Bank of England

Financial Stability Report

July 2022

6 July
National Agency Presentation

Key messages

Global economic conditions have worsened. This puts pressure on the finances of households and businesses.

Despite market volatility, businesses can still access market funding. But improving market resilience remains crucial

The outlook for the economy remains very uncertain. A number of risks could affect UK financial stability in the future.

UK banks remain strong and able to support households and businesses

Global economic conditions have worsened

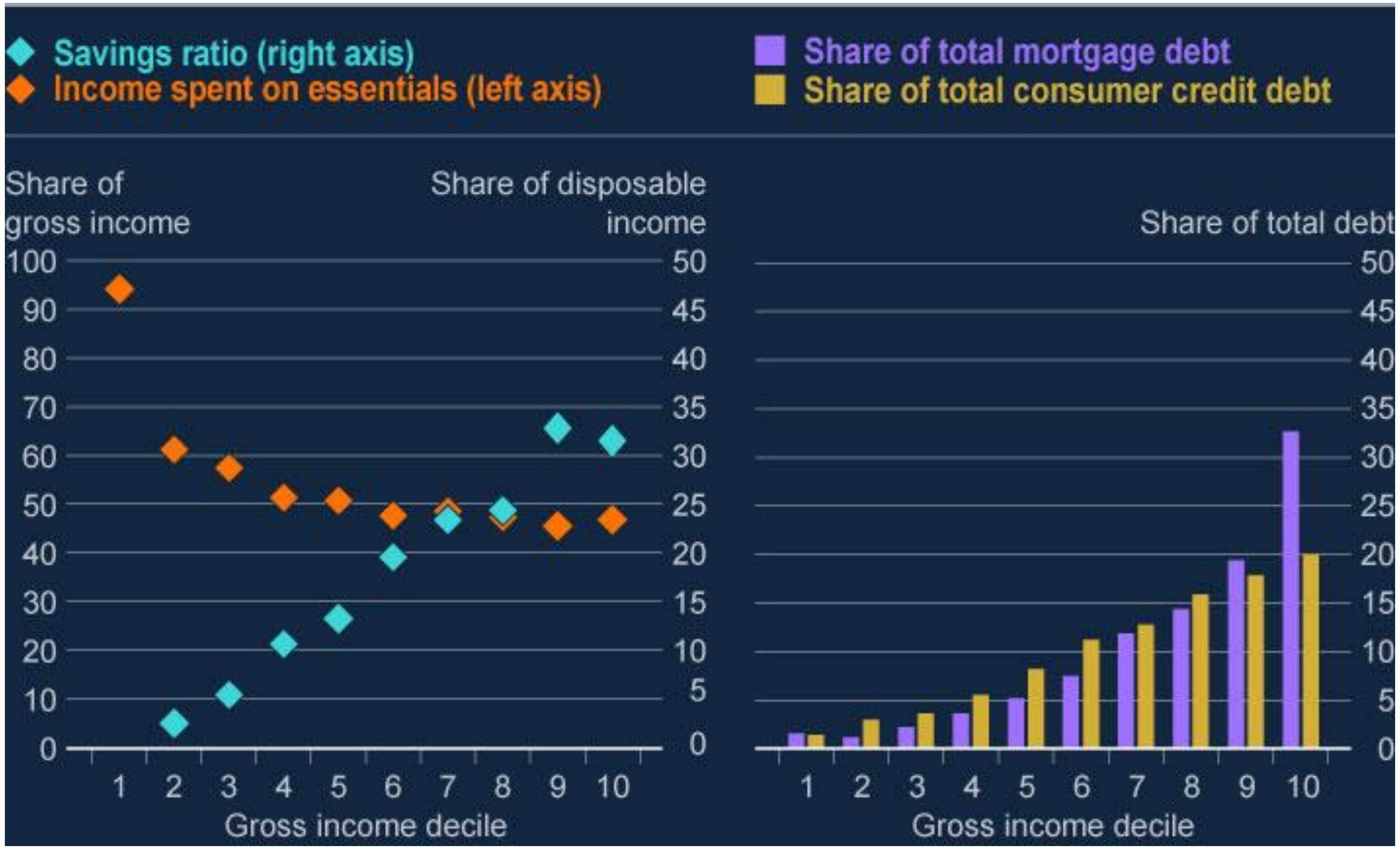
- Global inflationary pressures have led to a fall in household real incomes and profit margins of some businesses
- Global financial conditions have tightened significantly

- In the MPC’s May projections:
  - **Higher inflation** both in the UK and globally – particularly for commodities and tradable goods – was projected to reduce household real income substantially, lowering demand
  - UK **GDP** growth was forecast to **slow sharply** over the coming year
  - **Unemployment** is expected to **rise** over the medium term

Rises in living costs and interest rates will increase pressure on household finances, especially for those with lower incomes

- Higher cost of living will put pressure on household finances, especially those on lower incomes who spend more of their income on essentials
- Those households hold a smaller share of the total UK household debt stock

Share of income spent on taxes and essentials and share of total mortgage and consumer credit debt by gross income decile

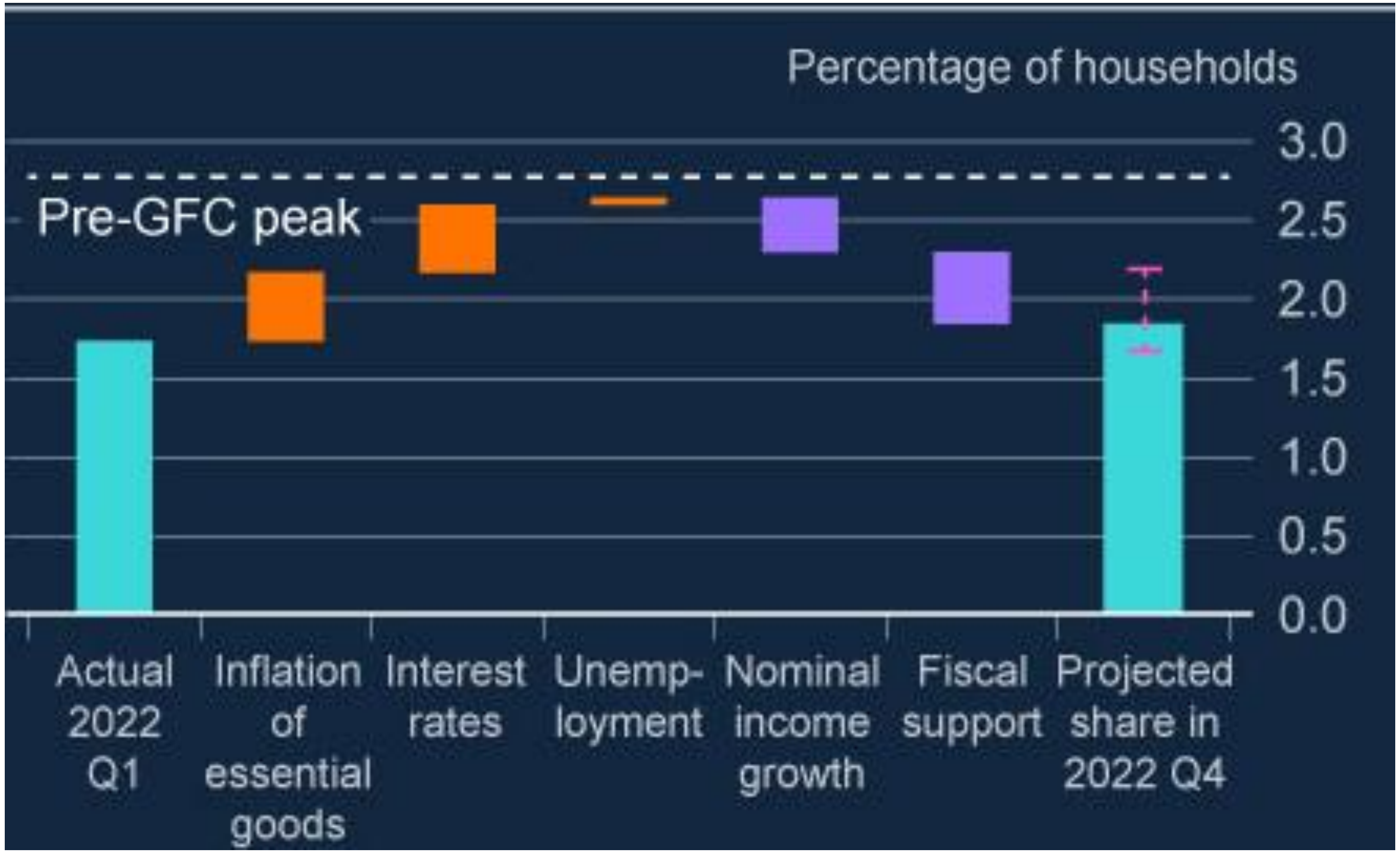


Despite this, the share of households more likely to experience repayment difficulties is not expected to increase substantially

- The share of households with high debt servicing ratios are likely to remain at around their current levels through 2022

- Government support measures will cushion the impact on on household finances

Share of households with cost of living adjusted DSRs on mortgage debt over 70% of net income

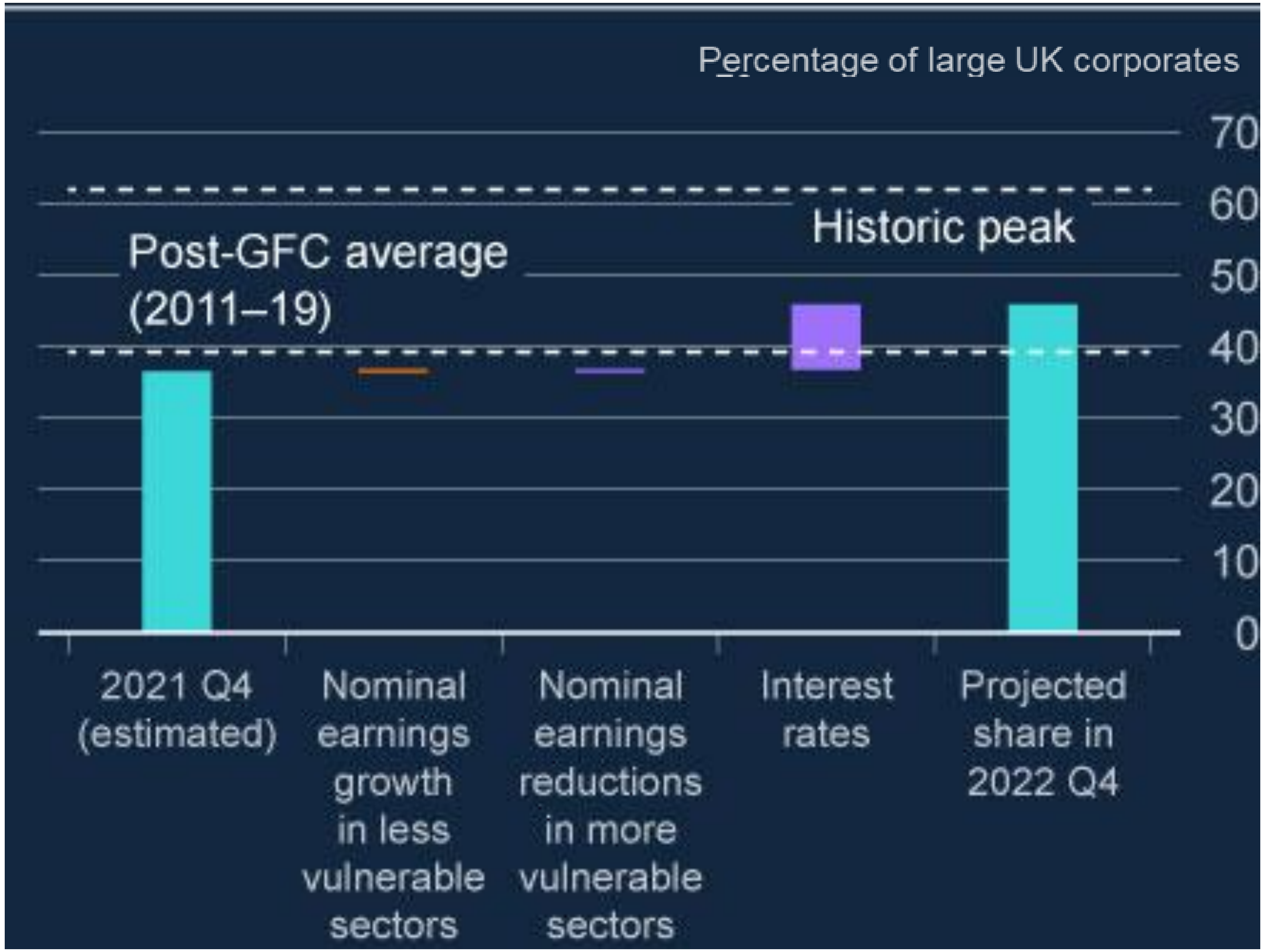


Debt servicing remains affordable for most UK firms

- Interest coverage ratios measure the ability of companies to cover their debt interest with earnings (measured by earnings before interest and tax divided by interest payments)

- Corporates with ICRs below 2.5 (those which are more likely to experience repayment difficulties) is expected to increase this year, but remain below historic peaks

Debt-weighted share of large UK corporates with ICRs below 2.5



But affordability will be more challenged in sectors exposed to energy prices and demand for non-essentials and for SMEs

- Sectors exposed to energy and fuel prices (eg manufacturing and transport) could face significant cost pressures

- The fall in household read incomes could reduce demand significantly in some sectors (eg non-essential household goods and services)

- UK SMEs have more debt than prior to Covid. The vast majority of new debt is at low rates and fixed for >6 years

- At least 70% of the SME debt stock was issued outside government schemes, and a large share of this is exposed to Bank Rate increases within a year.

The outlook is considerably uncertain and there are a number of downside risks that could adversely affect UK financial stability

If inflationary pressures become stronger and more persistent than currently expected (for example if **energy and food prices** rise further) it might lead to:

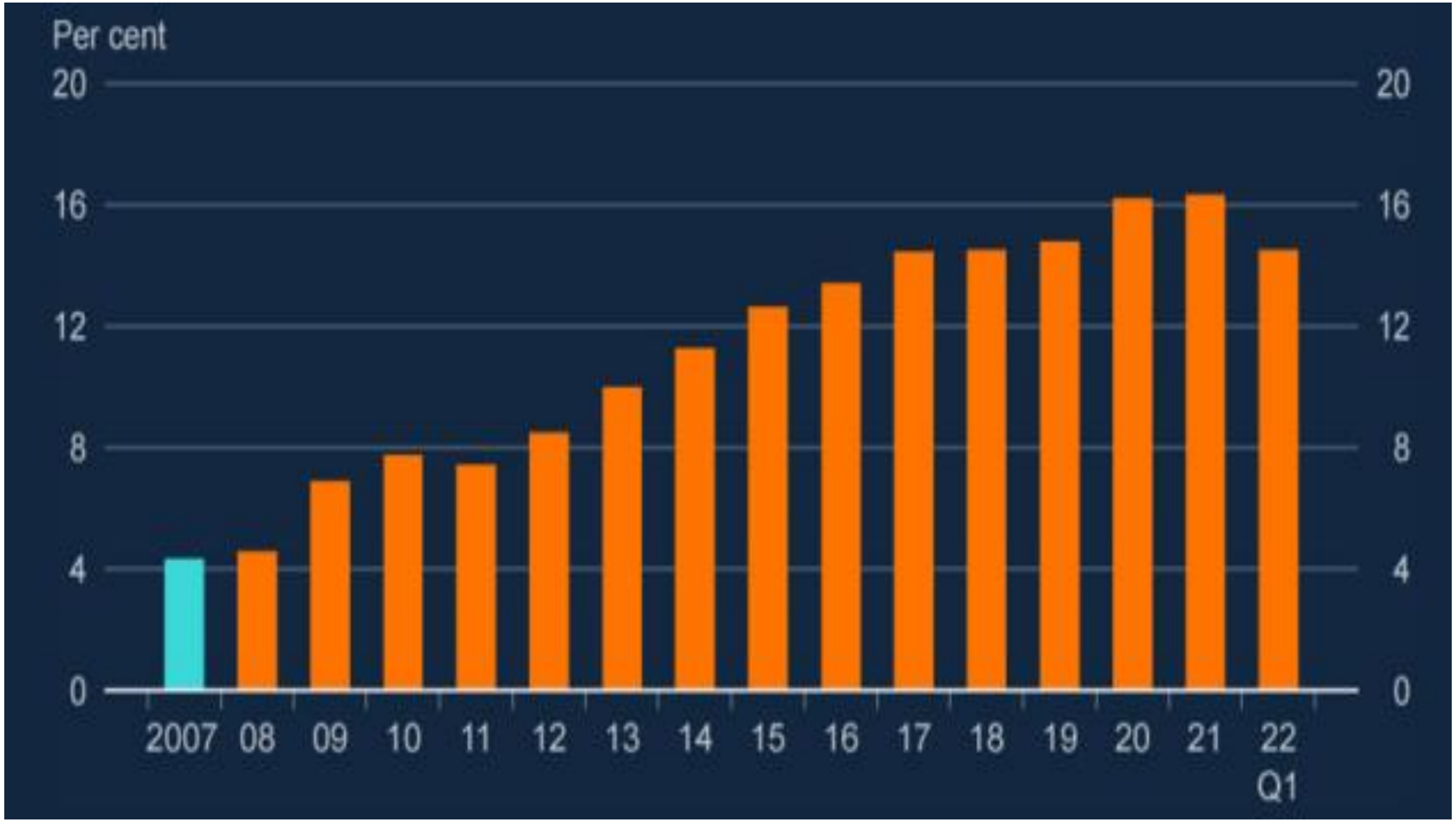
- Weaker economic growth globally
- A further sharp tightening in global financial conditions
- Further volatility and stress in commodity and financial markets

Tighter conditions would increase pressures already facing **households** and **businesses** and the serviceability of **public sector debt** in some countries

UK banks remain strong and able to support the economy

- Major UK banks' aggregate CET1 ratio is back to around pre-Covid levels
- It remains more than three times higher than pre-global financial crisis

Aggregate CET1 capital ratio of major UK banks



Tentative signs banks are reducing risk-taking at the margin

- Market intelligence suggests that banks are beginning to reassess risk appetite. This could result in a tightening of credit conditions over coming quarters.

- Banks are adjusting mortgage affordability tests to account for increases in inflation and interest rates.

- Banks have also tightened their risk appetites on lending to businesses, mostly to sectors most impacted by increased costs faced by UK households and businesses.

- Excessive tightening would harm the broader economy and ultimately the banks themselves.

The FPC is increasing the buffer of capital banks hold to absorb potential losses, and will stress test banks later this year

- We set the UK countercyclical capital buffer (CCyB) rate each quarter. This provides banks with an additional buffer of capital to absorb potential losses and support lending to UK households and businesses in a downturn.

- To help ensure UK banks have the resilience to lend in stress, we will increase the UK CCyB rate from 1% to 2% from July 2023. We stand ready to vary this rate in either direction in the future, depending on how risks develop.

- We keep a close watch on how resilient UK banks are by carrying out regular ‘stress tests’. Later this year we will test the ability of the UK banking sector to withstand deep recessions and high interest rates in the UK and globally.

Despite market volatility, businesses can still access market funding. But improving market resilience is crucial.

- The worsening economic outlook has caused markets (including commodity markets) to be volatile in recent months.

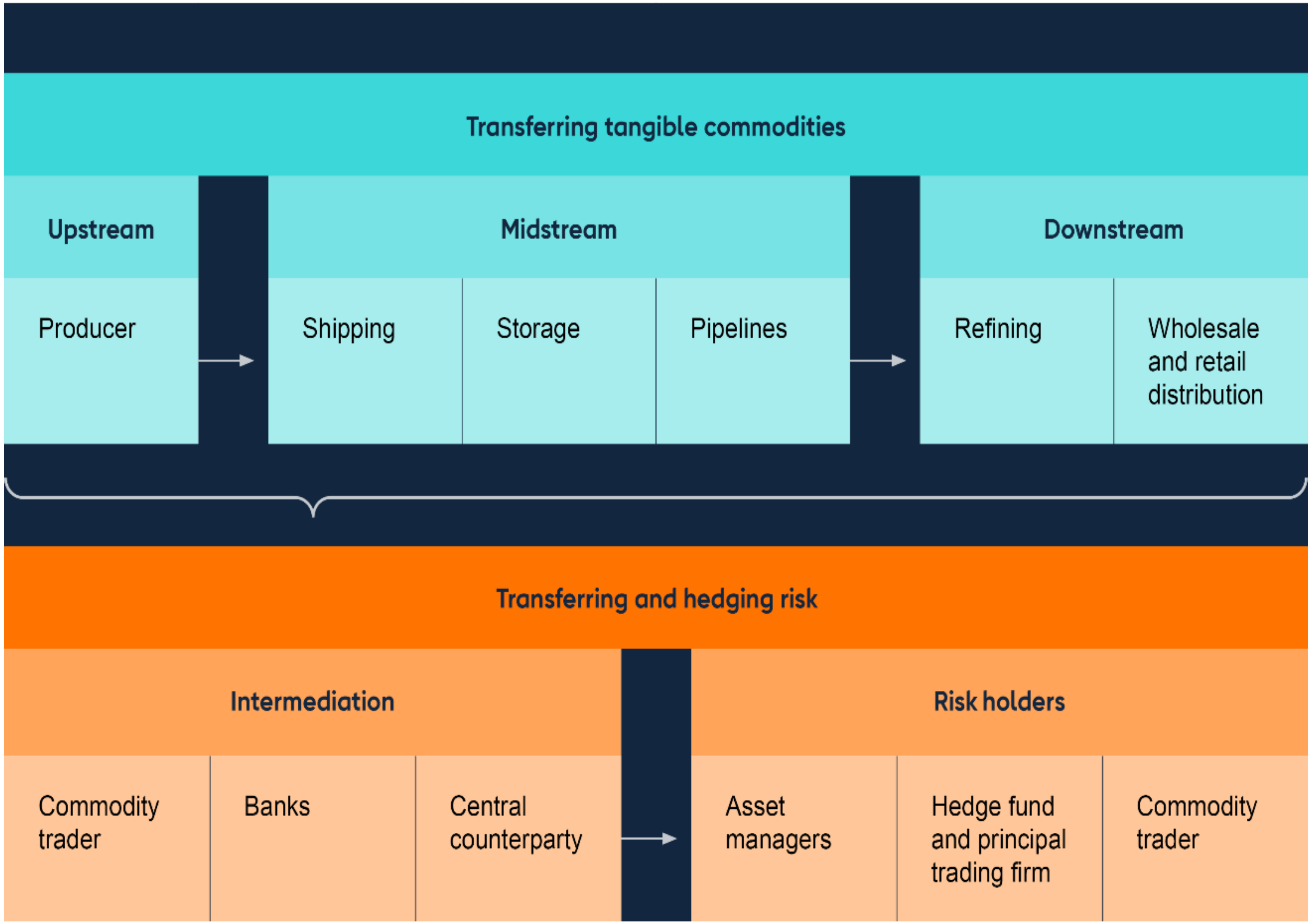
- However, the wider UK financial system has so far been resilient to the stress facing commodity markets.

- UK businesses that were previously able to access funding from financial markets have continued to be able to.

- But there are still risks in these markets that could affect UK financial stability. It is crucial that international work coordinated by the Financial Stability Board is successful in tackling these risks.

Financial markets support physical commodity markets

- Commodity markets are an essential part of the global economy
- Financial markets provide risk mitigation and intermediation services to physical commodity markets



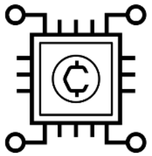
CCPs increased their margin requirements on commodity derivatives

- Between February and April, margin calls on commodity derivatives increased significantly more than they did in 2020

- Margin helps prevent counterparty credit risk building by ensuring transactions are adequately collateralised

Change in ICE Clear Europe and LME Clear's initial margin requirements between February to April 2020 and 2022

The FPC is also working to build resilience for longer-term risks



More regulation is needed to reduce risks to UK financial stability from **cryptoassets**

We ran an exercise to explore the effects of **climate-related risks** on UK banks and insurers

A regulatory framework is needed for cryptoassets

- There was extreme volatility in some cryptoassets (including those marketing themselves as ‘stablecoins’)

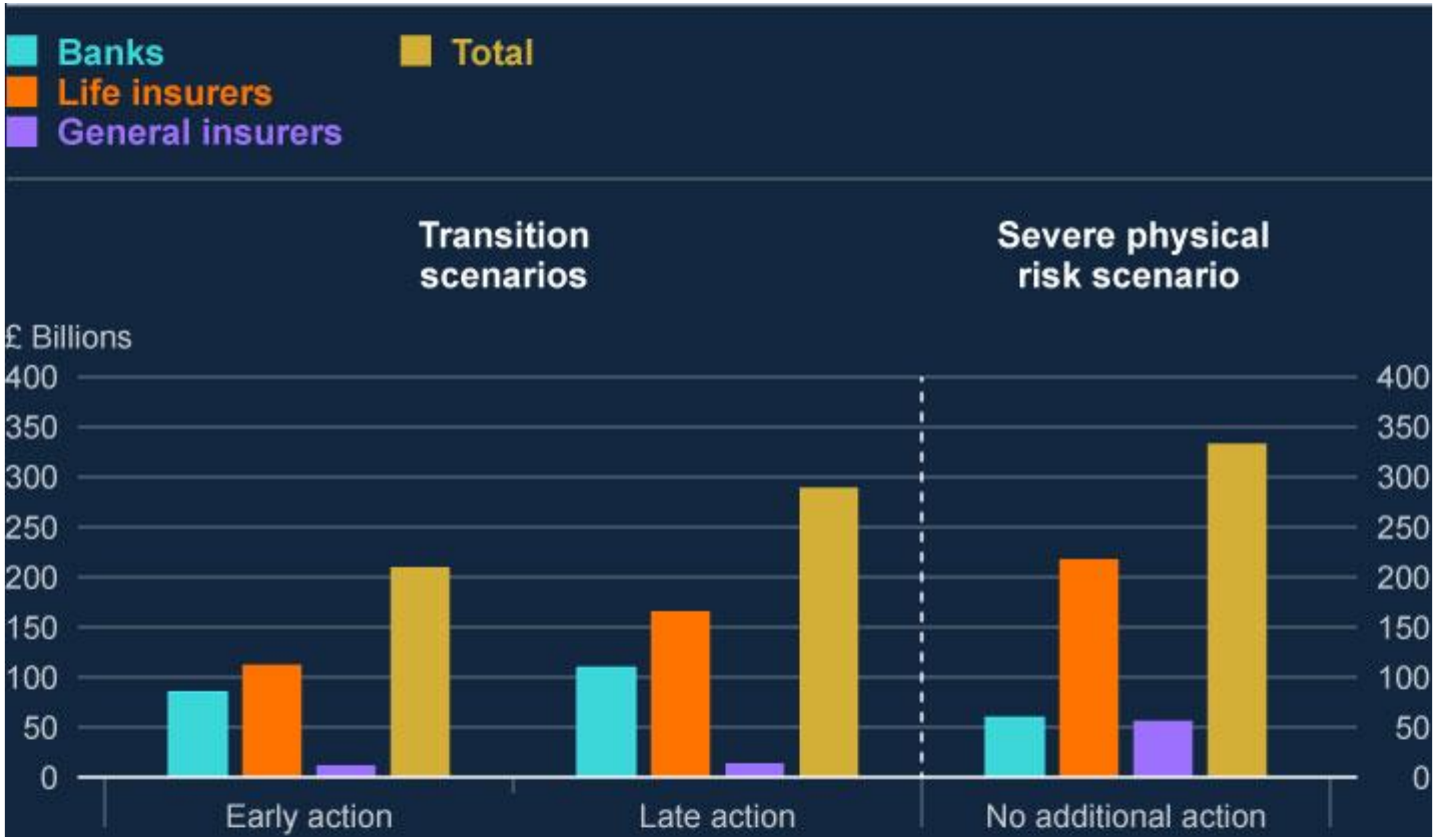
- These events **did not pose risks to financial stability overall**.

- But such **risks will emerge should cryptoasset activity, and its interconnectedness with the wider financial system, continue to develop**.

- This underscores the need for **enhanced regulatory** and law enforcement frameworks to address developments in these markets and activities.

We ran an exercise to explore the effects of climate-related risks on UK banks and insurers

Additional cumulative climate losses over scenario



- UK banks and insurers are **likely to be able to bear the costs** of the transition to net zero emissions that fall on them.
- Overall costs are **lowest with early, well-managed action** to reduce emissions.
- Banks and insurers have a **collective interest in supporting the transition to a net zero emissions** economy over time.
- Some **improvements to their climate risk management will need to be made** in order to do so.

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