



BANK OF ENGLAND

Financial Policy Summary and Record of the Financial Policy Committee Meeting on 11 March 2021

Publication date: 26 March 2021

This is the record of the Financial Policy Committee meeting held on 11 March 2021

It is also available on the Internet: <https://www.bankofengland.co.uk/financial-policy-summary-and-record/2021/march-2021>

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

The FPC's next policy meeting will be in June 2021 and the Record will be published in July 2021.

Financial Policy Summary

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

The outlook for financial stability

Support for the economy to weather economic disruption

UK households and businesses have needed support from the financial system to weather the economic disruption associated with Covid-19 (Covid). The financial system has so far been able to provide that support, reflecting the resilience that has been built up since the global financial crisis, and the extraordinary policy responses of the UK authorities.

The vaccination programme in the United Kingdom has proceeded at a rapid pace and plans for the easing of restrictions on activity have been announced. Nevertheless, households and businesses will need the continued support of the financial system. **Businesses, including many small and medium-sized enterprises, still need to finance cash-flow deficits this year**, even as the economy recovers. And it will be important for lenders to work flexibly with household borrowers as payment deferral schemes unwind.

The banking system has the capacity to continue to provide that support, even if economic outcomes are considerably worse than currently expected. This reflects the build-up of substantial buffers of capital since the global financial crisis. Major UK banks' and building societies' (banks') aggregate Common Equity Tier 1 capital ratio increased to 16.2% at end-December.

Cutting support to avoid the use of capital buffers would be costly for the wider economy and consequently for banks themselves. As government-backed lending guarantee schemes are scaled back, **it is in banks' collective interest to continue to support viable, productive businesses**, rather than seek to defend capital ratios by cutting lending, which would have an adverse effect on the economy and therefore could have an even greater negative effect on banks' capital ratios.

The FPC expects banks to use all elements of capital buffers as necessary, to continue to support the economy through the recovery phase. To this end, the FPC is maintaining the UK countercyclical capital buffer (CCyB) rate at 0% and expects to maintain the 0% UK CCyB rate until at least December 2021. Any subsequent increase would therefore not be expected to take effect until end-2022 at the earliest.

Global reforms are needed to make market-based finance more resilient

Large UK businesses have used markets to raise £53bn of finance since March 2020. They will need the continued support of market-based finance. Markets therefore need to be resilient.

However, the functioning of debt markets was shown in March 2020 to be vulnerable to economic shocks and subsequent sharp moves in asset prices. Without extraordinary central bank support in March 2020, financing conditions for governments, households and businesses would have tightened materially.

This episode demonstrated how adjustments in risky asset prices could spill over to core markets such as government bond markets. The vulnerabilities in the non-bank financial system that led to this episode remain. Moreover, some risky asset prices appear elevated — for instance, corporate bond spreads are currently notably compressed relative to historical levels. The resilience of core markets could be tested again were these prices to adjust.

More recently, the fragile nature of liquidity in some government bond markets was evident during a period when advanced economy government bond yields rose markedly. These increases in yields reflected improvements in the growth outlook, but they were associated with some instances of illiquidity.

Recognising the global nature of financial markets, work to assess and ensure the resilience of core markets should continue to be co-ordinated internationally. The FPC will continue to support this work.

The joint Bank-Financial Conduct Authority review of open-ended investment funds

As the FPC has noted previously, the mismatch between redemption terms and the liquidity of some funds' assets means there is an incentive for investors to redeem ahead of others, particularly in a stress. This first-mover advantage has the potential to become a systemic risk by creating run dynamics. It could result in forced asset sales by funds, further amplifying asset price moves and, by testing markets' ability to absorb sales, contributing to dysfunction in markets of the sort observed in March 2020. This could impair the issuance of new securities and thereby disrupt the supply of credit to the real economy.

The FPC judged in July 2019 that there should be greater consistency between the liquidity of funds' assets and redemption terms and supported a review by the Bank and Financial Conduct Authority (FCA). It welcomes the findings of a joint Bank and FCA survey of open-ended funds which provides insights on liquidity management during the period of market stress last year.

The survey found that many fund managers appeared to have overestimated the liquidity of fund portfolios, even after the experience of the stressed period in March 2020. **The FPC judges that the survey indicates that consistent and more realistic classification of the liquidity of funds' assets is an essential first step to ensuring funds can address mismatches between asset liquidity and redemption terms.**

Redemption terms that are better aligned with the liquidity of the underlying assets can help to reduce first-mover advantage. Swing pricing is one tool which allows the price to be adjusted to offset potential dilution costs to other investors in the fund.

The Committee judges that the survey indicates that use of swing pricing was inconsistently applied across funds and even when deployed, in many cases the swing was insufficient. The calculation and application of swing pricing could, in principle, be enhanced in order to reduce systemic risk that could be associated with first-mover advantage.

The Committee judges that it will be important to address these issues internationally, through the work on non-bank finance now in train with the Financial Stability Board, given the global nature of asset management. The effectiveness of domestic policy measures will depend in part on policies implemented in other jurisdictions. To support that international work, **the FPC will set out in the next Financial Stability Report its view on how a liquidity classification could be developed and an approach for how more consistent and complete swing pricing could be developed in order to promote financial stability.**

Funds that hold highly illiquid, infrequently traded, assets may not be able to implement swing pricing effectively in practice. In these cases, longer redemption notice periods can address the first-mover advantage and financial stability risks that otherwise arise.

Real estate is a notable example of a highly illiquid asset that, when held in an open-ended fund structure, is better suited to a long redemption notice period. The FCA has consulted on the appropriate redemption notice period for property funds. The FPC has previously judged that, from the perspective of UK financial stability, there would be benefits from extending the notice periods at least as far as the range proposed in the consultation.

Productive finance to support economic recovery

More generally, the development of funds with longer notice periods **could help to increase the supply of productive finance to the economy.**

Such 'long-term asset funds' can hold illiquid assets like unlisted equities, safely and sustainably. However, the FPC recognises that a number of operational obstacles and impediments to investment in such funds will need to be addressed to allow their successful development. These include the tax treatment of funds with long notice periods; the capability of platforms to host non-daily dealing funds; and pension fund investment practices.

The Bank, HM Treasury and the FCA have established an industry working group to facilitate investment in productive finance through the launch of a Long-Term Asset Fund (LTAF) structure.

Looking ahead, some businesses will enter the recovery phase of the Covid disruption with more leveraged balance sheets. Although debt-servicing burdens are in general very low, some businesses may choose to hold back on investment and employment in order to reduce leverage by retaining earnings. This could be a drag on economic recovery.

Increasing the availability of long-term, equity-like finance for businesses could help to reduce this risk. It could also promote the supply of finance for new growth areas and support the economic transition needed to achieve the UK Government's commitment to net zero carbon emissions by 2050.

Financial services and the UK's new relationship with the European Union

Reflecting the extensive preparations made by authorities and the private sector over a number of years, the transition period between the UK and European Union (EU) ended without any material disruption to the provision of financial services.

The UK has taken a number of steps to ensure UK clients can continue to access services provided by financial institutions in the EU. The EU has provided temporary equivalence decisions allowing EU clients to continue to access financial services provided from the UK in some areas. These steps were taken to manage financial stability risks. The FPC continues to monitor financial stability risks that could arise from disruption to the provision of financial services in the future, for example when the EU's temporary equivalence and recognition determinations for UK central counterparties expire on 30 June 2022.

The UK authorities remain committed to mutual regulatory and supervisory co-operation with the EU authorities. Alongside co-operation with other regulatory authorities globally, this will continue to promote an open and resilient financial system to the benefit of all participants. The FPC judges that such mutual co-operation is necessary to manage financial stability risks.

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

Record of the Financial Policy Committee meeting held on 11 March 2021

1. The Committee met on 11 March 2021 to agree its view on the outlook for UK financial stability and, on the basis of that, its intended policy action. The FPC discussed the risks faced by the UK financial system and assessed the resilience of the system to those risks. Its aim was to ensure the UK financial system was prepared for, and resilient to, the wide range of risks it could face – so that the system could serve UK households and businesses in bad times as well as good.

Macro-economic back-drop

UK outlook

2. The Committee noted that the backdrop to its discussion remained challenging. As had been set out in the February 2021 Monetary Policy Report (MPR), a resurgence in Covid-19 (Covid) cases and the reintroduction of measures to contain the spread of the virus had weighed on near-term UK and global activity. Nevertheless, Covid vaccination programmes had improved the outlook over 2021. The Committee noted the extension of government support schemes announced at *Budget 2021* published on 3 March.

3. The Committee noted that the Monetary Policy Committee's (MPC) central forecast in February 2021 *MPR* for the UK economy was similar to the November 2020 projections. The forecast remained materially less severe than the scenarios generated by the FPC's August 2020 'reverse stress test' exercise, which still had left banks with ample capital to support further lending.

Global outlook

4. The FPC was briefed on a range of international risks that could be relevant for UK financial stability. These included geopolitical risks, such as tensions between the United States (US) and China, and risks to overseas banking sectors. While banks in the US and the euro area had supported their economies through the pandemic, stretched corporate balance sheets could weigh on euro-area banks in particular, given a backdrop of weak profitability prospects in that sector. If corporate sector distress proved to be more severe than expected in the euro area, for example as government support measures unwound, that could place pressures on euro-area banks. That in turn could affect the UK financial sector directly, through its exposures to those banks and economies, and indirectly through additional macroeconomic spillovers.

5. The FPC noted that the outlook for global activity in the February *MPR* was little changed relative to the November 2020 *MPR* outlook. The near-term outlook had deteriorated in some countries as tighter restrictions had been imposed following a rise in Covid cases, but the rollout of

vaccines was expected to bolster the recovery further ahead. Expected cumulative global output losses over the three years since the start of the pandemic were similar in the February and November projections, and materially less severe than the scenarios generated for the FPC's August 2020 reverse stress test exercise.

Support for the economy to weather economic disruption

6. The FPC discussed how UK households and businesses would need the continued support of the financial system even as the economy recovered. The FPC judged, in aggregate, that the UK financial system had so far been able to provide the support that had been needed, reflecting the resilience that had been built up since the global financial crisis (GFC), and the extraordinary policy responses of the UK authorities. As government schemes came to an end the FPC considered it would be incumbent on the financial system to play a larger role in supporting the recovery.

Households

7. The FPC noted that government support had limited the increase in unemployment as a result of the Covid disruption and had helped to maintain household incomes. With many government support schemes now extended beyond Q1, the Committee agreed that the conclusion of schemes was likely to occur following the easing of Covid-related restrictions, alongside the pickup in economic activity over Q2 and Q3 reflected in the MPC's latest central forecast.

8. The Committee discussed the substantial rise in UK household savings since the start of the Covid pandemic. However, the FPC noted that there was wide variation in the ability of households to build up savings during the pandemic, so agreed that an increase in aggregate savings that could be drawn down might only partly increase the resilience of the household sector to future shocks.

9. The FPC noted that households' debt-servicing burdens had not increased sharply over 2020, partly reflecting the support of government schemes and payment deferrals and low interest rates. The latest Understanding Society special survey had suggested the share of households with high debt-servicing ratios (DSRs) was around 1.4% in November 2020 (excluding the effect of payment deferrals). This had fallen back from 2.2% in May reflecting a recovery in earnings, driven by those returning to work from furlough and the self-employed.

10. In contrast to the corporate sector, household debt levels had not increased significantly over the pandemic. Following a period of weakness in the mortgage market in 2020 H1, mortgage credit growth had recovered in 2020 H2. In the year to December 2020, the stock of mortgage credit grew by 3%. The stock of unsecured consumer credit – which comprised around 1/8th of household debt –

had fallen by around 10% over 2020, consistent with the weakness of consumption during the pandemic.

11. The FPC noted that the extension of the stamp duty holiday, and other government schemes, announced at *Budget 2021* might continue to support housing market activity in the coming months, and banks were well positioned to supply the necessary credit. While the evolution of household indebtedness in the future would depend on the economic outlook, the FPC's mortgage market recommendations, put in place in 2014, continued to guard against a significant increase in the number of highly indebted households.

Corporates

12. The FPC noted that the banking system and financial markets had supported UK businesses in raising substantial external financing since the start of the Covid pandemic, financing their cash-flow deficits. Government-backed loan guarantee schemes had supported the UK banking system in expanding the supply of credit to many businesses which may have found it difficult or costly to otherwise get credit – a particular issue for small and medium-sized enterprises (SMEs).

13. The FPC noted that Bank staff estimates of the total cash-flow deficit of businesses during the Covid disruption were little changed since the December *Financial Stability Report* (FSR), at up to around £180 billion for the 2020-2021 financial year. The cash-flow impact of the additional public health measures since December had been largely mitigated by the extension of fiscal support measures and stronger economic performance in 2020 Q4, which had supported UK corporate cash flows.

14. That cash-flow deficit compared to buffers of cash in those companies facing deficits of around £100bn. In addition, over 2020, UK businesses had raised around £86 billion of net additional financing from a combination of government-backed loan guarantee schemes, banks and financial markets.

15. Looking ahead to the next financial year of 2021-22, Bank staff had estimated the cash-flow deficit of the UK corporate sector would probably remain higher than typically. This reflected the likelihood that economic activity would not have recovered fully and the impact of deferred VAT and rent payments becoming due.

16. Businesses, including many SMEs, would still need to finance cash-flow deficits this year, even as the economy recovered. The FPC judged that the majority of larger businesses would continue to have access to additional finance if required. But SMEs typically have fewer options to

raise external financing. As the government-backed loan guarantee schemes were phased down, banks would need to take more responsibility for meeting the credit needs of viable SMEs.

17. The FPC considered how some structural changes in the economy, such as the shift from physical to online retail together with an increase in working remotely, were likely to have been accelerated by Covid. As a result, some businesses might have weaker earnings prospects; partly as a result of this, insolvencies were also likely to increase from their current very low levels.

The resilience of the UK banking system

18. The FPC discussed the resilience of the UK banking system, including its ability to withstand future shocks and maintain credit supply.

19. Major UK banks' and building societies' ('banks') liquidity positions remained strong. Banks' liquidity coverage ratios (LCRs) continued comfortably to exceed regulatory guidelines.

20. Banks' aggregate Common Equity Tier 1 (CET1) ratio had increased to 16.2% at end-December, which was over three times higher than at the start of the GFC. Even without the mitigating impact of International Reporting Standards 9 (IFRS 9) transitional relief measures on the £22 billion of credit losses that banks provisioned for over 2020, banks' aggregate CET1 ratio would have remained at 15.8%.

21. The increase in capital ratios over the quarter had been driven largely by revised European Union (EU) rules exempting software assets from capital deduction requirements. The Prudential Regulation Authority (PRA) had expressed concern that exempting software assets from the CET1 capital deduction requirements could undermine the safety and soundness of UK firms, and intended to consult on a proposal to maintain the earlier position whereby all software assets continue to be fully deducted from CET1 capital.¹ Banks' dividend payments had broadly matched their organic capital generation over the quarter, and were in line with the temporary guardrails set out by the PRA in December 2020.

22. The FPC noted the possibility of adverse developments which could affect bank capital positions over the coming quarters as unemployment and insolvencies increased resulting in credit losses and a commensurate inflation in risk-weighted assets. In addition to these headwinds, IFRS 9 transitional relief on the existing stock of provisions might decrease as some assets move into default

¹ The PRA had expressed concern that exempting software assets from the CET1 capital deduction requirements could undermine the safety and soundness of UK firms, and intended to consult on a proposal to maintain the earlier position whereby all software assets continue to be fully deducted from CET1 capital. <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-prudential-treatment-software-assets>

and become ineligible for transitional relief, and the PRA had announced its intention to consult on the removal of the recently introduced exemption of software assets from capital deduction requirements. As a result of these effects, banks' capital ratios may fall back somewhat, though would remain significantly above minimum requirements.

23. Market valuations of banks' equities remained low, with UK banks' average price to book ratio (which measures the market value of shareholders' equity relative to the accounting value of that equity) remaining substantially below 1. Weak valuations were likely to reflect market concerns over expected future profitability, rather than concerns over the solvency of banks. Consistent with this, credit default swap levels for UK banks remained low, at around their pre-Covid levels. Low profitability was still a concern as it limited banks' ability to generate internal capital.

24. However, the FPC judged that the UK banking system remained resilient to a wide range of possible economic outcomes. It had the capacity to continue to support businesses and households, even if economic outcomes were considerably worse than currently expected.

25. Banks would need to incur at least £120 billion of credit losses to deplete aggregate end-2019 capital buffers by 5.2 percentage points, the extent of the capital drawdown in the 2019 stress test in which banks demonstrated they could continue to lend. The FPC judged that to generate such losses would require a very severe global and UK economic scenario, much more severe than would be consistent with the MPC's central forecast in the February *MPR*, with, for example, UK unemployment peaking at around 15%.

26. In practice UK banks had buffers of capital larger than required by past stress tests. Based on the end-2019 start point of the August 2020 reverse stress test the £120bn of losses would, in aggregate, have used up around 60% of the buffers of capital which sit above banks' minimum requirements. In aggregate, they would have been left with the ability to absorb a further £80bn of losses arising from further shocks.

27. Cutting support to avoid the use of capital buffers would be costly for the wider economy and consequently for banks themselves. In that regard, the FPC agreed that the UK banking system was a source of strength for the economy, helping to absorb rather than amplify the economic shock caused by Covid. As government-backed lending guarantee schemes were scaled back it remained the FPC's judgement that it was in banks' collective interest to continue to support viable, productive businesses, rather than seek to defend capital ratios by cutting lending which would have an adverse effect on the economy and therefore could have an even greater negative effect on banks' capital ratios.

The resilience of financial markets and the provision of finance by non-banks

28. Large UK businesses had used markets to raise £53bn of finance since March 2020. The FPC noted that businesses would need the continued support of market-based finance. Markets therefore needed to be resilient.

29. However, the functioning of debt markets had been shown in March 2020 to be vulnerable to economic shocks and subsequent sharp moves in asset prices. Without extraordinary central bank support in March 2020, financing conditions for governments, households and businesses would have tightened materially.

30. This episode demonstrated how adjustments in risky asset prices could spill over to core markets such as government bond markets. The FPC noted that the vulnerabilities in the non-bank financial system that led to this episode remained. For example, although money market funds (MMFs) had increased their liquid-asset buffers, the structural vulnerabilities they had posed and which amplified the March 2020 stress still needed to be addressed. And although hedge funds had lengthened the maturity of their repo financing, high net levels of repo borrowing and short positions in US Treasury futures remained.

31. There also remained a risk of an adjustment in risky asset prices. Some risky asset prices appeared elevated – for instance, investment grade corporate bond spreads – which the FPC had previously considered to be compressed - had fallen further by around 5bps. Despite the economic uncertainty and structural changes accelerated by Covid, corporate bond spreads were notably compressed relative to historical levels.

32. More recently, in February, the fragile nature of liquidity in some government bond markets had been evident during a period where advanced economy government bond yields had risen markedly. These increases in yields reflected improvements in the growth outlook, but they had been associated with some instances of illiquidity. During this episode, some measures of market functioning deteriorated. For example, market depth on US Treasuries declined substantially, with 5-year Treasuries experiencing a particularly marked fall, and an auction of US Treasury notes saw very limited demand from the non-dealers. Some of these measures had subsequently begun to normalise. In general, low debt servicing burdens and high asset prices were predicated on the expectation of continued low rates.

33. Nevertheless, the FPC judged that recent experience showed the fundamental vulnerabilities in market functioning that had been exposed during the ‘dash for cash’ remained and could amplify any further repricing.

Global reforms are needed to make market-based finance more resilient

34. Recognising the global nature of financial markets, work to assess and ensure the resilience of core markets should continue to be co-ordinated internationally. The FPC would continue to support this work.

35. The FPC had previously identified priority areas for reform.

- Mismatch between the liquidity of assets held in open-ended funds – including MMFs – and the redemption terms offered by those funds. This mismatch could exacerbate stress in the financial system.
- Demands of non-bank financial intermediaries for liquidity in stress. These had arisen in the March stress from forced unwinding of leveraged positions and from increases in derivative margin calls.

36. The non-bank financial system would always have some need for additional liquidity in stress. It was important to ensure that this need could be met in ways that avoid forced sales of assets and disruption to market functioning. Prudent management by non-bank intermediaries of their own liquidity positions was essential for their resilience to stress. Seeking to increase the supply of liquidity from banks to non-banks in stress by compromising on the resilience of banks would not be acceptable or effective.

37. In addition, the FPC considered it important to examine whether central banks should have facilities to provide liquidity to the wider financial system in stress, in order to support market functioning. Any such backstop of liquidity would need to be provided in a way that was not just effective and efficient but that also, through appropriate pricing and accompanying regulatory requirements, reduced incentives for excessive risk taking in the future.

The joint Bank-Financial Conduct Authority review of open-ended investment funds

38. As the FPC had noted previously, the mismatch between redemption terms and the liquidity of some funds' assets meant there was an incentive for investors to redeem ahead of others, particularly in a stress. This first-mover advantage had the potential to become a systemic risk by creating run dynamics. It could result in forced asset sales by funds, further amplifying asset price moves and, by testing markets' ability to absorb sales, contributing to dysfunction in markets of the sort observed in March 2020. This could impair the issuance of new securities and thereby disrupt the supply of credit to the real economy.

39. The FPC had judged in July 2019 that there should be greater consistency between the liquidity of funds' assets and redemption terms and supported a review by the Bank and Financial Conduct Authority (FCA). At its March meeting, it welcomed the findings of a joint Bank and FCA survey of open-ended funds which provided insights on liquidity management during the period of market stress last year. The survey asked fund managers about their current liquidity management practices, focusing in particular on liquidity classification and swing pricing. The survey had received 272 responses from authorised funds investing in less liquid assets, accounting for assets under management of around £130 billion. These were primarily corporate bond funds but also some mixed bond funds and a small number of equity funds. The survey also provided insights on liquidity management during the period of market stress in March of last year.

40. The survey found that many fund managers appeared to have overestimated the liquidity of fund portfolios, even after the experience of the stressed period in March 2020. When assessing the liquidity of their asset portfolios, around a quarter of fund managers reported that more than 90% of their holdings were liquid in almost all market conditions, despite the experience of deteriorating liquidity across all bond ratings during the market stress in March 2020. Further evidence of fund managers overestimating the liquidity of their portfolios came from comparing fund managers' own classifications to an alternative simple benchmark prepared by the Bank. The FPC judged that the survey indicated that consistent and more realistic classification of the liquidity of funds' assets was an essential first step to ensuring funds could address mismatches between asset liquidity and redemption terms.

41. Redemption terms that are better aligned with the liquidity of their underlying assets can help to reduce first-mover advantage. Swing pricing was one tool which allows the price to be adjusted to offset potential dilution costs to other investors in the fund.

42. The Committee judged that the survey indicated that use of swing pricing had been inconsistently applied across funds and even when deployed, in many cases the swing had been insufficient. The calculation and application of swing pricing could, in principle, be enhanced in order to reduce systemic risk that could be associated with first-mover advantage. The survey indicated that fund managers had mainly used swing pricing during last year's stress, but there were significant variations in the way swing pricing had been applied. Fund managers had reported different thresholds for applying swing pricing and a range of methodologies had been used for calculating swing adjustment factors. Where swing pricing adjustments had been applied, in many cases this had not captured appropriately the cost of selling the necessary portion of a fund's assets in normal and stressed conditions. Most funds reported using bid-ask spreads in calculating swing price adjustments, which would not necessarily always be available for all underlying securities, nor

capture fully the impact on market pricing of trying to sell assets in larger scale or multiple funds selling at the same time in stressed market conditions.

43. The Committee judged that it would be important to address these issues internationally through the work on non-bank finance now in train with the Financial Stability Board, given the global nature of asset management. The effectiveness of domestic policy measures would depend in part on policies implemented in other jurisdictions. To support that international work, the FPC would set out in the next *FSR* its views on how a liquidity classification could be developed and an approach for how more consistent and complete swing pricing could be developed in order to promote financial stability.

44. Funds that hold highly illiquid, infrequently traded, assets might not be able to implement swing pricing effectively in practice. In these cases, longer redemption notice periods could address the first-mover advantage and financial stability risks that otherwise arise.

45. Real estate was a notable example of a highly illiquid asset that, when held in an open-ended fund structure, could be better suited to a long redemption notice period. The FCA had recently consulted on the appropriate redemption notice period for property funds. HMRC had also consulted on the implications for ISA eligibility of existing property open-ended funds in the event that longer redemption notice periods were introduced. The FPC has previously judged that, from the perspective of UK financial stability, there would be benefits from extending the redemption notice periods at least as far as the range proposed in the consultation. The proposals would reduce the liquidity mismatch associated with the current practice of offering daily dealing and limit the need to suspend funds. Suspensions of property funds had occurred on several occasions, including during the GFC and following the EU referendum in 2016. Almost all UK authorised funds that invest in property had suspended dealings last year because of valuation uncertainty in the light of the Covid pandemic.

46. The FPC had previously considered the implications for property funds of a disorderly Brexit. At its July 2019 meeting, the Committee had been briefed by the FCA that, in the event of a disorderly Brexit, some open-ended commercial real estate (CRE) funds could be suspended, as they were after the referendum. Many offered daily redemptions while investing in assets that typically took weeks or months to sell in an orderly way. On its own, this was unlikely to give rise to financial instability. However, the Committee had agreed that disclosure of this briefing could act to raise the probability of the risks of suspension being triggered in the event of Brexit, and so it was against the public interest to do so. It was agreed to defer publication of the Record of its discussion under Section 9U of the Bank of England Act 1998 and review this decision after the UK had left the EU.

47. In March 2020, the Committee agreed that it remained against the public interest to publish the discussion. This was on the grounds that there remained a risk that disclosure could act to raise the probability of suspension being triggered, as cliff-edge risks remained and volatility and market sentiment at that time were already contributing to fund suspensions. The Committee had agreed to review this decision again after the end of the transition period between the UK and the EU.

48. At its March 2021 meeting, the Committee agreed that it was no longer in the public interest to defer publication. The specific event that could have triggered CRE fund suspensions had passed. Property funds had in fact suspended redemptions during the Covid stress and so publishing the Committee's discussions therefore would not raise the probability of suspension being triggered. The longer notice periods proposed by the FCA for property funds, which the Committee supported, would help to address the remaining risk. The Records of the FPC's previous meetings would therefore be updated to include the text where publication had previously been deferred, when the Record of this meeting was published on 26 March.

Productive finance to support economic recovery

49. More generally, the development of funds with longer notice periods could help to increase the supply of productive finance to the economy, in line with the FPC's secondary objective. Such 'long-term asset funds' could hold illiquid assets like unlisted equities safely and sustainably. They could also help to address the financial stability risks that otherwise arise when illiquid assets were held in open-ended fund structures and swing pricing would be difficult to implement fully in practice. However, the FPC recognised that a number of operational obstacles and impediments to investment in such funds – similar to the issues for property fund notice periods – would need to be addressed to allow their successful development. These hurdles included the tax treatment of funds with long notice periods; the capability of platforms to host non-daily dealing funds; and pension fund investment practices.

50. To identify potential solutions to some of these problems, the Bank, HM Treasury and the FCA, had established an industry working group to facilitate investment in productive finance through the launch of a Long-Term Asset Fund (LTAF) structure and by identifying practical ways to address operational, regulatory and demand-side barriers. The FCA planned to publish a consultation on the LTAF in 2021 H1.

51. Looking ahead, some businesses would enter the recovery phase of the Covid disruption with more leveraged balance sheets. Although debt-servicing burdens were in general very low, some businesses might choose to hold back on investment and employment in order to reduce leverage by retaining earnings. The FPC discussed that, if widespread, this could be a drag on economic recovery.

52. Increasing the availability of long-term and equity-like finance for businesses could help to reduce this risk. It could also promote the supply of finance for new growth areas and support the economic transition needed to achieve the UK Government's commitment to net zero carbon emissions by 2050.

Market infrastructure

53. The FPC noted that retail trading volumes in US equities had increased significantly over the past twelve months, channelled through brokerage platforms that allowed retail investors to employ leverage, including through the use of call options. In late January, speculative retail investor activity, in part co-ordinated through social media, had caused significant volatility in certain US equities and commodity Exchange Traded Funds (ETFs). Some retail brokerage platforms were forced to temporarily suspend trading in some stocks in response to increased margin requirements from central counterparties (CCPs).

54. The FPC judged that the episode taken in isolation did not raise a UK financial stability risk. Nevertheless, it highlighted the importance in general of financial market infrastructure and regulation keeping up with developments in the nature of trading if market disruptions were to be avoided. The FPC would continue to monitor these developments closely.

The UK Countercyclical Capital Buffer (CCyB) Rate

55. At its Policy meeting the FPC continued to judge that cutting lending to businesses and households to avoid the use of capital buffers would be costly for the wider economy and consequently for the banks themselves.

56. Taking into account its discussion on the economy and the financial system the FPC agreed that it was appropriate to maintain the UK CCyB rate at 0% in 2021 Q1 and reiterated that it expected to maintain a UK CCyB rate of 0% until at least December 2021. Due to the usual 12-month implementation lag, any subsequent increase would not be expected to take effect until 2022 Q4 at the earliest. The FPC considered that this action supported banks' ability to supply the credit needed, and reinforced the expectation that all elements of banks' substantial capital buffers could be drawn down as necessary to continue to support the economy through the recovery phase.

57. The eventual pace of return to a standard UK CCyB rate in the region of 2% would depend on banks' ability to rebuild capital while continuing to support the UK economy, households and businesses. The FPC judged that this guidance should help to give banks clarity that they could use capital buffers as necessary.

UK mortgage market

58. In December 2020 the FPC had judged that changes over time in the risks faced by households meant that its mortgage market Recommendations warranted a review.

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

60. The review of the mortgage market Recommendations was underway and the Committee would report its conclusions later in the year.

Financial services and the UK's new relationship with the European Union

61. The transition period between the UK and EU had ended on 31 December, and the UK and EU had begun trading on the terms of the Trade and Co-operation Agreement.

62. Ahead of the end of the transition period between the UK and EU, the FPC had regularly published a checklist of actions to avoid disruption to the provision of financial services. Reflecting the extensive preparations made by authorities and the private sector over a number of years, the transition period had ended without any material disruption to the provision of financial services.

63. The UK had taken a number of steps to ensure UK clients could continue to access services provided by financial institutions in the EU, including granting a number of equivalence determinations in respect of the EU. The EU had provided temporary equivalence to the UK legal and supervisory framework for central securities depositories (CSDs) and CCPs and temporary recognition to UK CCPs and the UK CSD in order to manage financial stability risks.

64. The FPC would continue to monitor financial stability risks that could arise from disruption to the provision of financial services in the future, for example when the EU's temporary equivalence and recognition determinations for UK CCPs expire on 30 June 2022.

65. The UK and EU were negotiating a Memorandum of Understanding to establish structured regulatory cooperation on financial services. The UK authorities remained committed to mutual regulatory and supervisory co-operation with the EU authorities. Alongside co-operation with other regulatory authorities globally, this would continue to promote an open and resilient financial system to the benefit of all participants. The FPC judged that such mutual co-operation is necessary to manage financial stability risks.

66. Consistent with its statutory responsibilities, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

Cyber stress test

67. In June 2017, the FPC had set out the elements of the framework of regulation to strengthen the resilience of the UK financial system to cyber risk: (i) clear baseline expectations for firms' resilience that reflected the importance of firms and the services they provide for the financial system; (ii) regular testing by firms and supervisors to ensure that resilience kept pace with the evolving nature of the risk; (iii) identification of firms that were outside the financial regulatory perimeter, but which might be important for regulated firms; and (iv) clear and tested arrangements to respond to cyber incidents when they occurred.

68. The FPC had judged that resilience to cyber risk comprised both the ability to withstand cyber incidents and the ability to restore functioning after a cyber incident. In June 2018, the FPC had agreed that as part of establishing clear baseline expectations, it would set 'impact tolerances' for how quickly critical financial companies must be able to restore vital financial services following a severe but plausible cyber incident. Consistent with the FPC's remit, these would be calibrated at the point beyond which disruption would cause material economic harm. As such, the tolerances would not imply zero tolerance for disruption.

69. As set out in the June 2018 *FSR*, the Bank would use regular cyber stress tests to test firms' ability to meet these impact tolerances in severe but plausible scenarios. Firms would be invited to participate based on the significance of their contribution to the operations of the UK financial system's vital functions.

70. In May 2020, in response to diverting resources to managing the effects of the pandemic – both at the Bank and firms subject to cyber stress tests – the FPC decided to modify its approach to cyber stress testing work for at least three months. The text relating to that discussion had not been published in the Record of that meeting because the Committee viewed that it would be against the public interest to do so given the heightened level of cyber risk in the Covid environment, and the possibility of inadvertently increasing that risk by making this announcement. The FPC had agreed to review the text when it next discussed the Bank's work on cyber risk.

71. Work on the next cyber stress test had already restarted and at its March 2021 meeting, the Committee discussed its impact tolerance for payments services and initial plans for a 2022 stress

test. Those discussions would be set out in the 2021 Q1 Record. As such, the FPC agreed it was no longer in the public interest to defer publication of the May 2020 discussion. The Record of the FPC's May 2020 meeting would therefore be updated to include the text where publication had previously been deferred, when the Record of this meeting was published on 26 March.

Impact tolerance for payments

72. As noted in the June 2018 *FSR*, the FPC's impact tolerance for payments was defined as the point where disruption could begin to cause material economic impact. Reflecting its earlier discussions, and also drawing on insights from the 2019 cyber stress test pilot, the FPC confirmed that it would set its impact tolerance for payments at the end of the 'value date' – the date on which a payment is due.² This concept was well understood in industry, set a useful standard for firms' contingency planning, and value dates would occupy a central role in the FPC's cyber stress testing.

73. The FPC therefore expected the financial system to have the capability to complete critical payments by the end of the value date in the event of a cyber incident. The FPC was of the view that setting a baseline expectation for the finance sector would help guide firms' contingency planning and any required longer-term investments in their cyber (and broader operational) resilience capabilities. Robust *ex ante* planning would be particularly beneficial in those circumstances where a cyber incident had the potential to disrupt the provision of vital payment services, spill over into other equally important services or undermine market confidence.

74. Expecting the financial system to complete payments by the end of the value date would be consistent with existing international standards for Financial Market Infrastructures (FMIs), which required safe resumption of critical operations within two hours of a cyber disruption and to enable an FMI to complete settlement by the end of the day the disruption occurred.

75. The FPC acknowledged, however, that there might be particular instances where the disruption caused by a cyber incident was such that, despite prior planning, attempting to recover by the end of the value date could have a more adverse impact on financial stability than failing to meet the tolerance. This could be the case, for example if the integrity of data had been compromised and rapid recovery would risk further disruption. Firms therefore would need to be able to identify such circumstances at the earliest possible stage of an incident.

76. The FPC would use its cyber stress testing programme to explore: (a) firms' ability to identify quickly the nature of the disruption they faced and (b) the potential financial stability impact of firms

²International standards define the 'value date' as: 'The day on which the payment, transfer instruction or other obligation is due and the associated funds and securities are typically available to the receiving participant. See Committee on Payment and Settlement Systems (since rebranded as CPMI), *A glossary of terms used in payments and settlement systems*.

not meeting the impact tolerance in the case of some specific types of disruption where data integrity had been compromised.

77. The FPC expected that the findings of these stress tests would be used by supervisors and firms to enhance response and recovery capabilities, so that in future firms would be better prepared and able to meet the FPC's impact tolerances in similar severe but plausible scenarios.

2022 cyber stress test

78. The Committee therefore agreed that the 2022 cyber test should involve a scenario where data integrity had been compromised. This would build on the finance industry's own work.

79. The Committee agreed that the 2022 test should target the most systemic contributors in the end-to-end payments chain, as in the event of disruption, their ability to resume services in a timely manner was particularly important for UK financial stability. The Committee further agreed to focus the next cyber stress test on retail payments, so that the results from the test could help shed light on the potential financial stability impact of disruption to retail payments.

80. Building on the lessons of the 2019 pilot, the 2022 test would be expanded to include second-round effects. Participants would be asked to document how they would meet the FPC's impact tolerance, or, if they were not able to do so, what the impact might be. Firms would also be asked to document any barriers to meeting the FPC's impact tolerance, and to explore the extent to which their recovery options might depend on the actions of other participants.

81. Cyber stress testing was a relatively new tool and the voluntary pilot in 2019 had encouraged participants to revisit existing contingency work. In view of this, the FPC agreed that the 2022 test would be an exploratory test, rather than a formal pass-fail assessment. Participating firms would, however, be expected to share their findings and plans with their supervisors.

82. The Committee would provide more information on the 2022 cyber stress test in due course.

Libor transition

83. The Committee noted announcements on 5 March by ICE Benchmark Administration and the FCA, setting out the future cessation or loss of representativeness of the 35 Libor benchmarks settings. Market participants now had formal confirmation on the end dates for panel bank Libor in all cases. Panel submissions for sterling, Japanese yen, Swiss franc, euro and the 1-week and 2-month US dollar settings would cease immediately after 31 December 2021. Panel submissions to the remaining US dollar Libor settings would cease immediately after 30 June 2023.

84. The Committee also noted confirmation from the International Swaps and Derivatives Association that the announcements had caused the credit spread adjustment used in its fallbacks to be fixed for all Libor tenors and currencies. This would provide clarity on the outcome for the majority of Libor linked derivatives contracts and help to reduce economic uncertainty in the transition of other existing Libor linked contracts to more robust rates (e.g. SONIA in sterling markets).

85. The FCA confirmed its intention to consult on the need to compel continued publication of a 'synthetic' Libor rate for 1-month, 3-month & 6-month for sterling and Japanese yen after panel bank submissions cease. The use of the FCA's proposed powers to compel any such rate would need to be reviewed on an annual basis, up to a maximum of ten years, and the FCA intended for a Japanese yen synthetic Libor rate to only be published for one additional year, to end-2022. The availability of a synthetic rate was aimed at supporting the narrow pool of 'tough legacy' contracts only, and was not intended for use in new contracts. The approach for the US dollar Libor tenors that would cease in 2023 would be kept under review.

86. The Committee welcomed these announcements as a major milestone in the programme to remove the vulnerabilities to financial stability stemming from Libor. With clear end dates for the Libor panels now confirmed, the Committee reiterated that to avoid disruption in financial markets, market participants must continue to accelerate their plans to eliminate reliance on Libor benchmarks and ensure that the necessary steps are completed ahead of these dates.

The 2021 Solvency Stress Test Scenario

87. In Q4 2020 the Committee had announced that it would conduct its regular annual stress test, involving the major UK banks and building societies, in 2021.

88. The Committee had previously discussed the key parameters of the 2021 Solvency Stress Test scenario and so had taken the decision by written procedure to agree them ahead of the publication of the 'Key elements of the Solvency Stress Test' on 20 January 2021.

Liquidity Biennial Exploratory Scenario

89. In March 2020, the Bank had announced that it was pausing the 2019 Liquidity Biennial Exploratory Scenario (LBES) to alleviate the burden on core treasury staff at participating banks. In Q1 2021, the FPC³ and Prudential Regulation Committee agreed that in light of the experience of

³ The decision was taken by written procedure.

'live' liquidity management seen during 2020, further information was not required, so a restart of the exercise was not needed.

90. The LBES focussed on the implications of a severe and broad-based liquidity stress affecting major UK banks simultaneously. It was designed to explore how the reactions of banks and authorities to the stress would shape its impact on the broader financial system and the UK economy.

91. The stress scenario featured a material liquidity run lasting 90 days, affecting the major UK banks simultaneously, followed by a nine month recovery period. The magnitude of the liquidity outflows were calibrated to be similar to the set of stresses that determine the size of banks' regulatory liquidity buffers. In total they were equivalent to around 60% of the value of banks' high quality liquid assets at the start of the stress (for more details on the stress scenario, see the *July 2019 FSR*).

92. At the LBES launch in Q3 2019, participants started the exercise with liquidity buffers well in excess of regulatory buffer requirements: their aggregate liquidity coverage ratio (LCR) was around 140%. Given the extent of the liquidity shock, banks had little choice but to run their buffers down at the beginning of the stress. Their projections implied an aggregate LCR of 105% at the end of the stress period.

93. Banks' submissions to the LBES suggested that, on the whole, they were unwilling to allow their liquidity coverage ratios to fall below 100% if they could prevent them from doing so. At a group level almost all banks took enough actions in response to the stress to record LCRs at or above 100% by the end of the 3 month stress period.

94. As part of their response to the liquidity shock in LBES – banks reported that they would draw materially on Bank of England liquidity facilities, demonstrating a good understanding of the facilities on offer. Predominantly, they expected to use the standing Indexed Long-Term Repo facility, though there was also some usage of the Discount Window Facility and US dollar repo operations, backed by the swap line with the Federal Reserve. Total projected borrowing by banks from the Bank was around £140bn and US\$30bn in the scenario.

95. Banks also projected taking significant other defensive actions – including attracting back deposits by increasing deposit rates (which increased the cost of bank funding) and cutting lending to households and businesses. They used this to rebuild buffers quickly towards their starting levels after the three-month stress, whilst at the same time paying back borrowing from the Bank.

96. One key driver of banks' desire to maintain buffers where possible in stress and to re-establish previous liquidity buffers quickly afterwards seemed to be practices and perceived

obligations around disclosing their LCR ratios. Banks reported being keen to avoid the risk of being seen to be in liquidity difficulties relative to peers by financial market participants. Some LBES participants also cited a desire limit the reduction in their buffers during the stress in to guard against the possibility that the stress could worsen further.

97. FPC members noted that this was not in line with the way in which the prudential liquidity regime was intended to work. Liquidity buffers were intended to be drawn down in stress as necessary in order to avoid banks needing to take actions that could harm the wider economy. Liquidity regulation should not constrain banks' willingness or ability to draw down liquidity buffers in times of widespread stress, enabling them to continue supporting households, businesses, and the broader financial system. Similarly, the banks should not prioritise rebuilding buffers as quickly as possible after a stress solely for disclosure purposes, especially if that came at the expense of credit availability.

98. The FPC did not observe significant evidence of such liquidity hoarding and liquidity induced constraints to real economy lending by UK commercial banks during the March 2020 stress. That was for two reasons. Firstly, the LBES incorporated a much more severe liquidity run on banks than experienced in March 2020. In the LBES, the major UK banks experienced a simultaneous run on their retail and corporate deposits while in March 2020, these banks experienced a net inflow of these deposits. Secondly, timely central bank policy intervention meant banks had significant access to liquidity from an early stage.

99. The FPC planned to use the insights generated by the LBES, combined with experience gained from March 2020 in a number of ways. For example, it would be helpful to feed into international liquidity policy discussions, including at Basel, and the FPC's analysis of non-bank financial intermediation – in particular work to assess the factors that constrained dealer intermediation in March 2020. The FPC intended to publish this analysis in the next *FSR*.

Remit

100. On 3 March, the FPC received from the Chancellor a letter setting out the economic policy of Her Majesty's Government and Treasury's recommendations under Sections 9D-9E of the Bank of England Act 1998. The FPC would respond in due course.

The following members of the Committee were present:

Andrew Bailey, Governor

Colette Bowe

Alex Brazier

Ben Broadbent

Jon Cunliffe

Jon Hall

Anil Kashyap

Donald Kohn

Dave Ramsden

Nikhil Rathi

Elisabeth Stheeman

Sam Woods

Charles Roxburgh attended as the Treasury member in a non-voting capacity.

As permitted under the Bank of England Act 1998, court observer Bradley Fried was present at the 11 March meeting as observer in his role as a member of Court.

Andrew Bailey and the rest of the Committee recorded their thanks to both Don Kohn and Alex Brazier for their service to the Financial Policy Committee. Both had played a pivotal role in shaping the FPC's work. Don Kohn had been an external member of the FPC since its creation. Alex Brazier had been appointed to the FPC in his position as the Bank of England's Executive Director for Financial Stability in April 2015.

ANNEX: FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

The FPC has no Recommendations or Directions that have not already been implemented.

Other FPC policy decisions which remain in place

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

Topic	Calibration
Countercyclical capital buffer rate	The FPC agreed to maintain the UK CCyB rate at 0% in March 2021, unchanged from March 2020. 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. ¹ Under PRA rules, foreign CCyB rates applying from 2016 onwards will be automatically reciprocated up to 2.5%.
Mortgage loan to income ratios	<p>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.</p> <p>The PRA and the FCA have published their approaches to implementing this Recommendation: the PRA has issued a policy statement, including rules,² and the FCA has issued general guidance.³</p>
Mortgage affordability	<p>At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates:</p> <p>When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product rate at origination). This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2). This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.</p> <p>At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.</p>

¹ <https://www.bankofengland.co.uk/financial-stability>

² <http://www.bankofengland.co.uk/pru/Documents/publications/ps/2014/ps914.pdf>

³ <https://www.fca.org.uk/publications/finalised-guidance/fq17-2-fpc-recommendation-loan-income-ratios-mortgage-lending>