whole picture. I think to think that you can risk-manage by seeing 1 part of that picture, I think, as we saw, opens up the risk, and particularly when you get very large positions, as happened, in 1 part of the landscape, that's the OTC part actually. Obviously then, in a sense, rebounded into the exchange credit market part of it. Obviously, the reason I highlight the reviews going on, it's by no means over, but I think that is a particularly important first step to take. Jon, do you want to?

Jon Cunliffe: Yes, we'll have to see when the review comes out and I don't want to pre-empt that but we saw general stress in commodity markets after Russia's invasion of Ukraine. We saw it in what happened to industrial metals but what we saw in nickel was something much more extreme than what we saw in other industrial metals. While the invasion of Ukraine by Russia was clearly a factor in putting general stress on the market, there are a specific set of circumstances, I think, operating at the London Metal Exchange. 1 of them, I think a very important one, as has just been said, is there was a very large short position in the over-the-counter market which couldn't be seen, and when that position was squeezed, the prices came into the lit market. I think there are some really important lessons there about transparency in these markets, so that players can see that.

We saw that transparency issue also in a very different world, in Archegos, when a number of the players didn't really understand what was in the market. So, I think there'll be some lessons about transparency. When you get a price increase, where the price doubles overnight and then doubles again, there are questions about, 'To what extent do you need speed-bumps in the market?' Other markets have them. Then, of course, there's a question of very different sorts of players in commodities markets and other financial markets. You've got people who are supplying the real economy. You've got people who are hedging, people who are speculating and the like, and we need to think about the resilience in those markets. So I think, while there are specific circumstances, I think there'll be general lessons to learn as well for the way these markets operate.

Andrew Bailey: I think it's important to bear in mind, just developing what Jon was saying for a moment, that for some of these markets, some of these metal markets, for instance, what I might call the structural demand for these metals is changing because they're actually in demand particularly for sustainable products, like batteries for cars. I think it's important that the market structures keep up and reflect the change in the supply/demand balance in these markets that's going on, and indeed the size of these markets because certain commodities are now obviously highly in demand for these environmentally sustainable products.

Joel Hills, ITV News: I'm just looking at Chart 1.3. What level would bank rate have to reach for debt servicing ratios or mortgage debt to return to pre-financial crisis levels? 2.8% here, isn't it, percentage of households. What level would bank rate have to reach to get back to those levels please?

Andrew Bailey: Well, we stress the market rates quite substantially. It's not a straightforward question, I think, because of the shift, as Jon was just saying earlier, towards a fixed interest rate structure, a lot more mortgages are now on fixed interest rates, and therefore the pass-through of changes by the Monetary Policy Committee on bank rates takes effect differently.

Jon Cunliffe: For illustration, I'll give you a number which is easier to calculate, I think, on the corporate side. Okay, there are uncertainties but as the paper discusses, you'd need to see bank rate going somewhere between 2 and 500 basis points over where the market is expecting it. I think the market's got interest rates going to nigh-on 3%, you'd be looking at 5

to 7 to 8 on the corporate side. The picture is not that dissimilar on the mortgage market side because again, you've got mortgage market, consumer debt and you have got this question of how it comes through over time. I'd say, on the corporate side, it's important to remember that some of the corporate debt is fixed rate, some of the corporate debt is floating, right, and you have to make assumptions about what proportion is what, which is why there is a range. These are, maybe the best way to say it, rates significantly above where the market has them.

Andrew Bailey: There's a lot more resilience in the system in that sense. The figures Jon was giving, just for the corporate sector, for large corporates, the bank rate curve, I think, currently goes up to about 3%. The numbers Jon was giving you are on top of that.

William Shaw, Bloomberg: The government's interested in the possibility of very long mortgages, possibly 40, 50 years. Do the Bank of England and PRA view that as something that would help people cope with interest rate rises and the general strain on affordability, while also unlocking home-ownership for younger people? Or are there potential risks around that?

Andrew Bailey: I'll hand over to Sam. I would start with a general point here, which is that our approach, as a central bank and regulator, is that we will support and engage in any process which wants to, in a sense, envisage innovation in the market of that sort. It's something that we would certainly support a review of to see what is possible in the market. If it comes forward, we will certainly play our part in it. Sam do want to?

Sam Woods: Thanks, well I'd say we've got a completely open mind on it. That's not currently a feature of our market but as you know and as we point in the report, there are other markets which function perfectly well, non-UK markets, which do have much longer fixed rate mortgages, I think not often 50 actually but much longer than we're used to. I think, if such a product came forward in the market, we'd approach that with an open mind, whether it could be provided by banks or by insurance companies, but I think our job would then be just to make sure that the prudential regulation could be adapted as needed to capture any risks that came with that.

Lucy Hager, Market News: Just returning to the climate topic, what is the biggest potential green risk that you're seeing to financial stability? Are you seeing any more medium-term risks for financial stability as adoption of climate change measures get pushed back due the invasion of the Ukraine?

Andrew Bailey: Well, I think our approach on climate change is this. Some people sometimes say, 'It's a bit dilettante for central banks to be involved in this,' and I really reject that. Just to give you a little bit of history actually, it's worth starting with a bit of history, the Bank of England started its work on climate change, actually in the PRA, on the insurance industry, and the reason for that was that insurers typically hold assets for much longer, and therefore are much more exposed to the long horizon risks. Therefore, we could see that climate change was going to come into our world, as it were, directly, first through that channel, but what, of course, we've seen subsequently is that it's right to extend that to both

the banks, but also actually to the economy more broadly. I said this morning I'm not going to talk about monetary policy and again, I'm not speculating on monetary policy but the point I want to make is that this is affecting the economy around us, as we know, therefore it's important that we do look at it and that we do take it seriously. That's why I do push back on people who take the other view and that's why the bank does regard it as something that's important, as do other central banks, by the way. We are doing a lot of work at the moment with other central banks globally on macro-economic scenarios which seek to build in and model climate change more effectively. Now, of course it is a medium-term risk because the time horizon for these scenarios and the time horizon, obviously, for the adjustment that needs to be made is much longer than we normally deal with, certainly if you look at our stress tests for instance, but that's appropriate, given the nature of the risk.

It's appropriate that we have both a short-term and a medium-term focus in this respect. Now, I should say that medium-term economic scenarios are essentially, of course, quite challenging, in the sense that, obviously, the uncertainty goes up the further you go out, but you probably saw, obviously, the work we published as a result of the exploratory scenarios. As I say, those are the scenarios, with other central banks, we're going to keep working on to develop but I think it's absolutely essential that we do this work. I should also say that there are other very essential parts of the work going on which we're heavily involved in both as the FPC and because all 3 of us are heavily involved in the global financial stability board as well. I would put a lot of emphasis on the work that is being done by the ISSB to produce consistent reporting and measuring standards. I think that work is coming along very well, and I'm optimistic that while I think obviously countries will want to do somewhat variants of their own approaches, I understand that, but there will be a core of standards in there for reporting and measurement which will give us a much stronger basis to go forward both domestically and internationally.

Sam Woods: Just one point on the exploratory scenario that we ran, and we provided a summary of that in this report as well, it's interesting that we found from that that the cost of the transitional parts to the various insurance companies on the somewhat necessarily stylised scenarios that we ran would be equivalent to 10-15% of annual profits through those very long scenarios, and my comment about that would be (1) that is obviously a very significant number and something that firms will therefore need to manage but (2) it's not obviously the sort of thing that we would leap to a need to capitalise upfront with a special, new climate requirement. Now, that's not a settled position but I think that's a reasonable point to take from what we've published. The big caveat to that is what we did not test was a trading risk stress. I think the most obvious way to think about that is a policy shock. If you had a sudden and unanticipated hardening of climate policy perhaps in reaction to some event that happened that could potentially move asset prices around in a very dramatic way. I think that bit we have to come back to.

Siddharth Venkataramakrishnan, Financial Times: I was just curious on the notes of the tentative signs of tightening lending, whether you're concerned at all about areas of subprime

lending such as buy now, pay later taking a lot of the slack and what impact that might have on broader market conditions?

Sam Woods: What we're seeing, as you say, is just very tentative signs of tightening. We talk about this a bit in the report but what you're seeing is banks, I think very sensibly, adjusting their own affordability tests to take into account cost of living pressures, which I think we would expect them to do, on extension of new consumer credit, perhaps moving up the credit worthiness scales a bit. I think all of that you would anticipate it's quite small at the moment. Whether if the banks tighten that supply of finance in effect spills out to non-bank lenders of various kinds, there's buy now, pay later but there are also obviously many others. That I think's an open question and we'd have to see what happens. What I would say though is that the FCA I think has been taking very sensible steps to control bits of that market, particularly the high cost lending market, so to prevent, if you like, a perfectly sensible thing happening in a banking sphere leading to a worst consumer outcome in those non-banking areas.

August Graham, PA Media: In the past I think it's fair to say that the bank said that there's not been much impact or there's not much risk to their regular financial system from the crypto market. Now in the recent collapse there I was just wondering if that's changed your mind at all? If there's any new assessment on that front?

Andrew Bailey: I'll start off, I know Jon will want to come in, because we both spend a lot of time on this both domestically and internationally. First of all, of course, I mean, I'm afraid it hasn't changed the underlying view, and particularly I'm talking here about what we tend to call unbacked crypto. I'm going to make the distinction of unbacked crypto and so-called stable coins. I've been saying for a number of years that unbacked crypto in my view doesn't have intrinsic value. Doesn't mean to say of course it doesn't have value but it doesn't have intrinsic value, and that people should be very clear on the risks that are being taken there by investing in it. I think both the experience that we've had in recent weeks and also the work that we're doing both domestically and internationally I think further draws out that there are issues both in the unbacked crypto world and the so-called stable coin world. I tend to draw the distinction that I think unbacked crypto is better viewed as an investment, as I say bearing in mind what I've just said about intrinsic value, but I mean as an investment, 'store of value', as I say that's heavily qualified by what I just said, whereas I think stable coins are better viewed in terms of thinking about the uses of money as a means of payment. Now, I think we are both domestically and internationally therefore thinking about these 2 things together because obviously they're both developing quickly and there are interconnections, but I think they need a different lens, and that's what we're doing in terms of how we approach it. I'll hand over to Jon.

Jon Cunliffe: I think what I'll say is we reached a judgment last year, a number of us publicly, that the crypto market had grown very quickly, I think £2.3 trillion, £2.4 trillion, was growing, was starting to be integrated into what I would call the non-crypto conventional financial sector but it wasn't yet of a size or integration that was a financial stability risk. Well, it's lost, if you're looking at crypto assets, 70% of its value for bitcoin and Ether I think

will be the ones to take in recent weeks. We haven't seen an impact on the financial system as a whole so that judgement I think that it wasn't yet at a point where it would cause a financial stability risk, for the moment anyway, is borne out. I think what's also borne out, bluntly, is that technology doesn't change the laws of economics and finance and risks. It may enable you to manage them in different ways but if an asset is speculative and has no intrinsic value, it's only worth what somebody pays for it, it can go down very quickly when confidence is lost.

If you use something, as Andrew says, as money in a transaction and call it a stable coin, but if people lose confidence in that because they don't see how it's going to maintain its value, you know, think Terra, think LUNA, then you'll see stress across the system. If somebody borrows short to invest in highly speculative assets we call it leverage. When those assets start to drop in value there's a real pressure to sell those assets in fire sales, and we've seen that. We've seen all those lessons play out in the conventional financial system, that's why we have regulation to deal with it, and I think for me it underlines the fact that we need now to bring in the regulatory system that will manage those risks in the crypto world in the same way that we manage them in the conventional world. It's not something intrinsically different because the technology though you may have to apply the rules in a different way. I wouldn't take the lesson that we don't have to do anything because this has gone away. I think the technology has some real potential for use in the financial system more generally but we do have to get on with the work of putting in place the regulated framework, same risk, same regulatory outcome, and I think you've just seen the need for that in what's happened.

Andrew Bailey: I would add it's key that the work is done internationally because these are, as you know, international markets in that sense. These are instruments that cross borders very easily.