Bank of England

Financial Policy Summary and Record of the Financial Policy Committee meeting on 3 July 2023

12 July 2023

This is the record of the Financial Policy Committee meeting held on 3 July 2023.

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

The Financial Policy Committee (FPC) was established under the Bank of England Act 1998, through amendments made in the Financial Services Act 2012. The legislation establishing the FPC came into force on 1 April 2013. The objectives of the Committee are to exercise its functions with a view to contributing to the achievement by the Bank of England of its Financial Stability Objective and, subject to that, supporting the economic policy of His Majesty's Government, including its objectives for growth and employment. The responsibility of the Committee, with regard to the Financial Stability Objective, relates primarily to the identification of, monitoring of, and taking of action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC is a committee of the Bank of England.

The FPC's next Policy meeting will be on 26 September 2023 and the record of that meeting will be published on 10 October 2023.

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.

Key developments since the December 2022 FSR

Since the December 2022 Financial Stability Report, global interest rates have risen further, reflecting actual and expected increases in central bank policy rates in response to continued inflationary pressure. Returning inflation to target sustainably will support the FPC's objective of protecting and enhancing UK financial stability.

The sharp transition to significantly higher interest rates and greater market volatility over the past 18 months has, however, created stress in the financial system through a number of channels. The failure of three mid-sized US banks – and the failure of a global systemically important bank (G-SIB), Credit Suisse, due to long-running concerns about its risk management and profitability – caused a material rise in financial market risk premia and volatility earlier this year. The impact on the UK banking system through lower bank equity prices and increases in funding costs was limited, and market risk sentiment has stabilised since then. Nonetheless, elements of the global banking system and financial markets remain vulnerable to stress from increased interest rates, and remain subject to significant uncertainty, reflecting risks to the outlook for growth and inflation, and from geopolitical tensions.

In the UK, given the prevalence of variable-rate and short-term fixed-rate mortgages and other loans, the impact of higher interest rates is relatively lower in the financial system than in the real economy, compared to some other jurisdictions.

The UK economy has so far been resilient to interest rate risk, though it will take time for the full impact of higher interest rates to come through. In the financial system, interest rate risks crystallised in Autumn 2022, with stress in liability-driven investment (LDI) funds requiring a temporary and targeted intervention by the Bank. The ability of those funds to absorb shocks has since been reinforced through the setting of new standards, and the rest of the UK financial system has so far been resilient to higher interest rates. This is partly due to the range of regulatory measures introduced after the global financial crisis to manage interest rate risk and to build resilience into the financial system more generally.

The impact of higher interest rates on UK household and corporate debt vulnerabilities

Higher interest rates increase debt-servicing costs facing household and business borrowers. This makes them more likely to cut back on spending, worsening the economic environment, and increases the risk that they will default on loans. Both these factors increase credit risks for lenders.

In the UK, more households are being affected by higher interest rates as fixed-rate mortgage deals expire. The proportion of households with high debt service ratios, after accounting for the higher cost of living, has increased and is expected to continue to do so through 2023. But it is projected to remain some way below the historic peak reached in 2007.

There are several factors that should limit the impact of higher interest rates on mortgage defaults. Given robust capital and profitability, UK banks have options to offer forbearance and limit the increase in repayments faced by borrowers, including by allowing borrowers to vary the terms of their loans. There are now stricter regulatory conduct standards for lenders with respect to supporting households in payment difficulties. And on 23 June, the principal mortgage lenders, the Chancellor and the Financial Conduct Authority (FCA) agreed new support measures for mortgage holders.

The FPC's mortgage market measures, introduced in 2014 – including its loan to income flow limit on lending to borrowers with high loan to income ratios at or above 4.5 – and the FCA's responsible lending requirements, have limited the build-up of household indebtedness in the mortgage market. This has increased borrower resilience and played a role in reducing payment difficulties for residential mortgagors.

Buy-to-let mortgagors are also experiencing increases in mortgage interest payments, and other structural factors are also likely to put pressure on their incomes. This could cause landlords to sell, putting downward pressure on house prices. Alternatively, they may seek to continue to pass on higher costs to renters. Similar to other forms of borrowing, buy-to-let mortgages are subject to affordability testing. In 2016, the PRA issued a supervisory statement outlining its expectations for underwriting standards in the buy-to-let market to safeguard against a deterioration in such standards.

The overall number of mortgages in arrears increased slightly over the first quarter of 2023 but remained low by historical standards. It will take time for the full impact of higher interest rates to come through.

The UK corporate sector is expected to remain broadly resilient to higher interest rates and weak growth. Nevertheless, higher financing costs are likely to put pressure on some smaller or highly leveraged firms. The debt-weighted proportion of medium and

large corporates with low interest coverage ratios is projected to continue to increase throughout 2023 as debts are refinanced at higher rates, although it is expected to remain some way below previous peak levels.

While corporate insolvency rates have risen above pre-Covid rates, they remain low relative to longer-term average levels. The large majority of the increase in insolvencies has been among very small firms that hold little debt, and a high proportion of the debt they do hold is fixed at low rates and government guaranteed. More broadly, the corporate sector has been repaying debt and its near-term refinancing needs appear limited.

UK banking sector resilience in the context of higher interest rates

The UK banking system is well capitalised and maintains large liquidity buffers. Asset quality overall remains relatively strong, with higher interest rates having had a limited impact on credit risk so far. However, the overall risk environment is challenging. Some forms of lending, such as to finance commercial real estate investments, buy-to-let, and highly leveraged lending to corporates – as well as lenders that are more concentrated in those assets – are more exposed to credit losses as borrowing costs rise.

Major UK banks' capital and liquidity positions remain robust and profitability has increased, which enables them both to improve their capital positions and to support their customers.

In aggregate, smaller lenders are also well capitalised and maintain strong liquidity positions. These lenders typically hold greater amounts of capital as a share of their risk-weighted assets, relative to regulatory requirements, than larger firms and maintain significant liquidity buffers.

The results of the 2022/23 stress test indicate that the major UK banks are resilient to a severe stress scenario that incorporates persistently higher advanced economy inflation, increasing global interest rates, deep simultaneous recessions in the UK and global economies with materially higher unemployment, and sharp falls in asset prices. The stress test scenario is not a forecast of macroeconomic and financial conditions in the UK or abroad. Rather, it represents a 'tail risk' scenario designed to be severe and broad enough to assess the resilience of UK banks to a range of adverse shocks.

The rise in interest rates from a low level has increased bank net interest margins in aggregate. But the fact that higher rates also reduce the market value of banks' fixed-rate assets can present risks to all banks. UK banks manage these risks through their hedging practices within a regulatory framework that includes rules designed to ensure that UK banks have capital against interest rate risks in their banking book, the maintenance of substantial liquid asset buffers, supervision by the PRA, and regular stress testing.

The FPC continues to judge that the UK banking system is resilient, and has the capacity to support households and businesses through a period of higher interest rates, even if economic and financial conditions were to be substantially worse than expected.

The FPC judges that the tightening of lending standards seen over recent quarters does not reflect banks restricting lending primarily to protect their capital positions. The FPC will continue to monitor UK credit conditions for signs of tightening that are not warranted by changes in the macroeconomic outlook.

The FPC agreed to maintain the UK countercyclical capital buffer (CCyB) rate at 2%. This will help to ensure that banks have sufficient capacity to absorb future shocks without unduly restricting lending. The FPC stands ready to vary the UK CCyB rate, in either direction, in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment.

The impact of higher interest rates on global vulnerabilities

Higher interest rates have affected households and businesses in other advanced economies in similar ways. Jurisdictions where long-term fixed-rate mortgages are more prevalent are likely to have financial sectors that are more naturally exposed to interest rate risk. **Riskier corporate borrowing in financial markets – such as private credit and leveraged lending – appears particularly vulnerable, and global commercial real estate markets face a number of short and longer-term headwinds that are pushing down on prices and making refinancing challenging.**

Lessons from the recent global banking sector stress

The UK's regulatory and institutional framework has supported UK financial stability through recent stresses in parts of the global banking system, underlining the importance of maintaining robust macroprudential, regulatory and supervisory standards. Nevertheless, the FPC will draw lessons from the episode.

For example, the impact of the stress underscored how contagion can spread across and within jurisdictions, even where smaller institutions are involved. It also highlighted that while an individual institution may not be considered systemic, if a risk is common – or perceived to be common – among similar institutions, the collective impact can pose a systemic risk.

The stress highlighted the need for all banks to be adequately capitalised against the risks they are exposed to, including interest rate risk. This is consistent with the PRA's current regulatory frameworks, as well as its initiative to maintain the resilience of the smallest UK banks while considering measures to simplify regulatory requirements for these lenders, known as 'Strong and Simple'.

Deposit outflows at some regional US banks were large and rapid, with digital banking technology and social media playing a role in increasing the speed at which information was shared and deposits withdrawn. The Bank will contribute to relevant international work to consider whether lessons can be learnt for the liquidity framework for banks, or components of it, in the light of the size and pace of outflows witnessed in recent events.

These events also showed the importance of being able to resolve firms effectively and of maintaining confidence in resolution frameworks. **In co-ordination with HM Treasury, the Bank is seeking to ensure that for small banks, which do not need to hold additional resources to meet the minimum requirement for own funds and eligible liabilities (MREL), there are resolution options that improve continuity of access to deposits and so outcomes for depositors.** The FPC supports this work. The stress also demonstrated the importance of international authorities' commitment to ensuring that the resolution framework and plans for G-SIBs, in line with Financial Stability Board (FSB) standards, remain credible.

The resilience of market-based finance

Vulnerabilities in certain parts of market-based finance (MBF) remain. These could crystallise in the context of the current interest rate volatility, amplifying any tightening in financial conditions.

Although the business models of some non-bank financial institutions (NBFIs), such as pension funds and insurance companies, mean that they can benefit from the impact of higher interest rates, the use of derivatives to hedge their interest rate exposures can create material liquidity risk. Liquidity risks also arise when NBFIs use derivatives and repo to create leverage. These liquidity risks must be managed, as evidenced by the LDI stress seen in September 2022.

The risks from higher interest rates can also be amplified by NBFIs deleveraging and rebalancing their portfolios. The FPC will continue to develop its approach to monitoring such risks as the financial system adjusts to higher interest rates.

There continues to be an urgent need to increase resilience in MBF globally. Alongside international policy work led by the FSB, the UK authorities are also working to reduce vulnerabilities domestically where it is effective and practical.

For example, in March 2023, the FPC recommended that The Pensions Regulator (TPR) take action as soon as possible to mitigate financial stability risks by specifying the minimum levels of resilience for the LDI funds and LDI mandates in which pension scheme trustees may invest. Since then, both the FCA and TPR have published detailed guidance on LDI resilience. **The FPC welcomes this guidance and the steps taken by TPR and the FCA to ensure the continued resilience of LDI funds.** In recent months as interest rates have

risen further, funds have in general maintained levels of resilience consistent with the minimum levels recommended by the FPC in March, and have initiated recapitalisation at higher levels of resilience than previously. **The Bank will continue working with the FCA, TPR and overseas regulators to monitor the resilience of LDI funds closely.**

The Bank has recently launched its system-wide exploratory scenario (SWES) exercise, which will be the first exercise of its kind. It aims to improve understanding of the behaviours of banks and non-bank financial institutions in stressed financial market conditions. It will explore how these behaviours might interact to amplify shocks in financial markets that are core to UK financial stability. In bringing together information from various parts of the financial system to develop system-wide (and sector-specific) insights, it will be able to account for interactions and amplification effects within and across the financial system that individual financial institutions working alone cannot assess. The FPC supports the SWES and considers it an important contribution to understanding and addressing vulnerabilities in market-based finance.

Record of the Financial Policy Committee on 3 July 2023

1. The Committee met on 3 July 2023 to discuss and agree its view on the outlook for UK financial stability and other matters that would be included in the July 2023 Financial Stability Report (FSR). The FPC discussed the risks faced by the UK financial system and assessed the resilience of the system to those risks, including in light of the results of the 2022/23 annual cyclical scenario (ACS) stress test. The FSR and this document together record the judgements of the FPC and summarises the Committee's associated deliberations.

2. The Committee met subsequently on 11 July 2022 to confirm its response to the final results of the 2022/23 ACS.

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

Developments in financial markets

4. There had been a material increase in both shorter and longer-term UK government bond yields since the FPC's March 2023 meeting. This reflected actual and expected increases in the path of Bank Rate, given recent data that indicated greater inflation persistence in the context of a tighter labour market and continued resilience in demand. United States (US) and euro-area government bond yields had also increased, but by less than the UK.

5. The FPC judged that global financial markets remained subject to significant uncertainty, which reflected underlying uncertainties about the outlook for economic growth and inflation, and from geopolitical tensions – with volatility in some interest rate markets at particularly elevated levels. The Committee noted that credit spreads had widened in March but had largely retraced since, while equity indices in some markets had more than fully recovered. That left global risky asset prices broadly in line with their recent historical distributions (with the possible exception of US equities, where certain technology stocks in particular were relatively highly valued). But there was a risk that macroeconomic uncertainty was not sufficiently priced in.

6. The Committee noted that a deterioration in the global economic outlook, further increases in market interest rates, or further interest rate volatility could lead to sharp reductions in risky asset prices and further tightening in financial conditions for households and businesses. In addition, any such tightening could be amplified by vulnerabilities in market-based finance (MBF).

7. In line with higher volatility, liquidity in many markets deteriorated further in March following the failure of Silicon Valley Bank (SVB) and Credit Suisse (CS), but had since largely recovered. Primary market issuance of investment grade corporate bonds likewise had fallen amid risk aversion and heightened uncertainty in March, but had recovered since – though issuance remained subdued for riskier instruments, which may reflect increased risk aversion among investors.

8. Further detail on the analysis underpinning these judgements were set out in the 'Developments in financial markets' chapter of the July 2023 FSR.

Interest rate risk in the financial system and real economy

9. The FPC noted that the material increase in global interest rates over the past 18 months had been in large part driven by global inflationary pressures, to which monetary authorities had responded by raising policy rates. The FPC agreed that returning inflation to target sustainably would support the FPC's objective of protecting and enhancing UK financial stability.

10. However, the sharp transition to significantly higher interest rates and greater market volatility had created risks in the financial system through a number of channels, including:

- Increases in debt servicing costs for households and businesses, which could make borrowers more likely to be unable to refinance their debt, default (potentially increasing losses for lenders), or adjust their spending and saving behaviour, which could reduce the financial resources they had available to cope with future shocks;
- Reductions in the market value of fixed-rate assets, which could present risks if exposures were not managed prudently within a regulatory framework (as illustrated during the banking stress in the US in March 2023); and
- Liquidity risks from the use of derivatives or leveraged products if those users lacked sufficient liquidity to meet higher margin and collateral calls. The pressure of liquidity calls could lead to the fire-sale of assets (as evidenced by the liquidity-driven investment (LDI) stress in autumn 2022) and tighten credit conditions for households and businesses.

11. The FPC also agreed that the period of very low financing costs prior to 2022 meant that some parts of the financial system may be more vulnerable to higher interest rates.

12. The FPC noted that in the UK, given the prevalence of variable-rate and short-term fixed-rate mortgages and other loans, the impact of higher interest rates was relatively lower in the financial system than in the real economy compared to some other jurisdictions.

13. While the full impact of the higher interest rate environment would take time to be felt, the FPC noted that large parts of the UK financial system and real economy had been resilient to

the change in interest rates so far – as discussed in detail in the sections below. This in part reflected the range of regulatory measures introduced after the global financial crisis (GFC) to manage interest rate risk and to build resilience into the financial system more generally, including robust prudential standards for bank capital and liquidity and the FPC's mortgage market measures that limit the build-up of household indebtedness.

14. The FPC noted that there was more information available on interest rate risk in some parts of the financial system, such as entities regulated by the Bank and the Prudential Regulation Authority (PRA), the household sector, and to a lesser extent the corporate sector. But it was challenging to understand fully the distribution of interest rate risk held across the financial system due to the complexity and opacity of other exposures, including some of those in the non-bank sector. In particular, the FPC agreed it would continue to develop its framework for monitoring exposures to liquidity risk across the financial system via gilt repos and interest rate derivative positions.

15. Further detail on the analysis underpinning these judgements were set out in the 'Interest rate risk in the economy and financial system' Financial Stability in Focus.

The impact of higher interest rates on UK household and corporate debt vulnerabilities

UK household resilience

16. The FPC noted that higher interest rates were impacting more households as fixed rate mortgage deals expired. Around half of mortgage accounts (around 4.5 million) were estimated to have faced an increase in their payments since mortgage rates started to rise in late 2021. Higher rates were expected to affect the vast majority of the remainder (around 4 million) by the end of 2026.

17. The Committee judged that the aggregate mortgage debt servicing ratio (DSR) would rise as higher interest rates affected more households – from 6.2% to around 8% by mid-2026 – but was expected to remain below the peaks preceding the GFC and 1990s recession. Additionally, the household debt to income ratio was 118% in 2023 Q1, much lower than at the GFC peak (around 150%).

18. Furthermore, since the end of 2022, higher interest rates and cost-of-living pressures had led to an increase in the proportion of households with high mortgage cost of living adjusted debt servicing ratios (COLA-DSR), from 1.6% in 2022 Q3 to 2.0% in 2023 Q1. The proportion was expected to continue to increase to around 2.3% by the end of 2023. But it was projected to remain some way below the historic peak reached in 2007. To reach that peak level by the end of 2024 it would require, other things equal, mortgage rates to be around 3 percentage points higher relative to current expectations.

19. The FPC also noted that the core UK banking system was now more resilient than in the GFC and 1990s recession, in part due to lower risk lending to households. Robust capital and profitability, and the stricter regulatory conduct standards for lenders, meant UK banks were both able and expected to offer forbearance and limit the increase in repayments faced by borrowers, including by allowing borrowers to vary the terms of their loans. In this context, the FPC welcomed the new support measures for residential mortgage holders agreed by the principal mortgage lenders, the Chancellor and the Financial Conduct Authority (FCA) on 23 June.[1] These factors should limit the impact of higher interest rates on mortgage defaults.

20. The FPC's mortgage market measures, introduced in 2014, including its flow limit on lending to borrowers with high loan to income ratios at or greater than 4.5, had limited the build-up of household indebtedness in the mortgage market. This had increased borrower resilience and played a role in reducing payment difficulties for mortgagors.

21. The FPC judged that the FCA's Mortgage Conduct of Business (MCOB) responsible lending requirements continued to guard against the risk that mortgage repayments become unaffordable. Lenders had recently been stressing borrowers at higher interest rates of around 8.5%, compared to 7% in 2022 Q1. This had led to a reduction in aggregate mortgage lending and lending at high LTIs. New lending at terms longer than 35 years had increased from 5% in 2022 Q1 to 11% in 2023 Q1.

22. The FPC noted that buy-to-let mortgagors were also experiencing increases in mortgage interest payments, and other structural factors were also likely to put pressure on their incomes. This could cause landlords to sell, putting downward pressure on house prices. Alternatively, they could seek to continue to pass on higher costs to renters. Evidence suggested that the number of rental properties had declined recently, but property sales had not been on a scale likely to have had a material impact on house prices overall. Similar to other forms of borrowing, buy-to-let mortgages were subject to affordability testing. In 2016, the PRA issued a Supervisory Statement outlining its expectations for underwriting standards in the buy-to-let market to safeguard against a deterioration in such standards.

23. The FPC noted that the number of owner-occupier and buy-to-let mortgages in arrears had increased slightly over the first quarter of 2023. This was still low by historical standards but it would take time for the full impact of higher interest rates to come through.

24. As part of the 2022/23 ACS, major UK banks were stress tested against a severe macroeconomic scenario, including a rise in the unemployment rate to 8.5% and a house price fall of 31%. In light of the results of that test, the FPC judged that the major UK banks were resilient to its exposures to owner-occupier and buy-to-let borrowers, including in the

[1] For further details see HM Treasury, **Mortgage Charter: https://www.gov.uk/government/publications/mortgage-charter**

event of sharp rises in unemployment and falls in house prices significantly in excess of external central case projections.

25. Consumer credit growth had increased from 2022 onwards following a contraction in the pandemic. But the stock of outstanding consumer credit debt as a share of income remained below pre-pandemic levels – at around 12% throughout 2022, compared to 15% at the end of 2019. The FPC judged that the UK banking system was also resilient to a significant increase in UK consumer credit default rates, such as those generated in the ACS.

UK corporate resilience

26. The FPC judged that the UK corporate sector remained resilient overall. In aggregate, the amount of outstanding corporate debt relative to corporate earnings had continued to fall since its recent pandemic-era peak. The net debt to earnings ratio was at its lowest point in the last 20 years at around 120% at the start of 2023.

27. Nevertheless, the FPC also judged that some businesses were under pressure from higher interest rates. The debt-weighted proportion of medium and large corporates with low interest coverage ratios (ICRs) increased in 2022. It was projected to continue to increase throughout 2023 as debts refinanced at higher rates (assuming borrowing was not further reduced), although it was expected to remain some way below previous peak levels. A significant further upward shock to borrowing costs of around 800 basis points compared with market expectations would be required for this share to reach the estimated historical peak in the early 2000s.

28. The FPC noted that while corporate insolvency rates had risen above pre-Covid rates, they remained low relative to longer-term average levels. The large majority of the increase in insolvencies had been among very small firms that held little debt and available evidence indicated that a high proportion of this debt was fixed at low rates and was government guaranteed. More broadly, the corporate sector had been repaying debt and its near term refinancing needs appeared limited. But the FPC noted that insolvencies were likely to rise further, as more businesses were affected by higher rates.

29. The FPC judged that there remained a risk that debt burdens among some firms, especially smaller or highly indebted firms, could cause them to cut back sharply on employment or investment.

30. As evidenced by the 2022/23 ACS results, the UK banking system would be resilient to its exposures to corporates in the event that a severe macroeconomic scenario led to significantly increased levels of defaults.

31. The FPC also noted that while MBF had the potential to diversify corporates' funding sources, improving the resilience of lending, an increased reliance on it could also amplify financial stability risks from corporates. Investor sentiment could change rapidly in response

to adverse shocks. This could trigger widening credit spreads and make it harder or more expensive for borrowers to roll-over their debts, particularly as corporates accessing riskier credit markets could be unable easily to access alternative markets. However, the FPC judged that this risk was currently relatively low, given the limited need for refinancing in the near term.

Commercial real estate

32. The FPC noted that there were a number of headwinds facing global commercial real estate (CRE) markets that were putting downward pressure on prices and making refinancing challenging. UK CRE prices had already fallen by nearly 20% since their mid-2022 peak. The FPC noted that CRE prices in the US and the euro area had so far fallen by less than in the UK relative to their recent peaks. Real estate investment trusts (REITs) indices suggested that further price falls were likely to come in the UK, and that further declines in the US and euro area were likely to be bigger. Price falls could present a risk to lenders if they materially reduced the value of the collateral held against their loans.

33. The FPC noted that the results of the 2022/23 ACS, which included a 45% decline in UK CRE prices from their mid-2022 levels and significant stresses in the US, euro area and China, evidenced that major UK banks would be resilient to significant further falls in CRE prices, relative to those already observed. As a proportion of their total assets, some smaller UK lenders were more exposed to CRE than larger banks. However, the majority of this exposure was to residential CRE – this sub-sector was less volatile and was not facing the same structural challenges as the wider CRE market, such as offices and retail.

34. The FPC noted that the trend away from UK bank lending to CRE investors had been associated with a broadening of funding sources. Investors were now more reliant on MBF and international banks. The resilience of this new funding mix had yet to be tested in a severe CRE market stress event.

35. The appetite of foreign investors for UK assets would be influenced by a number of factors, including the strength of their domestic market and the exchange rate. Although most investors were likely to invest long-term, reducing the risk of forced-selling, losses or risk aversion in both UK and non-UK markets could cause foreign investors to retrench rapidly from their UK exposures, exacerbating refinancing challenges for the sector.

36. The FPC noted that stress in non-UK CRE markets could also affect the UK indirectly, if stresses in the overseas banks caused, or exacerbated, by actual or expected losses in CRE markets were to spill over and affect funding conditions for UK banks.

37. Further detail on the analysis underpinning these judgements were set out in the ‘UK household and corporate debt vulnerabilities’ chapter of the July 2023 FSR.

Global vulnerabilities

38. The FPC noted that, since their previous meeting, the market reaction to the stress in parts of the global banking sector in March had moderated significantly. After their sharp fall in March, US regional bank share prices had since stabilised somewhat, albeit at low levels for some institutions.

39. The FPC judged that those parts of the global banking system most directly linked to the UK financial system appeared resilient. However, parts of the global banking system that were more exposed to interest rate risks and falling CRE valuations might be more susceptible to risks crystallising. The recent banking stress had also demonstrated how contagion, even if emanating from smaller institutions, could spread within jurisdictions and across borders via financial market pricing, affecting banks' funding costs and share prices, especially where those banks were – or were perceived to be – exposed to common risks. The FPC would continue to monitor the global banking sector and potential signs of contagion closely.

40. While interest rates had risen further in many advanced economies, the Bank of Japan had maintained its yield curve control policy. In its April 2023 Financial System Report, the Bank of Japan had noted that yen interest rate risk remained near its historical peak. Banks could incur losses should interest rates rise, but the Bank of Japan had judged that they would have adequate capital to absorb such losses.

41. Higher interest rates had also affected households and businesses in other advanced economies. Jurisdictions where long-term fixed-rate mortgages were more prevalent were likely to have financial sectors that were more naturally exposed to interest rate risk.

42. The FPC also judged that riskier corporate borrowing in financial markets – such as private credit and leveraged lending – appeared particularly vulnerable. Signs of stress in the leveraged loan market, for example due to a worsening macroeconomic outlook, could cause a rapid reassessment of risks by investors, potentially resulting in sharp revaluations and fire sales. Those major UK banks active in leverage lending markets had global holdings worth around 12% of their corporate loan book in aggregate. The 2022/23 ACS captured the risks to major UK banks from leveraged lending.

43. The FPC noted that risks relating to the Chinese property sector, including CRE, remained. Chinese property prices had declined in recent years, and while the exit from the zero-Covid policy had brought some stabilisation, the latest data pointed to renewed weakness. Some UK banks had material exposures to Chinese property markets and developers, including via Hong Kong. The outlook in these markets remained important as it could be a source of losses for UK banks. The results of the 2022/23 ACS indicated that UK banks were resilient to – among other things – the direct effects of a severe downturn in

China and Hong Kong, as well as indirect effects through sharp adjustments in global asset prices.

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

45. Further detail on the analysis underpinning these judgements were set out in the 'Global vulnerabilities' chapter of the July 2023 FSR.

UK banking sector resilience in the context of higher interest rates

46. The UK banking system was well capitalised, and continued to maintain large liquidity buffers. Lasting spillovers from the recent overseas banking stress to UK banks had been limited thus far. UK bank equity prices had stabilised quickly and were trading above recent troughs. Wholesale funding spreads had retraced somewhat from their peaks in March.

47. The FPC discussed the impact of rising rates on banks' earnings. The rise in interest rates from a low base had increased UK banks' profitability in aggregate, primarily through higher net interest income. However, increasing competition for deposits, as well as the possibility of increased impairments, may mean profitability was near its peak.

48. The Committee also discussed the impact of changes in interest rates on the relative value of banks' assets and liabilities. Interest rate risk was an inherent part of banking. The UK regulatory regime that applied to all UK banks included rules designed to ensure that UK banks had capital against interest rate risks in their banking book. Resilience was also tested through regular stress testing.

49. The FPC discussed banks' hedging of interest rate risk, noting that banks have to make assumptions related to deposit stability as part of this process. For example, current accounts have no contractual maturity, and so banks have to make assumptions on how depositors will behave in response to higher interest rates. The Committee judged that banks' holdings of liquid assets reduced the likelihood that any hold-to-maturity assets would need to be sold as a result of depositor outflows.

50. The FPC judged that the overall risk environment was challenging, and that further stresses could not be ruled out. The Committee discussed related risks to the UK banking sector, including from the decline in UK and global CRE prices and rising defaults on leveraged loans. They noted that banks' asset quality overall remained relatively strong, with higher interest rates having had a limited impact on credit risk so far. However, some forms of lending, such as to finance CRE investments, buy-to-let and highly leveraged lending to corporates, as well as lenders more concentrated in those assets, were more exposed to credit losses as interest rates rose.

51. Major UK banks' capital and liquidity positions remained robust. Pre-provision profitability had increased, which enabled them to improve their capital positions whilst supporting their customers. The results of the 2022/23 ACS indicated that the major UK banks would be resilient to a shock that included a 45% reduction in CRE prices from their mid-2022 levels, and to a cumulative 5-year impairment rate of 10.5% on UK, US and European leveraged loans – higher than the 8% impairment rate seen in the GFC.

52. In aggregate, smaller lenders were also well capitalised and maintained strong liquidity positions. There was a wide range of business models amongst smaller and medium-sized UK banks, some of which were specialised in particular activities or served particular sectors. In a more challenging environment, these business models would be impacted by different risks in different ways.

53. The FPC was briefed on the PRA's approach to the supervision of smaller banks as part of the PRA's objective to promote the safety and soundness of the firms it regulates. That approach was judgement based and forward looking, taking into account both risks from different business models and a firm's potential to adversely impact the stability of the system. The PRA required banks to have credible plans in place to enable them to recover from stress events. It had an established process for facilitating the orderly exit of small firms that are solvent but no longer viable. The PRA also required all firms to work to remove barriers to their resolvability to support the management of failure in an orderly manner.

54. Smaller firms typically had greater amounts of capital as a share of their risk-weighted assets, relative to regulatory requirements, than larger firms; maintained significant liquidity buffers; and members of the Sterling Monetary Framework (SMF) could borrow liquidity from the Bank of England against a broad range of eligible collateral.

55. The FPC judged that the UK banking system was well placed to absorb shocks and continue to meet the credit demand of creditworthy households and businesses. The Committee judged that the UK banking system was resilient, and had the capacity to support households and businesses through a period of higher interest rates even if economic and financial conditions were to be substantially worse than expected.

56. The Committee monitored UK credit conditions for signs of tightening that would not be warranted by changes in the economic outlook. It noted that the number of mortgage products on offer had as lenders withdrew some products after heightened volatility and sharp increases in UK Bank Rate expectations in May and June. Lenders had withdrawn some products to adjust pricing and ease operational constraints. There were no indications that banks were restricting lending primarily to defend their capital positions. The FPC would continue to monitor the availability of credit as this adjustment of pricing completed.

57. Further detail on the analysis underpinning these judgements were set out in the 'Resilience of the UK banking system' chapter of the July 2023 FSR.

Results of the 2022/23 Annual Cyclical Scenario

58. The Committee agreed that the results of the 2022/23 stress test indicated that the major UK banks were resilient to a severe stress scenario that incorporated persistently higher advanced economy inflation, increasing global interest rates, deep and simultaneous recessions in the UK and global economies with materially higher unemployment, and sharp falls in asset prices. It was substantially more severe than current macroeconomic conditions, given that it combined increasing interest rates with considerably higher inflation than that observed in the current climate, along with severe stresses on other key variables, such as GDP and unemployment. The scenario was also more severe than the GFC.

59. Reflecting the resilience built up by banks in recent years, the results showed the UK banking system was able to withstand the severe macroeconomic scenario and had the capacity to support households and businesses throughout the stress.

60. The FPC emphasised that the stress test scenario was not a forecast of macroeconomic and financial conditions in the UK or abroad. Rather, it was a coherent 'tail risk' scenario designed to be severe and broad enough to assess the resilience of UK banks to a range of adverse shocks.

61. Banks had begun the stress test with improved asset quality relative to that at the start of the last cyclical stress test performed in 2019, which had dampened the negative effect of a higher cost of living in this scenario. Banks had also begun the stress test with higher deposit balances than recent years, and net interest income (NII) had increased in aggregate as policy rates rose in response to higher inflation. This benefit was constrained by banks being required to assume an increasing share of deposits are interest bearing, and that the interest paid increased by more than recent experience.

62. Reflecting a combination of these factors, the Committee noted that the aggregate capital drawdown was smaller than in the 2019 ACS, despite the overall severity of the scenario being broadly similar.

63. The stress test results showed that in the scenario, all participating banks and building societies remained above their CET1 and Tier 1 leverage ratio hurdle rates on an IFRS 9 transitional basis and no bank was required to strengthen its capital position as a result of the test.

64. As in previous stress tests, banks' resilience relied in part on their ability in stress to cut dividend payments, employee variable remuneration, and coupon payments on additional Tier 1 instruments, as well as other management actions taken in response to the stress. Only actions that could be credibly executed were permitted and the Committee judged it important for investors to be aware that banks would take such actions as necessary if such a stress were to materialise.

65. The results of the stress test supported the FPC's judgement that the banking system had the capacity to support households and businesses through a period of higher interest rates, even if economic and financial conditions were to be substantially worse than expected.

66. Further detail on the analysis underpinning these judgements were set out in 'Stress testing the UK banking system: 2022/23 results'.

The UK countercyclical capital buffer rate decision

67. The FPC discussed its setting of the UK countercyclical capital buffer (CCyB) rate. The Committee reiterated that its principal aim in setting the UK CCyB rate was to help ensure that the UK banking system was better able to absorb shocks without an unwarranted restriction in essential services, such as the supply of credit, to the real economy. Its policy was to vary the rate in line with the risk, at the system level, that banks would incur losses on UK exposures in a manner that might lead them to defend their capital positions by restricting lending in a counterproductive way. This approach therefore included an assessment of financial vulnerabilities and banks' capacity to absorb losses on their UK exposures, including their sensitivity to shocks.

68. In 2016 the FPC published a Policy Statement that set out how it would set the UK CCyB rate in response to its remit. Since then, the FPC has used the CCyB to respond to a number of different shocks to UK financial stability - some of which originated from outside of the financial system, such as the coronavirus pandemic. To reflect the FPC's experience in operationalising the CCyB, the FPC agreed to publish an updated version of its **Policy Statement**.[2]

69. In considering the appropriate setting of the UK CCyB rate this quarter, the FPC discussed its judgements around underlying vulnerabilities that could amplify economic shocks. In aggregate these vulnerabilities were broadly unchanged since the previous quarter, with several key indicators, including UK private-sector credit growth and household indebtedness, around their historical long-term averages. The outlook for UK economic activity had improved since Q1, consistent with stronger global growth and lower energy prices, albeit it was still subdued by historical standards. Recent data news indicated more persistence in inflation than previously expected, and in response policy rates (and market expectations for future policy rates) had continued to rise. Financial conditions remained tight, which would put pressure on debt serviceability and could bring greater risk to banks' resilience.

[2] The FPC considered that the **updated Policy Statement** did not represent a material change in their approach to setting the CCyB. Rather, the revisions were intended to reflect and consolidate in one place the incrementally developing approach (as explained publicly in the relevant FPC Records) since the original Policy Statement had been published in 2016.

70. The subdued macroeconomic backdrop and the need for corporates to refinance at tighter conditions and higher rates meant that a tail of corporates were under financial pressure. Increases in interest rates were still to pass through to majority of mortgagors, which could put pressure on household debt serviceability. However, the FPC noted that the share of UK households with high mortgage cost-of-living adjusted DSRs was expected to increase to similar levels as projected last quarter and that some measures of corporate leverage were falling.

71. Given this context, some members considered whether there was a case for increasing the UK CCyB rate. Some FPC members put weight on the possibility that the uncertain environment could mean that severe outcomes would be more likely, and that building resilience against that possibility would be less costly if it started earlier, while bank earnings were strong. However, the Committee judged that underlying vulnerabilities remained consistent overall with a UK CCyB rate at its neutral setting of around 2%.

72. The FPC also considered whether there was a case for releasing the CCyB. Supervisory intelligence and the Credit Conditions Survey suggested credit conditions had tightened over recent quarters. However, the FPC judged that the tightening to date reflected increased credit risk, rather than defensive actions by banks to protect their capital positions; and so it agreed that there were limited arguments in favour of decreasing the UK CCyB rate.

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

74. In view of these considerations, the FPC agreed to maintain the UK CCyB rate at 2%.[3]

75. The Committee recognised the uncertain environment and reiterated that it would continue to monitor the situation closely and stood ready to vary the UK CCyB rate – in either direction – in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment. If vulnerabilities that could amplify future economic shocks increased to an elevated level, so as to pose greater risks to banks' resilience, the FPC would be prepared to raise the UK CCyB rate above 2%. If conditions

[3] See **here (https://www.bankofengland.co.uk/financial-stability/the-countercyclical-capital-buffer)** for details of the FPC's approach to setting the CCyB and the CCyB core indicators

deteriorated by significantly more than currently expected, in a manner that might otherwise lead banks to restrict lending primarily to defend their capital ratios, the FPC would be prepared to cut the UK CCyB rate as necessary. This would enable banks to use the released buffer to absorb losses and so be able to support lending.

Initial lessons from the recent overseas banking sector stress

76. The FPC agreed that the UK's regulatory and institutional framework had supported UK financial stability through the recent period of stress. Since the GFC, the UK authorities had put in place a range of robust prudential standards, including for bank capital and liquidity, designed to ensure levels of resilience that are at least as great as those required by international baseline standards.

77. The FPC noted the importance of maintaining these robust macroprudential regulatory and supervisory standards. This included rules designed to ensure that UK banks had capital against interest rate risk in their banking books and maintained substantial liquid asset buffers. The FPC observed that other jurisdictions were considering lessons from this episode – for example, the Federal Reserve Board had published the findings of the review of the supervision and regulation of Silicon Valley Bank, led by Michael Barr, on 28 April 2023.

78. The stress had highlighted that while an individual institution may not be considered systemic, if a risk was common – or was perceived to be common – among similar institutions the collective impact could pose a systemic risk. In addition, the stress had highlighted how banks largely operating in a domestic market could potentially impact the wider international financial system even where there was no direct connection between institutions.

79. The Committee noted the need for all banks to be adequately capitalised against the risks they are exposed to, including interest rate risk. This was consistent with the PRA's current regulatory framework, as well as its initiative to maintain the resilience of the smallest UK banks while considering measures to simplify regulatory requirements for these lenders, known as 'Strong and Simple'.[4]

80. The FPC supported Bank staff's contribution to international fora such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), which were also examining the recent banking sector stress and considering any implications for the international regulatory framework.

[4] Further details of the PRA's 'Strong and Simple' Framework can be found **here**. The initiative seeks to simplify the prudential framework for non-systemic domestic banks and building societies, while maintaining their resilience.

81. This included the Bank's contribution to international discussions to consider whether lessons could be learnt for the liquidity framework for banks, or components of it, in light of the size and pace of outflows witnessed during the recent stress. Deposit outflows in some recent events had been large and rapid, with digital banking technology and social media likely playing a role in increasing the speed at which information was shared and deposits withdrawn.

82. The FPC agreed that recent stress events in parts of the global banking system showed the importance of being able to resolve firms effectively and, in doing so, being able to draw on a range of flexible and credible resolution tools for domestic banks and global systemically important banks (GSIBs). In co-ordination with HM Treasury, the Bank was seeking to ensure that for small banks, which did not need to hold additional resources to meet the minimum requirement for own funds and eligible liabilities (MREL), there were resolution options that improved continuity of access to deposits and so outcomes for depositors. The FPC supported this work. The stress also demonstrated the importance of international authorities' commitment to ensuring that the resolution plans for G-SIBs, in line with FSB standards, remained credible.

83. Further detail on the analysis underpinning these judgements were set out in the 'Initial lessons from the recent overseas banking sector stress' Box in the July 2023 FSR.

Market-based finance resilience

Recent developments

84. The FPC noted that there was evidence that the recent market volatility associated with movements in interest rates had led to increased margin and collateral requirements. The FPC recognised that increases in margin requirements during volatile periods were a necessary and expected element of risk management and judged that, overall, counterparties had been able to provide initial margin and meet high variation margin calls.

85. The FPC also noted that riskier open-ended funds had seen outflows as investors had shifted to less risky investment following recent periods of uncertainty. The FPC assessed outflows had been orderly and that there had been no evidence of fund redemptions triggering fire-sale dynamics.

86. The FPC judged that although the system of MBF had broadly been able to absorb recent developments, vulnerabilities in certain parts of MBF remained. The FPC observed that these could crystallise in the event of further volatility or sharp movements in asset prices, amplifying any tightening in financial conditions. The risks from higher interest rates could also be amplified by NBFIs deleveraging and rebalancing their portfolios in response.

87. The FPC recognised that the need to increase the resilience of MBF through the implementation of policy responses by international and domestic regulators was vital and

urgent. The Bank and FPC would continue to support strongly the FSB's international work programme to increase the resilience of MBF.

88. Alongside international policy work, the UK authorities were working to reduce domestic vulnerabilities where it was effective and practical to do so. In addition, the Bank was also developing its framework for monitoring and assessing UK financial stability risks from MBF, learning lessons from previous events. The FPC also agreed that the Bank should continue to develop the tools the Bank needed to address dysfunction in MBF should it threaten UK financial stability.

The resilience in liability-driven investment funds

89. In March 2023, the FPC had recommended that The Pensions Regulator (TPR) took action as soon as possible to mitigate financial stability risks by specifying the minimum levels of resilience for the LDI funds and LDI mandates in which pension scheme trustees could invest.

90. Since then, both the FCA and TPR had published detailed guidance on LDI resilience. The FPC welcomed this guidance and the steps taken by TPR and the FCA to ensure the continued resilience of LDI funds.

91. The FPC judged that recent volatility in market interest rates had demonstrated that the resilience framework recommended by the Committee was functioning broadly as intended. In recent months, as interest rates had risen further, funds had in general maintained overall levels of resilience consistent with the minimum levels recommended by the Committee in March, and well above the levels estimated prior to the LDI stress episode in September 2022, and had initiated recapitalisation at far higher levels of resilience than previously. The Committee would assess this recent experience for the implementation of its recommendations.

92. The FPC would continue to work with the FCA, TPR and overseas regulators to monitor the resilience of the sector closely.

System-wide exploratory scenario exercise

93. In June, the Bank launched[5] its system-wide exploratory scenario (SWES) exercise. The exercise would aim to improve understanding of the behaviours of banks and NBFIs in stressed financial market conditions. It would explore how those behaviours might interact to amplify shocks in UK financial markets that are core to UK financial stability. The Bank would be conducting this exploratory exercise under the guidance of the FPC and the Prudential

[5] https://www.bankofengland.co.uk/financial-stability/boe-system-wide-exploratory-scenario-exercise

Regulation Committee (PRC), working closely with and with full support of the PRA, FCA and TPR.

94. The exercise intended to focus on a specific set of important UK financial markets – specifically, the gilt, gilt repo, and sterling corporate bond markets, as well as associated derivative markets. Participating firms had been drawn from a wide cross-section of the financial system: comprising banks, insurers, pension funds, asset managers, hedge funds and central counterparties.

95. The launch of this exercise commenced the information-gathering phase, through which the Bank intended to gather important information to help design and execute an effective stress scenario. It would be followed by the scenario phase later this year.

96. The SWES would be the first exercise of its kind, and offered a novel opportunity to better understand system-wide dynamics. In bringing together information from various parts of the financial system to develop system-wide (and sector-specific) insights, it would be able to account for interactions and amplification effects within and across the financial system that individual financial institutions working alone could not assess.

97. The FPC supported the exercise, and considered it an important contribution to understanding and addressing vulnerabilities in the system of MBF.

98. Further detail on the analysis underpinning these judgements were set out in the 'Resilience of market-based finance' chapter of the July 2023 FSR.

IMF Financial Sector Assessment Program

99. The FPC was briefed on the progress made to date by the Bank and other UK authorities in addressing the recommendations in the IMF's 2021 Financial Sector Assessment Program (FSAP). The FPC welcomed the very good progress that had been made on the recommendations, with the vast majority judged to be on track for implementation within the IMF's proposed timelines. A summary of the progress was included in the **IMF's Staff Report for the 2023 Article IV Consultation of the UK**.

The following members of the Committee were present at the 3 July 2023 Policy meeting:

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

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

- Elisabeth Stheeman had notified the Committee of her position on the Board of Directors of W.P. Carey, a US company predominantly active in sale leasebacks in the US. It was agreed that she would recuse herself from discussions on international CRE, and that she would not receive the related papers.

- Sam Woods had previously notified the Committee of his wife's employment at the consulting firm, Flint Global. It had been announced on 13 February 2023 that his wife would lead a review of The Pensions Regulator. It was therefore agreed that Sam Woods would be recused from discussion of issues (and not receive papers) relating to The Pensions Regulator and – as a precaution given the connection – liability driven investment issues more broadly. The expectation was that this recusal would fall away when his wife's work with The Pensions Regulator was complete, but the position would be reviewed again at that point.

Annex: Financial Policy Committee policy decisions

Outstanding FPC Recommendations and Directions (as at the date of the FPC's meeting on 3 July 2023).

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

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

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

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

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

Other FPC policy decisions which remain in place

The following text sets out previous FPC decisions, which remain in force, on the setting of its policy tools. The calibration of these tools is kept under review.

Countercyclical capital buffer rate

The FPC agreed to maintain the UK CCyB rate at 2% on 3 July 2023, unchanged from its 23 March 2023 Policy meeting. At its July 2022 Policy meeting, the FPC agreed to increase the UK CCyB to 2%, 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.[6] Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.

Liability driven investment funds

On 28 November 2022, the FPC recommended (22/Q4/1) that regulatory action be taken by TPR, in coordination with the FCA and overseas regulators, to ensure LDI funds remain

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

resilient to the higher level of interest rates that they can now withstand and defined benefit pension scheme trustees and advisers ensure these levels were met in their LDI arrangements.

Mortgage loan to income ratios

In June 2014, the FPC made the following Recommendation (14/Q2/2): The Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5. This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The Recommendation should be implemented as soon as is practicable.

The PRA and the FCA have published their approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,[7] and the FCA has issued general guidance.[8]

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[9].

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

The full text of the FPC's new Direction to the PRA on the leverage ratio is set out in the Annex of the October 2022 Record[10] (see Annex), together with the original Recommendation (now implemented).

The PRA has published its approach to implementing this direction and recommendation[11].

[7] 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.
[8] See www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending.
[9] https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/october-2021
[10] https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2022/fpc-summary-and-record-october-2022.pdf
[11] PS21/21 | CP14/21- The UK leverage ratio framework | Bank of England (https://www.bankofengland.co.uk/prudential-regulation/publication/2021/june/changes-to-the-uk-leverage-ratio-framework)