BANK OF ENGLAND

Financial Policy Summary and Record of the Financial Policy Committee Meetings on 29 July and 3 August 2020

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This is the record of the Financial Policy Committee meetings held on 29 July and 3 August 2020.

It is also available on the Internet: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2020/august-2020

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 on 30 September 2020 and the Record of that meeting will be published on 8 October.

Record of the Financial Policy Committee meetings held on 29 July and 3 August 2020

The Financial Policy Committee (FPC) met on 29 July and 3 August 2020 to discuss and reach its consensus judgments on the outlook for UK financial stability and other matters that would be included in the next Financial Stability Report (FSR), including the Committee's assessment of the resilience of the banking system utilising a reverse stress test exercise. The FSR and this document together record the decisions of the FPC taken at these meetings and summarise the Committee's associated deliberations.

The performance of the UK financial system during the Covid-19 pandemic

The FPC discussed the "*Performance of the UK financial system during the Covid-19 pandemic*" chapter of the FSR and agreed the analysis in it. The UK financial system and policy action by the UK authorities had supported businesses and households to weather the economic disruption associated with Covid-19. This was evident in companies increasing their borrowing from banks, including through Government-backed loan guarantee schemes, larger companies using market-based finance in increasing volumes and households taking up payments holidays.

The UK financial system had so far been able to mostly meet the initial surge in demand for credit; and domestic critical market infrastructure had coped well. The FPC considered that this reflected both the resilience that had been built up in the UK financial system and the unprecedented policy responses of the Government and the Bank of England.

The FPC noted that although markets had partially rebounded following the disruption in March – as evidenced by a number of indicators, including increased UK corporate bond issuance – asset prices were still sensitive to Covid-19 developments. They agreed that risky asset prices could sharply correct if the UK or global economic outlook deteriorated. Members noted the importance – and difficulty – of distinguishing between re-pricings which occurred because of changes in economic fundamentals and those which were generated by dynamics within the financial system.

The FPC also noted that they had discussed 'fallen angel' risk – the selling of corporate bonds downgraded from investment grade to high yield – several times in the past, and agreed there could be an amplified tightening in credit conditions if a large wave of 'fallen angels' led to a deterioration of conditions across the sterling high-yield corporate bond market. As the FPC had discussed previously, institutional investors selling downgraded corporate bonds in high volumes could make it difficult for the sterling high-yield corporate bond market to function smoothly. This could amplify price falls. The FPC observed that the pattern of downgrades in past downturns or financial crises might not be informative of future downgrades given the differences between the current economic shock and previous ones.

Household indebtedness and Covid-19

The FPC discussed and agreed the chapter "*Household indebtedness and Covid-19*" in the FSR. The FPC noted that UK households entered the Covid-19 shock in a stronger financial position than at the start of the global financial crisis (GFC). This was due to households having lower debt to income and debt servicing ratios on average, and a smaller proportion of mortgage borrowers who had very high levels of repayments relative to their income than before the financial crisis.

The Committee recognised that the fall in economic activity as a result of the Covid-19 outbreak had put considerable pressure on the income of many households. As a consequence, the proportion of borrowers with high debt burdens had increased since March.

However, the Committee noted that the Government's extraordinary policy response to the Covid-19 pandemic, particularly the Coronavirus Job Retention Scheme (CJRS) had helped to cushion the fall in UK household incomes. Together with measures such as payment holidays, this had reduced the extent to which households had had to reduce consumption to make loan repayments to date.

Unemployment was expected to rise sharply under the central projection in the Monetary Policy Report (MPR). The FPC considered that this would lead to increased pressure on the incomes of a significant proportion of UK households as Government support programmes started to unwind and payment holidays ended. The FPC anticipated that consumer credit and buy-to-let lending were likely to experience higher loss rates than mortgages, both due to their greater risk and because the economic impacts of Covid-19 had affected this type of lending more adversely.

Given this, it was important for banks to be flexible in their treatment of borrowers, where this was consistent with sound lending practices. This would help to ensure the financial system could be a source of strength for the real economy, rather than increasing the negative economic effects of the shock if households were forced to cut spending sharply.

Based on the MPC's central projection in the August MPR, the FPC judged that the level of mortgage borrowers with high debt service ratios would decrease over time as incomes recovered and unemployment fell, but acknowledged that the economic outlook was uncertain. The impact on consumption would depend on a balance of factors, including the extent to which household incomes recovered, the level of job losses and the ending of payment holidays.

Staff had modelled a number of possible scenarios for the evolution of debt service ratios and of retail impairments, and the Committee noted that these factors had been incorporated in the analysis in the "*Resilience of the UK banking system*" Chapter of the FSR.

The UK corporate sector and Covid-19

The FPC discussed and agreed the analysis in the FSR chapter "*The UK corporate sector and Covid-19*". The impact of Covid-19 had reduced turnover for most UK companies, with around 60% of respondents to the ONS Business Impact of Covid-19 Survey reporting declines. This cash-flow shock had translated into a large increase in credit demand. The FPC judged that the UK financial system had largely met this demand with increased volumes of new credit, primarily through Government-backed loan guarantee schemes.

The Committee considered that it was important that banks continued to work with the corporate sector in order to support solvent but illiquid companies. The FPC's judgement remained that major UK banks and building societies ("banks") had the capacity, and it was in the collective interest of the banks, to continue to support businesses and households through this period.

The Committee reviewed staff estimates of the cash-flow deficits that UK companies could face which had been updated since the May *interim* FSR. Given the unprecedented nature of the shock, the lack of granularity in reporting requirements for smaller companies, and the limitations of the cash-flow deficit analysis, the FPC considered that estimating the impact of the Covid-19 shock on smaller companies' cash-flows was more uncertain than for larger companies. Since the initial cash-flow deficit analysis reported in the May *interim FSR,* staff had estimated deficits for 1.5 million additional small and medium enterprises (SMEs). Nevertheless, the FPC agreed that the exercise provided valuable insights into the cash needs of those SMEs at the smaller end of the spectrum. The FPC would continue to update its assessment of these needs.

Corporate insolvencies had remained low to date. However, the Committee anticipated that some companies, of all sizes, that had been highly indebted at the start of the pandemic would become insolvent as a result of the shock. Others would become unviable in the longer term if the pandemic led to permanently lower demand in certain sectors. For others, further borrowing might not be a solution. The FPC therefore saw a greater role for equity in the aftermath of the pandemic.

The FPC judged that corporate insolvencies mattered for UK financial stability because UK banks had direct exposures through their corporate lending and the resulting loss of jobs would lead to higher impairments on banks' lending to households. In addition deleveraging by companies seeking to avoid insolvency could also have indirect financial stability consequences through reduced investment and economic output. Finally, the household deleveraging mentioned in the "*Household indebtedness and Covid-19*" chapter could also lead to reduced spending.

Nevertheless, based on the results of its reverse stress test the committee judged banks would be resilient to risks from corporate and household distress even under the 'slow recovery' and 'double-dip' paths detailed in the "*The resilience of the UK banking sector*" chapter.

The Committee discussed the outlook for bank lending. The May *interim* FSR had demonstrated that it would be in banks' collective interest to meet new credit demand from companies during the stress. As had been shown in that report, given the government-backed loan guaranteed schemes in place, the costs of the additional capital charges would be far exceeded by the indirect benefits of avoiding large numbers of corporate failures and the associated spillovers to unemployment, which between them would increase losses on bank loan books. The FPC considered that the analysis still held as outlined in "*The resilience of the UK banking sector"* chapter of the FSR. The FPC also noted that there would be a significant nominal amount of corporate loans coming to maturity shortly, much of which would need refinancing. It was important that banks continued to support borrowers who wished to refinance, particularly where companies were facing temporary liquidity shocks associated with cash flow disruption, rather than fundamental challenges to their solvency.

The supply of finance for productive investment

The FPC discussed and agreed the analysis set out in the FSR Box "*The supply of finance for productive investment*", which describes the distortions - such as the information available to investors, liquidity needs and regulatory requirements - that might reduce the supply of finance for productive investment.

The FPC's discussion focussed on investing in illiquid and equity like assets though members recognised that a wide range of assets can produce productive investments. However, the Committee judged that frictions, such as regulatory or structural barriers, were greater for investing in illiquid and equity like assets.

The FPC considered that it was important that regulation and, structural and other barriers to investing in illiquid and equity like assets did not restrict the sustainable supply of finance for productive investment. Addressing issues related to productive investment was part of the FPC's secondary objective, but could also improve financial stability outcomes, in line with the FPC's primary objective. The FPC recognised that removing barriers in themselves might not lead to the desired increase in the flow of finance for productive investment, especially if there was a lack of demand from investors and trustees, and might impact other regulatory objectives. Nonetheless, the FPC agreed that more work should be undertaken in this area.

The resilience of the banking sector

The FPC discussed and agreed the analysis in the "*Resilience of the UK Banking system*" chapter of the FSR. The FPC discussed developments since it had conducted the desktop stress test, the results of which had been set out in the May *interim* FSR. At the time, the Committee had discussed a stress test for major UK banks' and building societies' ("banks") capital ratios based on the illustrative macroeconomic scenario published in the May 2020 MPR. That exercise had concluded

that banks' capital buffers were more than sufficient to absorb losses under that scenario, which under prudent assumptions, could have generated credit losses of just over £80bn.

The MPC's latest central projection was set out in the August 2020 MPR. The FPC judged that this outlook would be consistent with credit losses of somewhat less than £80bn and so it continued to judge that banks' capital buffers were more than sufficient to absorb losses under the MPC's central forecast.

As set out in the August MPR, there was a material level of uncertainty around the economic outlook. It was important that banks were able to continue to serve the economy through a range of possible economic outcomes.

The banking system cannot be resilient to all possible outcomes - there are inevitably very severe economic outcomes that would challenge banks' ability to lend. However, the Committee recognised that having entered a period of stress, there would be costs to banks taking defensive actions, such as cutting lending as doing so could make the central outlook materially worse.

The FPC considered that defensive actions might be necessary - but only if there was a material probability of the economy following a path whose stress was so severe that it might jeopardise banks' resilience and challenge their ability to absorb losses and continue to lend.

In light of that, the FPC had carried out a 'reverse stress test' exercise to analyse how much worse than the central projection the economic outcome would need to be in order to deplete regulatory capital buffers by as much as in the 2019 stress test, that had informed the setting of those buffers. In the 2019 exercise, banks' capital ratios had been depleted by around 5 percentage points equivalent to impairments of around £120 billion.

There was a range of scenarios that could generate that level of loss but in general, the cumulative loss of economic output associated with the outbreak of Covid-19 would need to be around twice as big as the MPC's central projection, and accompanied by a significant rise in unemployment.

The exercise used two illustrative reverse stress test paths for the UK and global economies that could generate £120bn of credit losses and deplete banks' capital ratios by around 5 percentage points: a very slow recovery from the 2020 H1 shock and a double-dip recession later in 2020. The second of these would have required the economic impact of events to be worse than those seen from March onwards.

The Committee also noted that there were a wide range of other possible scenarios that could generate the same degree of capital depletion. For example different assumptions around the impact and persistence of Covid-19, and sectoral distribution of shocks, could have materially different outcomes for banks' lending portfolios. And similar falls in capital ratios could be generated using

different assumptions about the size of the initial shock, and the speed of the subsequent recovery of key macroeconomic variables. In that regard, the FPC noted that it was the cumulative falls in output, employment and property prices, which would be most relevant for banks' losses, rather than the size of the falls in any one specific quarter.

Because banks actually had buffers of capital larger than required by past stress tests, the £120bn of losses in the reverse stress test would have, in aggregate, used up around 60% of the buffers of capital which sit above banks' minimum requirements. In aggregate, they would be left with the ability to absorb a further £80bn of losses arising from further shocks, in addition to the extremely severe paths in the reverse stress test.

Based on this exercise, the FPC judged banks to be resilient to a very wide range of possible outcomes. The FPC agreed that it would therefore be costly for banks and for the wider economy to take defensive actions. It remained the FPC's judgement that banks had the capacity, and it was in the collective interest of the banking system, to continue to support businesses and households through this period.

Building the resilience of market based finance

The FPC discussed and agreed the "*Building the resilience of market-based finance*" chapter of the FSR. The Committee considered that the analysis presented in the chapter also represented the preliminary findings of a more detailed assessment of the oversight and mitigation of systemic risks from market based finance, as recommended in the FPC's remit letter from the Government.

The FPC observed that market-based finance had become increasingly important for the provision of financial services to the UK economy. The FPC also noted that companies and banks rely on the smooth functioning of some financial markets to raise funding and liquidity and that disruption of these markets might have negative spillovers, both in contributing to fire sales and impeding price discovery. Market dysfunction could happen when individual investors acting in their own interest was suboptimal for society as a whole because they did not fully internalise the impact on others of their actions. Market based finance should be resilient so that it did not amplify shocks in the same way that a resilient banking sector ensured that it did not amplify shocks.

The FPC agreed that although the recent shock was exceptionally severe, the March 'dash for cash' had exposed a number of underlying vulnerabilities in market-based finance. The FPC recognised that the disruption demonstrated the potential damage that a lack of resilience in market–based finance could cause. The FPC judged that there was evidence that in recent years market-based finance had become more prone to liquidity shocks, raising the possibility of further disruption – and the need for central bank intervention; as a result it was therefore essential to review the resilience of market-based finance.

The FPC considered whether central banks have a role to play, especially in times of severe stress, to provide a liquidity backstop to support UK financial stability and reduce the likelihood and cost of disruption to the provision of financial services. The FPC also noted the risk of moral hazard by creating incentives for market participants to become overly dependent on central bank backstops.

The FPC discussed whether there were some central bank interventions that might be less prone to moral hazard than others, in particular those that relied on very low-risk collateral such as government bonds. The appropriate balance between private sector resilience and reliance on central bank liquidity support – or, alternatively put, prevention and cure - would be very important. The FPC discussed whether change would potentially be needed in both the financial system and the framework for central bank intervention and how to find the right balance.

The FPC considered that any review, including its own, into the functioning of market-based finance should take into account the system as a whole rather than just focusing on individual parts. The Financial Stability Board's (FSB) review of market-based finance, which would take account of interlinkages across different parts of the financial system would be valuable in that regard. The FPC recognised that due to the global nature of financial markets, it was particularly important to recognise that work to improve the resilience of market-based finance would need to be a domestic and international effort.

Accelerating the transition from Libor

The Committee was updated on the transition away from Libor and the temporary disruption to this transition due to Covid-19. As the Committee had stated previously, it was essential that reliance on Libor benchmarks was eliminated before end-2021. After that point, Libor benchmarks could cease to be available at short notice.

Market volatility earlier this year had highlighted the long-standing weaknesses of Libor, and authorities and industry working groups had revised plans to ensure that the transition from Libor was delivered by the end-2021 deadline. The FPC welcomed the forthcoming publication of a protocol for legacy Libor-linked derivatives contracts by ISDA. Firms should seek to incorporate appropriate fallback language into their legacy derivative contracts.

The Committee agreed that contractual parties who could transition away from Libor should do so on terms that they themselves agree with their counterparties. This would provide the best route to certainty for parties to contracts referencing Libor. By contrast, those who relied on regulatory action, enabled by the legislation that the Government plans to bring forward, would not have control over the economic terms of that action - and it might not be able to address all issues, or be practicable in all circumstances.

The FPC observed that market participants must now accelerate and execute their plans to deliver Libor transition, including the important milestones set out by industry working groups over the coming months.

In October 2019, the Committee agreed to continue to defer publication of Record text discussing Libor transition risks from legacy contracts. It agreed that it would review this decision again in 2021 Q4, or earlier if proposals for a legislative solution for the legacy stock of contracts were made public.

In June 2020, the UK Government announced its intention to ensure that the FCA had the appropriate regulatory powers to manage and direct any wind-down period prior to eventual Libor cessation. In addition, in July 2020, the European Commission published a proposal to amend the Benchmarks Regulation to provide for the designation of replacement benchmarks for certain benchmarks in cessation. Following these announcements, at its August meeting, the Committee again reviewed whether to publish or continue to defer publication of its previous discussion of legislative solutions from the Q2 and Q3 2019 Records.

The Committee concluded that, given other jurisdictions had not yet made public how they intended to approach the cessation of Libor under their domestic legal regimes, it remained against the public interest to publish its previous discussion of legislative solutions in the Record of its meeting. This is because doing so could precipitate the financial stability risks authorities were seeking to mitigate. Market participants could put undue reliance on the possibility of further legislative solutions being devised and this could reduce their incentives to transition to new reference rates in time, ahead of 2021.

The Committee decided to continue to defer publication, under Section 9U of the Bank of England Act 1998. It agreed that it would review again in 2021 Q4, or earlier if there are material developments in proposed legislative solutions for the legacy stock of contracts.[1]

Developments in payments

The Committee turned to the risks to UK financial stability from the potential for the pace of innovation in payments to outpace changes to the regulatory framework. In designing an effective regulatory approach for payments that is robust to rapid innovation and changes in technology, the FPC discussed the importance of identifying the characteristics of payments systems that could impact UK financial stability.

[1] The text in this and the three preceding paragraphs was omitted from the version of the Record that was initially published on 6 August 2020. The Committee agreed at its 9 March 2022 meeting to publish this text, for the reasons set out in the Record of that meeting.

The FPC agreed the analysis in the FSR Box 'Payments innovation and the need for changes to the regulatory framework'. In particular, the Committee agreed that there should be a focus on work by UK authorities to consider reforms to payments regulation to ensure that the FPC's principles for regulation and supervision of payments can continue to be met.

The FPC also discussed stablecoins and reiterated that where stablecoins were used in systemic payment chains they must offer the equivalent protections to stable and reliable money currently used in traditional systemic payment chains. The FPC viewed that, at the current time, major stablecoin proposals did not appear to meet these expectations. While this might be acceptable for speculative investment purposes, it would not be for payments widely relied upon in by UK households and businesses. Consistent with its statutory responsibilities, the FPC would where necessary, make Recommendations to HM Treasury regarding gaps in the regulatory perimeter which might represent risks to financial stability.

The financial stability implications of the UK's changing relationship with the EU

Having left the EU with a Withdrawal Agreement on 31 January 2020, the UK was in an 11-month transition period and negotiations on the shape of the future relationship between the UK and the EU were continuing.

The FPC reviewed a checklist of actions that would mitigate risks to financial stability that could arise from disruption to households and companies if no further arrangements were put in place for UK-EU cross-border trade in financial services for the end of the transition period on 31 December 2020.

Further action was needed to minimise risks of disruption to derivatives markets. Although such disruption would primarily affect EU households and businesses, it could increase volatility and spill back to the UK in ways that could not be fully anticipated or mitigated. Disruption to cleared derivatives markets could be avoided by ensuring clarity on the recognition of UK central counterparties by the end of September.

The Court of Justice of the European Union had ruled that standard contractual clauses were a valid means of transferring personal data from the EU to non-EU countries. The FPC considered that this reduced the risk of disruption to the provision of financial services arising from requirements on the lawful transfer of personal data from the EU to the UK. The Committee also reviewed other risks that could cause some, albeit less material, disruption to activity if they were not mitigated and there are no further financial services arrangements in place at the end of the transition period. The FPC's assessment of these risks would be published alongside the checklist of actions in the August FSR.

Overall, the FPC judged that, reflecting extensive preparations made by authorities and the private sector, should the transition period end without the UK and EU agreeing equivalence or other

arrangements for financial services, most risks to UK financial stability that could arise from disruption to cross-border financial services had been mitigated.

Irrespective of the particular form of the UK's future relationship with the EU, and 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 baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

The Financial Policy Committee (FPC) met on 29 July and 3 August 2020 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. The following members of the Committee were present:

Andrew Bailey, Governor
Colette Bowe
Alex Brazier
Ben Broadbent
Jon Cunliffe
Anil Kashyap
Donald Kohn*
Dave Ramsden
Elisabeth Stheeman
Sam Woods
Chris Woolard*
Charles Roxburgh attended as the Treasury member in a non-voting capacity.

**Members attended 29 July Policy meeting but were unavoidably unable to attend on 3 August*

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 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 June 2020, unchanged from March. 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	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,[2] and the FCA has issued general guidance.[3]
Mortgage affordability	At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability Recommendation to reference mortgage contract reversion rates: 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. 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.

[1] https://www.bankofengland.co.uk/financial-stability
[2] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[3] https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending