FINANCIAL STABILITY REPORT PRESS CONFERENCE

Wednesday 12 July 2023

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

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

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

In particular, I would like to draw out:

- Key developments so far this year in the global financial stability outlook;
- The FPC's judgements on the resilience of the UK banking system, including the results of our stress test and our decision on the countercyclical capital buffer;
- The lessons we have learnt so far from the recent stress in the global banking system;
- And the continued importance of addressing vulnerabilities in non-bank financial institutions.

Key developments so far this year

<u>I will first say a few words about the key developments so far this year.</u>

Global interest rates have risen further in the first half of this year. This reflects actual and expected increases in central banks' policy rates in response to continued inflationary pressures. In the UK, returning inflation to target sustainably will support the FPC's objective of protecting and enhancing UK financial stability.

The increase in interest rates and market volatility over the past 18 months has created stress in the financial system. The failure of three mid-sized US banks and Credit Suisse caused a rise in risk premia and volatility in March.

The impact of the March stress on the UK banking system was limited, and globally market risk sentiment has stabilised since then.

More broadly, the UK economy and financial system have so far been resilient to interest rate risk.

- Compared to previous periods of high interest rates, households and businesses are less likely to cut back on spending and default on loans for at least two reasons:
    - The resilience of UK banks, which means they have options to offer support to their customers;
    - And the FPC and the FCA's mortgage market measures, which have limited the build-up of household indebtedness and increased borrower resilience.

However, elements of the global financial system remain vulnerable to increased interest rates, and uncertainty surrounding the economic outlook and geopolitical tensions:

- Riskier corporate borrowing in financial markets – such as leveraged lending – appears particularly vulnerable.

- Global commercial real estate markets face a number of short and longer-term headwinds that are pushing down on prices and making refinancing challenging.

Moreover, it will take time for the full impact of higher interest rates to come through, both in the UK and other advanced economics. The FPC remains vigilant to these risks.

UK banking sector resilience, the 2022-23 stress test and the FPC's CCyB decision

<u>In the UK we've taken steps to ensure that the banking system is resilient to these risks, and that it maintains robust capital ratios and liquidity buffers.</u>

First, the results of our 2022-23 stress test show that the major UK banks are resilient to a severe stress scenario. Our scenario incorporated:

- Deep simultaneous recessions with materially higher unemployment in the UK and global economies;
- Increasing global interest rates;
- Persistently higher advanced economy inflation;
- And sharp falls in asset prices.

While interest rates are higher today and therefore closer to those which we published in the scenario, the scenario is significantly more severe than today's conditions. This is in large part driven by the scenario being based on deep simultaneous recessions and materially higher unemployment.

Second, we are also announcing today that the FPC has decided 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. We stand 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.

We have observed a tightening of lending standards from banks over the past few quarters. Our judgement so far is that this reflects appropriate risk management in line with changes in the macroeconomic outlook, rather than restricting lending primarily to protect capital positions. However, we will continue to monitor credit conditions for any signs of tightening which are not explained by changes in the macroeconomic outlook.

The overall risk environment is challenging. That said, we continue to judge that the UK banking system has the capacity to support households and businesses through a period of higher interest rates. Our stress test shows that this would be the case even if economic conditions were substantially worse than expected.

Lessons from the recent global banking sector stress

<u>The recent stresses in parts of the global banking system have underscored the importance of maintaining robust macroprudential, regulatory and supervisory standards.</u>

The FPC has, and will continue to draw lessons from this episode.

The episode also underscored how contagion can spread across and within jurisdictions, even where smaller institutions are involved. It 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 PRA's regulatory framework seeks to ensure that UK banks are adequately capitalised against the risks they are exposed to, including interest rate risk.

The Bank will contribute to relevant international work to consider whether lessons can be learnt for the liquidity and capital frameworks, in light of the size and pace of the recent bank runs in the US and Switzerland

Crucially, these events demonstrated the importance of credible resolution frameworks, and maintaining confidence in them. Over the weekend that Silicon Valley Bank's UK subsidiary failed, the Bank conducted a successful resolution transaction – demonstrating the effective operation of the UK's regime. These actions protected both depositors and public money.

In co-ordination with HM Treasury, we are now seeking to ensure that for small banks, which do not need to hold additional resources to meet so-called 'MRELs', there are resolution options that ensure continuity of access for depositors.

The stress also demonstrated the importance of international authorities' commitment to ensuring that the resolution framework and plans for global systemic banks, in line with Financial Stability Board standards, remain credible.

The resilience of market-based finance

<u>While recent events have brought risks in the global banking system into sharp focus, vulnerabilities in certain parts of market-based finance (MBF) remain.</u>

There remains an urgent need to increase resilience in market based finance 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.

These vulnerabilities could crystallise in the context of the current interest rate volatility. These risks were also evident in Autumn 2022, when the stress in liability-driven investment (LDI) funds required 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:

- 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.
- 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. We will also develop our approach to monitoring these risks across market based finance as the financial system adjusts to higher interest rates.

The Bank has also recently launched its system-wide exploratory scenario (SWES) exercise.

This 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.

I'd like to finish my remarks with two personal notes.

This is the last press conference where we are joined by Jon. Jon has served on the FPC and as the Bank of England's Deputy Governor for Financial Stability for ten years. During that time, as well as for the two and a half decades before it, Jon has been a public servant of the highest calibre. The Bank's gratitude to Jon is only rivalled by that of the other institutions in this country which he has tirelessly and steadfastly served over a distinguished career. I also owe a heartfelt personal thanks to Jon for his contributions and our discussions over the last decade. Jon will be missed – but he leaves the Bank with his ideas and energy having shaped and inspired a grateful institution.

The other note is I am afraid much sadder. Recently, we heard the news that our Executive Director for Resolution, Mel Beaman, tragically passed away. Mel was a world class bank supervisor – among the very best I have known. She was also the life and soul of the Bank. We miss her greatly.

Thank you.