Executive summary

The recovery in advanced economies has continued, supported by highly accommodative monetary policies. Strengthening economic growth has bolstered the resilience of global and UK banks, and market concerns about tail risks have declined. According to the Bank's latest *Systemic Risk Survey*, the perceived probability of a high-impact event in the UK financial system has fallen to its lowest level since the crisis. Yet financial stability risks remain.

Historically low levels of interest rates globally and the current backdrop of low volatility across financial markets may encourage market participants to underestimate the likelihood and severity of tail risks. There are increasing signs that investors, in searching for yield, may be increasing the vulnerability of the financial system to shocks. This vulnerability is amplified by structural changes in markets potentially reducing the availability of market liquidity at times of stress.

The recovery in the UK housing market has been associated with a marked rise in the share of mortgages extended at high loan to income multiples. At higher levels of indebtedness, households are more likely to encounter payment difficulties in the face of shocks to income and interest rates. This could pose direct risks to the resilience of the UK banking system, and indirect risks via its impact on economic stability.

The FPC does not believe that household indebtedness poses an imminent threat to stability. But it has agreed that it is prudent to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. The FPC has recommended that:

- 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, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination.

- The PRA and the FCA should ensure that mortgage lenders limit the proportion of mortgages at loan to income multiples of 4.5 and above to no more than 15% of their new mortgages.

These steps will be supported by the UK banking sector stress-test exercise, to be completed by the end of 2014, which will assess the resilience of UK banks to a marked fall in house prices and substantial increases in interest rates.

In light of its assessment of the outlook for financial stability and the FPC's recommendations, the FPC also decided at its June meeting to set the countercyclical capital buffer rate for UK exposures at 0% (as set out on pages 68–69).

The FPC also reviewed risks beyond the core banking sector, in particular channels through which stress in selected parts of the non-bank financial system could affect wider UK financial stability. Based on that assessment and initiatives under way to improve understanding and manage risks within these sectors, the FPC did not at present see a case for recommending changes to the regulatory framework.