Bank of England

Financial Policy Summary and Record of the Financial Policy Committee meeting on 30 September 2022

12 October 2022

This is the record of the Financial Policy Committee meeting held on 30 September 2022.

It is also available on the Financial Policy Summary and Record page of our website: **https://www.bankofengland.co.uk/financial-policy-summary-and-record/2022/october-2022**

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 His 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 28 November 2022 and the record of that meeting will be published on 13 December 2022.

Financial Policy Summary, 2022 Q3

The Financial Policy Committee (FPC) seeks to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face – so that the system is able to absorb rather than amplify shocks and serve UK households and businesses.

Global economic and financial market developments

Since the July 2022 Financial Stability Report (FSR), the global economic outlook has continued to deteriorate significantly, and by more than had been expected, while geopolitical risks have remained heightened. Inflationary pressures have intensified further, driven in part by a sharp reduction in gas supply from Russia to Europe. That followed steep rises in energy and other commodity prices after Russia's illegal invasion of Ukraine in February 2022, which had already exacerbated inflationary pressures arising from the pandemic. Household real incomes and the profit margins of some businesses have fallen this year as a result.

Financial conditions have tightened further, and financial markets have remained volatile in recent months, with significant rises in government bond yields, large moves in exchange rates, and falls in risky asset prices. Overall, the adjustment in global market prices has been consistent with tighter monetary policy globally and the further deterioration in the economic outlook. While generally orderly so far, pressures have been observed in parts of the global financial system, including challenging liquidity conditions across some energy and fixed income markets, but without a widespread crystallisation of financial stability risks. Global financial markets were, however, affected by spillovers from dysfunction in the market for long-dated UK government debt in response to which the Bank announced measures to support UK financial stability.

Global debt vulnerabilities

Rapid increases in the prices of a range of goods, including energy, and tighter financial conditions will continue to weigh on debt affordability for households, businesses and governments in many countries. That increases the risks posed by global debt vulnerabilities to UK financial stability through economic and financial spillovers. Pressure on household and corporate balance sheets could lead to losses for banks, particularly in the euro area where energy prices have risen very sharply. While there are pockets of deteriorating asset quality, recent analysis by the European Central Bank suggests that the euro-area banking system as a whole is resilient to a severe downturn.

Government support measures in many countries will reduce the pressure on vulnerable households and businesses, but are also likely to increase public sector debt. The FPC has previously highlighted vulnerabilities created by high public debt levels, including in the euro area, where yields on public sector debt in some countries remain elevated. Spreads on ten-year Italian government bond yields over their German equivalents have increased significantly since the start of the year.

The FPC has also previously highlighted vulnerabilities associated with riskier corporate borrowing, particularly in the United States. The stock of outstanding leveraged lending and private credit in the United States has risen sharply in recent years. Companies with such debt are likely to be particularly vulnerable to tighter financial conditions and the weaker growth outlook.

Debt vulnerabilities in China's property market appear to be crystallising. Housing investment and property prices have continued to fall, weighing on activity, alongside headwinds from Covid-related disruption. The tightening in global financial conditions, and the strengthening dollar, will also weigh on debt serviceability in non-China emerging market economies, particularly energy importers and those with high levels of dollar-denominated debt.

UK economic and financial market developments

The intensification of inflationary pressures, reflecting, in part, Russia's reduction of gas supplies to Europe, and the associated tightening in global financial conditions since the July 2022 FSR have led to a further material deterioration in the UK economic outlook.

In response to cost-of-living pressures, the UK Government announced support measures for households and businesses, including an Energy Price Guarantee. Other proposals, relating to taxation and supply-side reforms, were also announced. The Energy Price Guarantee is likely to reduce the near-term peak in CPI inflation and, together with other Government measures, support demand. On the other hand, rapid increases in financing costs for mortgages and other borrowing will increasingly stretch UK household and business finances in coming months. As previously communicated, the Monetary Policy Committee will make a full assessment at its next scheduled meeting in November of the impact on demand and inflation from the Government's announcements.

In late September, UK financial assets saw further significant repricing, particularly affecting long-dated UK government debt. The rapid and unprecedented increase in yields exposed vulnerabilities associated with the leveraged liability-driven investment (LDI) funds in which many defined benefit pension schemes invest. This led to a vicious spiral of collateral

calls and forced gilt sales that risked leading to further market dysfunction, creating a material risk to UK financial stability. This would have led to an unwarranted tightening of financing conditions and a reduction in the flow of credit to households and businesses.

On 28 September, the FPC assessed the risk to UK financial stability from dysfunction in the gilt market. It recommended that action be taken to address it and welcomed the Bank's plan for temporary and targeted purchases in the gilt market on financial stability grounds at an urgent pace. The Bank announced a temporary programme of purchases of long-dated UK government bonds until 14 October, and other measures. Real and nominal gilt yields fell materially following the initial announcement, creating an environment where LDI funds could build resilience to future shocks. The Bank, The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) are closely monitoring the progress of LDI managers as they put their funds on a sustainable footing for whatever level of asset prices prevails when the Bank ceases purchasing gilts, and to ensure LDI funds are better prepared for future stresses given current market volatility. The Bank's purchases will be unwound in a smooth and orderly fashion.

While it might not be reasonable to expect market participants to insure against all extreme market outcomes, it is important that lessons are learned from this episode and appropriate levels of resilience ensured. Although the PRA regulates bank counterparties of LDI funds, the Bank does not directly regulate pension schemes, LDI managers, or LDI funds. Pension schemes and LDI managers are regulated by TPR and the FCA. LDI funds themselves are typically based outside the UK. **The Bank will work with TPR and the FCA domestically to ensure strengthened standards are put in place.**

More generally, the vulnerabilities exposed by the gilt market dysfunction share characteristics with those in the non-bank financial system previously identified by the FPC that are being addressed by the Bank and Financial Stability Board's (FSB) long-standing work programmes. The FPC judges it crucial that this work results in effective policy outcomes to improve the resilience of non-bank financial institutions globally to sharp reductions in asset prices and liquidity. Absent such an increase in resilience, the financial stability risks associated with core market dysfunction could resurface in other ways or in other parts of the financial system. The FPC looks forward to the FSB's forthcoming report to the G20 on progress made in 2022. It is important that the report sets out clear priorities and expectations for international policy development in 2023.

UK debt vulnerabilities

In the UK, higher inflation and rising interest rates will weigh on households repaying debt. Rising interest rates will also increase debt-servicing costs for UK corporates, while higher input costs and lower household demand will impact business earnings.

The continued rise in living costs and interest rates will put increased pressure on UK household finances in coming months and make households more vulnerable to shocks. Overnight swap rates, which feed directly into mortgage interest rates, were, at the time of the FPC Policy meeting, priced to peak at around 6%. Assuming rates follow this market-implied path, the share of households with high cost-of-living adjusted mortgage debt-servicing ratios would increase by end-2023 to around the peak levels reached ahead of the global financial crisis (GFC).

However, households are in a stronger position than in the run-up to the GFC, so UK banks are less exposed to household vulnerabilities. In particular, the ratio of aggregate household debt (excluding student loans) to income is well below the pre-GFC peak and the share of outstanding mortgage debt at high loan-to-value ratios is much lower. The UK banking sector is also much better capitalised compared with the pre-GFC position, mitigating the risk that losses on loans cause lenders to reduce credit supply in order to preserve capital. In addition, lenders are now required to apply flexible approaches to repayments and only use repossessions as a last resort. Nevertheless, it will be challenging for some households to manage the projected rises in the cost of essentials alongside higher interest rates.

Higher input costs and lower demand will weigh on earnings for many businesses, especially those in sectors with large exposure to energy and fuel prices, or who provide non-essential household goods and services. This pressure on corporate earnings, combined with the rising cost of credit, will reduce companies' ability to service their debts, which is likely to lead to some business failures and reduced corporate spending as some companies seek to deleverage. Based on the path implied by financial markets for market interest rates at the time of the FPC Policy meeting, the share of businesses with low interest coverage ratios is expected to increase materially, but remain below historical peak levels.

Larger companies have a relatively large share of fixed-rate debt and this will insulate them to some extent from the immediate effects of rising interest rates. In contrast, small and medium-sized enterprises (SMEs) are more exposed to rising borrower costs: the majority of UK SME debt is floating-rate lending by banks. Although SMEs make up a relatively small share of total corporate debt, and therefore pose limited direct risk to the UK financial sector in terms of bank losses, they represent a much larger share of employment.

UK external financing vulnerabilities

The UK has a large external balance sheet and a current account deficit financed by gross inflows of capital. The UK's ability to continue financing its current account deficit is supported by a large, positive net international investment position (NIIP) when measured at market prices. In part, this reflects the fall in the value of sterling since 2015, which has

boosted the NIIP because UK liabilities tend to be denominated in sterling and UK assets tend to be denominated in foreign currencies.

But the size and composition of the UK's external balance sheet make it vulnerable to reductions in foreign investor appetite for UK assets, which can cause falls in UK asset prices and tighter credit conditions for UK households and businesses. The composition of the UK's external liabilities may also make it vulnerable to refinancing risk. Both of these risks may be heightened in current circumstances. The FPC continues to monitor the nature of capital flows in and out of the UK, and risk premia on a range of UK assets.

UK bank resilience

The FPC continues to judge that major UK banks have considerable capacity to support lending to households and businesses even with the further deterioration in the economic outlook. Major UK banks' capital and liquidity positions remain strong, and profitability has strengthened in aggregate. Capital ratios continued to fall slightly in 2022 Q2, but banks maintain headroom above their regulatory buffers. Looking forward, asset quality is likely to deteriorate in view of the worsening macroeconomic outlook, leading to increasing impairments and risk-weighted assets, although higher interest rates are likely to continue to have a positive effect on banks' profitability overall.

Although downside risks present headwinds, the FPC judges that UK banks have capacity to weather the impact of severe economic outcomes. In such scenarios, banks are likely to manage prudently their lending activity, commensurate with changes in credit quality in the real economy. Setting lending terms to reflect the new risk environment is appropriate - to date, the observed marginal tightening in major banks' risk appetites has been consistent with this. Restricting lending solely to defend capital ratios or capital buffers would be counterproductive and could prevent credit-worthy businesses and households from accessing funding. Such excessive tightening would harm the broader economy and ultimately the banks themselves. **The FPC will continue to monitor banking sector resilience, including in the 2022 stress test, and banks' risk appetite for lending.**

The UK Countercyclical Capital Buffer rate

The FPC is maintaining the UK Countercyclical Capital Buffer (CCyB) rate at 2%. This rate will come into effect on 5 July 2023, in line with the generally required 12-month implementation period. While the global and UK economic outlooks have deteriorated significantly and financial conditions have continued to tighten, any signs of a persistent reduction in credit supply from UK banks are limited and the Government's support measures will reduce the impact on domestic debt vulnerabilities from higher energy prices. As such,

the FPC continues to judge that a UK CCyB rate of 2% is appropriate to ensure that banks have sufficient capacity to absorb shocks and are able to lend through downturns.

Given the considerable uncertainty around the outlook, the Committee will continue to monitor the situation closely and stands ready to vary the UK CCyB rate – in either direction – in line with the evolution of economic conditions, underlying vulnerabilities and the overall risk environment.

The 2022 annual cyclical scenario

To support the FPC's monitoring and assessment of the resilience of banks to potential downside risks, the Bank commenced its annual cyclical scenario (ACS) stress test in September 2022. It tests the resilience of the UK banking system to deep simultaneous recessions in the UK and global economies, real income shocks, large falls in asset prices and higher global interest rates, as well as a separate stress of misconduct costs. Results will be published in Summer 2023.

The Future Regulatory Framework

On 20 July 2022, HM Government published the Financial Services and Markets (FSM) Bill. The FSM Bill will, among other things, implement the outcomes of the Future Regulatory Framework (FRF) Review, which was established by the previous Government to consider how the UK's financial services regulatory framework should adapt for the future, and in particular to reflect the UK's position outside the European Union.

The FPC continues to judge that UK financial stability will require levels of resilience at least as great as those put in place since the GFC and required by international baseline standards, and - recognising the importance of the United Kingdom as a global financial centre - in some cases greater. In this context, the Bill introduces new secondary objectives for the PRA and FCA to facilitate, subject to aligning with international standards, the international competitiveness of the UK economy and its growth in the medium to long-term. The FPC stresses the importance for UK financial stability of alignment with international standards within that objective. **The FPC supports the FRF measures contained in the Bill introduced into Parliament.**

Subsequently, the Bill passed its second reading on 7 September. During that reading, the Economic Secretary to the Treasury stated the Government's intention to include an amendment to introduce an intervention power that would enable HM Treasury to direct a regulator to make, amend or revoke rules where there are matters of significant public interest.

The FPC considers that the operational independence of regulators is an essential part of the regulatory regime in support of both of its public interest objectives, namely to deliver UK financial stability and strong, sustainable and balanced growth. The FPC will continue to monitor closely the Bill's progress through Parliament and will consider the implications of all amendments once details are available.

Record of the Financial Policy Committee meeting on 30 September 2022

1. The Committee met on 30 September 2022 to agree its view on the outlook for UK financial stability and, on that basis, 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. The FPC seeks to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face – so that the system is able to absorb rather than amplify shocks and serve UK households and businesses.

Global economic and financial market developments

2. The FPC judged that, since the July 2022 Financial Stability Report (FSR), the global economic outlook had continued to deteriorate significantly, and by more than had been expected. Global inflationary pressures had intensified further, driven in part by a sharp reduction in gas supply from Russia to Europe. That followed steep rises in energy and other commodity prices after Russia's illegal invasion of Ukraine in February 2022, which had already exacerbated inflationary pressures arising from the pandemic. Household real incomes and the profit margins of some businesses had fallen this year as a result. The FPC noted that further geopolitical developments could pose additional risks to the outlook.

3. Global financial conditions had tightened further, in part as central banks in major advanced economies continued to tighten monetary policy. Reflecting these developments, financial and energy markets remained volatile. Government bond yields had risen, with US ten-year yields reaching their highest levels since 2010. Global risky asset prices remained significantly down in the year to date, having weakened further since the July 2022 *FSR*. In the period since the July *FSR*, advanced economy equity prices were down by 4-13%, and investment-grade corporate bond spreads had widened by c.20-50bps. Natural gas prices in the UK and EU had risen sharply over the summer, and although they had subsequently fallen from their August highs, they remained elevated and volatile. The FPC noted that the adjustment in global asset prices had been generally orderly so far, albeit in challenging liquidity conditions across some energy and fixed income markets, and dysfunction in the market for long-dated UK government debt had been experienced in September, as set out in the UK economic and financial market developments section.

4. Reflecting the moves in asset prices over the quarter, measures of risk premia in credit markets were wider and sitting in the upper half of their historical distributions. Risk premia appeared more compressed in equity markets, with US equity risk premia in the bottom

quartile of its historical distribution. The FPC judged that risky asset prices remained volatile and vulnerable to further adjustment given risks to the macroeconomic outlook, potential for further inflationary shocks, related monetary policy responses, and geopolitical developments.

5. The Committee highlighted that weak risk appetite globally had limited primary issuance of corporate debt, especially by riskier firms. Year-to-date issuance of advanced economy high-yield bonds was down around 60%-90% relative to the levels observed over the past five years. Primary credit markets generally remained open for investment-grade corporates, but bond issuance had been around 30% lower relative to recent averages and issuers faced higher costs, as manifested in higher new issuance premia.

6. The deteriorating economic outlook and higher interest rates could challenge corporate creditworthiness. This might impact the ability of firms, particularly lower-rated ones, to roll over debt. The FPC noted that such pressures could be exacerbated if there was an increase in corporates downgraded from investment grade to high yield ('fallen angels'), which could force investors to sell downgraded securities into illiquid bond markets.

7. The FPC noted that amid high volatility, liquidity conditions had remained challenging, even in usually liquid markets such as US Treasuries, gilts and interest rates futures. For example, US Treasury market depth had continued to deteriorate this quarter, at times reaching its lowest levels since March 2020. The FPC noted that such deterioration in liquidity conditions was largely to be expected, given the levels of interest rate volatility and uncertainty.

8. The FPC noted that pressures in some parts of the system of market-based finance observed earlier in the year had continued over Q3. Those were manifested in outflows from riskier corporate bond funds, as well as elevated levels of margin calls, especially in commodity and interest rates derivatives markets. For example, US and European high-yield open-ended corporate bond funds had continued to see outflows since the July 2022 *FSR*, with year-to-date outflows reaching 11% and 15% of assets under management (AUM), respectively. The FPC noted that outflows from less liquid high-yield bond funds were three times more sensitive to losses than for more liquid equity funds. And although resilient earlier in the year, leveraged loan funds had also seen net outflows since May. In addition, sharp increases in margin requirements were observed at UK central counterparties (CCPs), which provide clearing services for global financial institutions. For example, initial margin on options and futures contracts, which include commodities and interest rate derivatives, had tripled since 2021 Q3 to record highs, and daily variation margin calls materially exceeded Covid peaks.

Global debt vulnerabilities

9. The FPC judged that the rapid increases in the prices of a range of goods, including energy, and tighter financial conditions would continue to weigh on debt affordability for households, businesses and governments in many countries, increasing the risks from global debt vulnerabilities. These global debt vulnerabilities posed a material risk to UK financial stability through economic and financial spillovers.

10. The further weakening in the global economic outlook increased the risk of these debt vulnerabilities crystallising, for example if corporate insolvencies and unemployment were to increase sharply. Pressure on household and corporate balance sheets could lead to losses for banks, particularly in the euro-area where energy prices had risen very sharply. In September, the European Systemic Risk Board had issued a general warning on vulnerabilities in the EU financial system. While there were pockets of deteriorating asset quality, recent analysis by the European Central Bank (ECB) suggested that the euro-area banking system, as a whole, was resilient to a severe downturn. Euro-area banks' aggregate Common Equity Tier 1 (CET1) capital ratio had increased in recent years, to around 15% in 2022 Q1.

11. The FPC had previously highlighted vulnerabilities associated with riskier corporate borrowing, particularly in the United States (US). The stock of outstanding leveraged lending and private credit in the US had increased sharply in recent years, for example with leveraged lending increasing from around $2 trillion in 2017 to around $3 trillion at the end of 2021. Companies with such debt were likely to be particularly vulnerable to the tightening in financial conditions and the weaker growth outlook.

12. Governments in many countries had introduced support measures that would reduce the pressure on vulnerable households and businesses, but were also likely to increase public sector debt. The FPC had previously highlighted vulnerabilities created by high public debt levels, including in the euro-area, where yields on public sector debt in some countries remained elevated. Spreads on ten-year Italian government bond yields over their German equivalents had increased significantly since the start of the year. In July, the ECB had established a new Transmission Protection Instrument that would enable it to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals.

13. Debt vulnerabilities in China's property market appeared to be crystallising. Housing investment and property prices had continued to fall, weighing on activity, alongside headwinds from Covid-related disruption. A sharper slowdown, for example if property sector stresses were to spread to the corporate sector more broadly, could have significant spillovers to the UK through trade and financial market channels.

14. The tightening in global financial conditions, and the strengthening dollar, would weigh on debt serviceability in other emerging market economies, particularly energy importers and those with high levels of dollar-denominated debt. Outflows of portfolio capital had continued since July, although so far this had not led to widespread strains in those financial markets.

UK economic and financial market developments

15.The FPC assessed that the intensification of inflationary pressures in the UK and globally, reflecting, in part, Russia's reduction of gas supplies to Europe, and the associated tightening in global financial conditions since the July 2022 *FSR* had led to a further material deterioration in the UK economic outlook.

16. In response to cost-of-living pressures, the UK Government announced on 8 September support measures for households and businesses, including an Energy Price Guarantee. On 23 September, the UK Government announced further measures relating to taxation and supply side reforms in its Growth Plan. The Guarantee was likely to reduce the near-term peak in CPI inflation and, together with other Government measures, support demand. Notwithstanding that, the rapidly rising financing costs for mortgages and other lending would increasingly stretch UK household and business finances in coming months. The Monetary Policy Committee would make a full assessment at its next scheduled meeting in November of the impact on demand and inflation from the Government's announcements.

17. In late September, UK financial assets saw further significant repricing, particularly affecting long-dated UK government debt. The path of Bank Rate implied by financial markets increased sharply, gilt yields increased at an unprecedented speed and sterling depreciated further. From 23 September, gilt yields rose c.100-120bps across the curve in three days, greater than the c.25-85bps increase seen over a seven-day period during the "dash-for-cash" in March 2020. And sterling depreciated by a further 5% against the US dollar, having already depreciated significantly following sustained dollar strength over the quarter. Sterling also depreciated against the euro, although moves were smaller. In contrast, the moves in sterling credit spreads, UK equity prices, and US and euro-area government bond yields were moderate over the same period.

18. The FPC observed that this extreme volatility in UK interest rate markets had led to a further reduction in market liquidity and an increase in the cost of trading in both cash gilt markets and sterling interest rate derivatives. The FPC noted that gilt bid-ask spreads increased across the curve from already elevated levels to exceed March 2020 peaks. However, the strains in the market were particularly acute in the market for long–dated gilts.

19. During 26 and 27 September, the UK authorities had an increasing number of discussions with market participants concerned about a material dysfunction in the market for

long-dated UK government debt. In particular, they noted that the size and pace of the increases in UK yields exposed vulnerabilities associated with leveraged liability-driven investment (LDI) funds that was exacerbating the fall in prices and reduction in market liquidity. These LDI funds were investment vehicles used by defined benefit (DB) pension schemes to help ensure that the value of their assets moved more in line with the value of their liabilities in order to create a more certain path to fully funded status. LDI funds typically used leverage, both through interest rate derivatives and repo borrowing, which allowed pension scheme clients to increase their hedges against falling interest rates with a lower upfront investment. However, it also meant that if interest rates rose the LDI funds could face rapidly accelerating losses and collateral calls, resulting in the need to provide extra cash.

20. The rise in yields had caused the net asset value (NAV) of LDI funds to fall significantly and their measured leverage to increase significantly, whilst they experienced large margin calls. This had forced the funds to urgently rebalance, either by asking their DB pension scheme investors to provide more capital into the fund by a cash injection or by selling gilts into an illiquid market. In some LDI funds, the speed of the yield moves and fall in some funds' NAV had far outpaced the ability of the DB pension scheme investors to provide new capital in the time available. Where capital was not incoming quickly enough, pooled LDI funds would have been forced to deleverage by selling gilts. Based on market intelligence, the Bank understood that some LDI funds planned forced sales of gilts in quantities far exceeding the normal daily level of gilt trading in an increasingly illiquid market. The market would have been unable to absorb these sales, without pushing yields higher still.

21. On 28 September, the FPC assessed the risk to UK financial stability from dysfunction in the gilt market. It recommended that action be taken to address it and welcomed the Bank's plans for temporary and targeted purchases in the long-dated gilt market on financial stability grounds at an urgent pace.[1] The FPC judged that absent this action, a large number of pooled LDI funds would have been left with negative NAV and would have faced shortfalls in the collateral posted to banking counterparties. If the LDI funds defaulted, the large quantity of gilts held as collateral by the banks that had lent to these funds would then potentially be sold on the market. This would amplify the stresses on the financial system and further impair the gilt market, which would in turn have forced other financial institutions to sell assets to raise liquidity and add to self-reinforcing falls in asset prices. This would have resulted in even more severely disrupted core gilt market functioning, which in turn would have led to an excessive and sudden tightening of financing conditions for the UK real economy. The FPC noted that the purchases would be targeted and intended to tackle a

[1] The decision was taken by written procedure on 28 September

specific dysfunction in the long-dated government bond market; and that they were time-limited – from 28 September until 14 October – and would be unwound in a smooth and orderly fashion once risks to market functioning were judged to have subsided.

22. Following the start of the Bank's gilt market operation the dysfunction in the long-dated gilt market had moderated. UK yields had fallen sharply, with 30-year nominal gilt yields falling by around 115 bps over the course of the day following the announcement, with long-term real yields falling even further. The FPC highlighted that this created a temporary environment where the necessary raising of liquidity and reduction of leverage by LDI funds could take place, avoiding the vicious spiral of collateral calls, forced gilt sales and market dysfunction. The FPC noted the importance of LDI funds using this period to take action to ensure they were more resilient once the Bank's temporary gilt purchases stopped. During this period, the Bank, The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) were closely monitoring the progress of LDI managers as they put their funds on a sustainable footing for whatever level of asset prices prevailed when the Bank ceased purchasing gilts, and to ensure LDI funds were better prepared for future stresses given current market volatility. This was important to mitigate the risk of future gilt market dysfunction and risks to UK financial stability.[2]

23. The Committee noted that the issues in LDI funds were one example of how abrupt market moves could result in a crystallisation of financial stability risks across different parts of the financial system, and demonstrated clearly how shocks could be amplified by vulnerabilities in the system of market-based finance. The FPC discussed that further corrections in global asset prices, especially if sharp and accompanied by rising credit risk concerns, could trigger further and faster redemption from money market funds (MMFs) and open-ended funds (OEFs) investing in less liquid and riskier credit assets. In addition, asset price falls could lead to the forced unwind of leveraged positions in other parts of the non-bank financial system which could be exacerbated by increases in margins reflecting greater asset price volatility. The FPC noted that those could interact with lower market liquidity conditions and pose the risk of dysfunction in other funding markets, such as those for high-yield corporate bonds and leveraged loans, as well as crystallise large losses for banks. This in turn could result in excessive tightening in financing conditions for UK corporates and households.

24. While it might not be reasonable to expect market participants to insure against all extreme market outcomes, it was important that lessons were learned and appropriate levels

[2] Further details of the Bank's temporary long-dated gilt purchase operation can be found in **the letter** from Sir Jon Cunliffe to the Treasury Select Committee.

of resilience ensured. Although the Prudential Regulation Authority (PRA) regulates bank counterparties of LDI funds, the Bank does not directly regulate pension schemes, LDI managers or LDI funds. Pension schemes and LDI managers are regulated by FCA and TPR. LDI funds themselves are typically based outside the UK. In this context, given the Bank's financial stability mandate, as stated in the FPC's November 2018 Financial Stability Report, the Bank had worked with TPR and the FCA on enhancing monitoring of the risks and to ensure strengthened standards are put in place. That had included working with TPR on a survey of DB pension schemes in 2019, and prompting work to improve DB pension liquidity risk management.

25. More generally, the vulnerabilities exposed by the gilt market dysfunction share characteristics with those in the non-bank financial system previously identified by the FPC that are being addressed by long-standing work programmes by the Bank and Financial Stability Board (FSB). Amidst the uncertain outlook and the crystallisation of risks in some markets, the FPC underlined the importance of making further progress in the international work programme coordinated by the FSB to remediate the underlying structural vulnerabilities in the non-bank financial institutions (NBFI) sector. The FPC judged it crucial that this work resulted in effective policy outcomes to improve the resilience of NBFIs globally to sharp reductions in asset prices and liquidity, and guard against the moral hazard risks associated with central bank interventions. Absent such an increase in resilience, the financial stability risks associated with core market dysfunction could return or resurface in other parts of the financial system.

26. The FPC highlighted that further policy work was needed to address structural liquidity mismatches in MMFs and OEFs, risks arising from pro-cyclicality in margin requirements, insufficient transparency and preparedness to meet margin calls, and risks arising from leverage in NBFIs, as evidenced in the LDI episode. In this context, the FPC welcomed the publication by the Basel Committee on Banking Supervision, the Bank for International Settlements' Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions of the report analysing the margining practices during the March 2020 market turmoil. The FPC strongly supported the recommendations for further policy work highlighted in the report, which included increasing transparency in centrally cleared markets, evaluating the responsiveness of initial margin models to market stresses, and, importantly in the light of recent stress in the UK LDI sector, enhancing the liquidity preparedness of market participants, especially non-banks, for margin calls. The FPC looked forward to the FSB's forthcoming progress report to the G20 that will set out progress in 2022 and highlighted the importance for the report to set out clear priorities and expectations for international policy development in 2023.

UK debt vulnerabilities

UK Household resilience

27. The FPC discussed the resilience of the UK household sector to higher inflation and rising interest rates, and judged the sector was in a stronger position than in the run-up to the Global Financial Crisis (GFC) so UK banks were less exposed to household vulnerabilities. The ratio of aggregate household debt (excluding student loans) to income had remained broadly stable at 124% in recent quarters, well below the pre-GFC peak of 144%. The share of households with mortgages had declined and, within that, the share of loan-to-value (LTV) mortgage lending of at least 75% was also much lower at 12% compared to around 20% prior to the GFC. The share of households with high debt-service ratios (DSRs) had been near historic lows in recent years. This resilience in the stock of mortgage debt in part reflected the FPC's mortgage market Recommendations, which had guarded against a material loosening in underwriting standards and an excessive build-up of household debt.

28. The continued rise in living costs and mortgage interest rates since the turn of the year had increased the proportion of income that households were devoting to meet mortgage payments and household bills. This would increase the number of households who were having difficulty meeting debt repayments and make households more vulnerable to future shocks.

29. Ahead of the significant repricing of UK financial assets in late September, the share of households with high cost-of-living adjusted mortgage DSRs had been expected to increase above its historical average by end-2023, but remain a little below the peaks seen ahead of the GFC. This increase was driven by rising prices for household essentials and higher mortgage interest rates. The impact of these factors was expected to be mitigated by the UK Government Energy Price Guarantee Scheme, continued nominal wage growth, and by the high proportion of mortgagors with fixed-rate mortgages, with only around 20% of mortgagors due to refinance within the next year.

30. Since late September, the market pricing of overnight swap rates had, at the time of the Policy meeting, risen to around to a peak of 6% in 2023. As a result, mortgage interest rates were likely to increase further over coming months. If market rates were to remain at that level, the share of households with high cost-of-living adjusted mortgage DSRs would be expected to increase further to around pre-GFC peaks by end-2023.

31. The FPC noted that debt servicing burdens on unsecured credit were also expected to increase. Historically, aggregate defaults on unsecured credit had been correlated with unemployment, which was projected to increase in the August 2022 Monetary Policy Report. As a result, consumer credit defaults were expected to rise, but by materially less than major UK banks had been stress-tested against in the Bank's annual stress tests.

32. The FPC also noted that the UK banking sector was much better capitalised compared to its pre-GFC position. This would mitigate the risks of an adverse feedback loop, whereby losses on loans caused lenders to reduce credit supply in order to preserve capital, leading to lower spending and house prices, and further losses for lenders. Furthermore, the FCA's Mortgage Market Review introduced in 2014 included updated arrears management practices. These had ensured lenders applied a flexible approach on repayments while repossessions were used only as the last resort. As a result, repossessions of large numbers of borrowers' properties, as had occurred in the early 1990s recession, were less likely.

33. The FPC also discussed broader conditions in the mortgage and housing markets. Annual house price growth had remained above 10% in recent months, but there were clear signs that house price growth was slowing, driven by the deteriorating economic outlook and rising mortgage interest rates. The FPC judged that the recent tightening in mortgage interest rates would put further downward pressure on house price growth.

34. Mortgage approvals for house purchases had continued to fall and had now returned to around pre-pandemic levels. Approvals were expected to fall further following the recent market volatility and sharp increases in mortgage rates. Some lenders had withdrawn mortgage products from the market, citing high swap rates relative to mortgage product rates, heightened uncertainty and the negative economic outlook. The FPC judged that this was likely to be temporary as lenders repriced their products. The FCA had contacted UK lenders to ensure options were available for borrowers once their fixed rates ended.

35. The FPC also noted that while it was too early to assess the impact on the mortgage market of the withdrawal of its affordability test Recommendation in August 2022, to date, there had been little evidence of an impact on lending standards.

UK Corporate resilience

36. The FPC judged that the material deterioration in the economic outlook would weigh on corporate earnings. Pressures on corporate earnings would be felt in most sectors due to higher input costs and reduced demand. Some sectors would be impacted more than others. The fall in household real incomes could reduce demand significantly in some sectors, such as non-essential household goods and services. And sectors with large exposures to energy or fuel prices, such as transport and some manufacturing subsectors, could come under significant cost pressures. The Government's Energy Bill Relief Scheme would cap the increase in energy costs that businesses would face over the winter.

37. The pressure on corporate earnings combined with a rising cost of credit would reduce companies' ability to service their debts, likely leading to some business failures and reduced corporate spending as some companies sought to deleverage. Ahead of the significant repricing of UK financial assets in late September, staff had estimated that the debt-weighted

share of mid to large-cap companies with Interest Coverage Ratios (ICRs) below 2.5 – a threshold below which staff estimated that failure becomes more likely – might rise from 36% at the end of 2021 to 45% at the end of 2022. Following the further tightening in UK financial conditions in late September, the peak in forward market interest rates implied by financial markets had increased substantially to around 6%. If market interest rates were to remain at that level, staff estimated that the debt-weighted share of companies with ICRs below 2.5 might increase to 54%, a material increase but below the historic high of 62%. The FPC noted that larger companies had a relatively large share of fixed-rate debt and that this would insulate them to some extent from the immediate effects of rising interest rates.

38. The FPC also discussed current conditions in corporate credit markets. Credit demand had been subdued in the year to date. Credit supply appeared to have tightened somewhat, concentrated in sectors that were more vulnerable to higher energy costs and lower demand. Finance raised in riskier markets had slowed sharply.

39. The FPC noted that small and medium sized enterprises (SMEs) had more debt than prior to the Covid pandemic and that their liquidity position had deteriorated in recent months. The majority of this new debt was issued at relatively low rates and fixed for six years or longer. Despite this, over 70% of the stock of SME debt was estimated to have been issued outside government loan schemes, and a large proportion of this debt was exposed to interest rate increases. Although SMEs made up a relatively small share of total corporate debt and therefore posed limited direct risk to the UK financial sector in term of bank losses, they accounted for a much larger share of employment. The FPC noted that the share of SMEs with insufficient cash to cover at least 7 days of turnover had increased in the latest data available up to June, although remained below pre-pandemic levels. This may be in part due to some SMEs having spent loans acquired through government-sponsored schemes at the start of the pandemic.

40. The FPC noted that insolvencies had continued to increase in recent months to above pre-pandemic levels. This reflected the phased withdrawal of temporary restrictions on insolvency proceedings during 2021 and early 2022 and a deterioration in companies' operating environment. The large majority of the increase in insolvencies was among very small, younger entities that held little debt with a high proportion guaranteed by the government. Since the start of the pandemic, the cumulative level of insolvencies of UK corporates remained below what would have been expected had the 2019 level of insolvencies prevailed. Insolvencies were likely to rise further over coming quarters, reflecting the deteriorating economic outlook and the continued effect of the pandemic.

UK external financing vulnerabilities

41. The FPC noted that the UK's current account deficit was large by historical and international standards and that, since 2016, it had been financed by substantial gross inflows of foreign capital. In the years prior to 2016, it was financed by UK investors selling overseas assets at a faster rate than foreign investors were selling UK assets. The Committee had noted previously that the ease of financing the current account deficit rested on the credibility of the UK's macroeconomic policy framework and its continued openness to trade and investment.

42. The UK's ability to continue financing its current account deficit was supported by its large, positive net international investment position (NIIP) that, while negative when measured at book value, is large and positive when measured at market prices. In part, this reflected the fall in the value of sterling since 2015. The UK's NIIP tended to improve when sterling depreciates because UK liabilities tend to be denominated in sterling and UK assets tend to be denominated in foreign currencies.

43. The FPC also noted that the current account deficit was small compared to the size of gross capital flows. These large gross flows reflected the UK's position as an international financial centre and its large, pre-existing, external balance sheet.

44. The FPC judged that the UK's large external balance sheet exposed it to the risk of a reduction in foreign investor appetite for UK assets, which can cause a fall in UK asset prices and tighter credit conditions for UK borrowers. This would be particularly likely to impact areas of the economy where foreign investors had a significant presence, such as the commercial real estate market.

45. The FPC also judged that the composition of the UK's external liabilities made it vulnerable to refinancing risks. A large share of its external liabilities were 'other investment' liabilities, comprised of loans and deposits to the financial sector that are typically of a relatively short duration. Other investment liabilities had contracted during the GFC as wholesale funding to UK banks dried up, exacerbating the liquidity crunch on UK banks. But there were some factors that mitigated this risk. A large share of the UK's other investment liabilities consisted of intragroup transactions that were typically more stable in a stress. Relative to the GFC, these refinancing risks were also mitigated by the reduction in the scale of 'other investment' liabilities and the improved resilience of the UK banking sector. This was partly due to the development of a regulatory framework that, for example, enforced regulation that required financial institutions with a greater exposure to these risks to hold larger buffers of liquid assets.

46. The FPC judged that risks associated with the UK's external balance sheet may be heightened in current circumstances. The FPC would continue to monitor the nature of capital flows in and out of the UK, and risk premia on a range of UK assets.

UK bank resilience

47. The FPC discussed the resilience of the UK banking system, including its ability to withstand shocks and maintain credit supply to businesses and households. The FPC judged that the major UK banks' capital and liquidity positions remained strong. Capital ratios had slightly declined in 2022 Q2 – the headline aggregate CET1 capital ratio was 14.2% in 2022 Q2 compared with 14.5% at the end of Q1.

48. The FPC noted that capital ratios of major UK banks were expected to continue to fall slightly over coming quarters, though banks were expected to maintain sufficient headroom to accommodate an increase in the UK Countercyclical Capital Buffer (CCyB) rate to 2%. Supervisory intelligence suggested recent market movements, to date, had not had a significantly detrimental impact on the aggregate liquidity coverage ratio for major UK banks. The FPC judged that major UK banks had the capacity to support lending to households and businesses even with the further deterioration in the economic outlook.

49. The FPC noted that UK banks reported strong profitability in Q2, driven by the rising interest rate environment. Impairments in Q2 remained below average pre-pandemic levels. Looking forward, the FPC noted that banks faced considerable headwinds. Although higher interest rates were likely to continue to have a positive effect on banks' profitability, asset quality was likely to deteriorate in view of the worsening macroeconomic outlook. Any deterioration of the credit quality and ratings of banks' borrowers would result in banks taking additional impairment charges and experiencing risk-weighted asset inflation.

50. The FPC noted that UK banks were faced with additional risks associated with large market moves, in particular through banks' counterparty exposures to NBFIs. The FPC judged that absent the Bank's temporary and targeted purchases in the gilt market, sales and price falls in gilts would have been amplified further in an adverse feedback loop and could have crystallised losses for banks (see UK economic and financial market developments). The FPC judged that a further tightening in financial conditions, beyond that priced in by markets, could result in a crystallisation of financial stability risks in other parts of the financial system, particularly if amplified by the vulnerabilities in the system of market-based finance previously identified by the FPC. This could crystallise losses for banks and, in turn, result in excessive tightening in financing conditions for UK corporates and households.

51. The FPC noted that net retail lending remained strong in Q2, but net lending to businesses was subdued. To date, there had been no evidence of excessive tightening in

banks' lending appetites, beyond that in line with standard risk management practices. However, the FPC noted that in the week commencing 26 September, dysfunction in the swap market had led a number of UK banks to withdraw mortgage products given the uncertainties associated with pricing them.

52. Although downside risks would present headwinds, the FPC judged major UK banks had capacity to weather the impact of severe economic outcomes. In such scenarios, banks were likely to manage prudently their lending activity, commensurate with changes in credit quality in the real economy. Setting lending terms to reflect the new risk environment was appropriate. Restricting lending solely to defend capital ratios or capital buffers would be counterproductive and could prevent credit-worthy businesses and households from accessing funding. Such excessive tightening would harm the broader economy and ultimately the banks themselves.

53. The FPC would continue to monitor banking sector resilience, including through the 2022 stress test (see Stress testing the UK banking system: the 2022 annual cyclical scenario (ACS) section below) and banks' risk appetite for lending.

The UK Countercyclical Capital Buffer rate

54. The FPC discussed its setting of the UK CCyB rate. In line with its communications, the Committee reiterated that its policy was to vary the UK CCyB rate in line with system-wide risks to the UK banking sector and to set the UK CCyB rate in the region of 2% when vulnerabilities that could amplify economic shocks were judged to be at a standard level. This approach aimed to ensure that the buffer was large enough to create capacity for banks to absorb shocks so that they were able to lend through downturns.

55. In considering the appropriate setting of the UK CCyB rate, the FPC discussed its judgements around the economic outlook and underlying vulnerabilities that could amplify economic shocks. The FPC noted that while the global and UK economic outlooks had deteriorated significantly and financial conditions had continued to tighten, any signs of a persistent reduction in credit supply from UK banks were limited, and the Government's support measures would reduce the impact on domestic debt vulnerabilities from higher energy prices.

56. The Committee noted that major UK banks' capital positions remained strong and that their profitability had increased further in Q2. Major UK banks' aggregate CET1 capital ratios were expected to continue to fall slightly over coming quarters, though they were expected to maintain sufficient headroom to accommodate an increase in the UK CCyB rate to 2%.

57. In view of these assessments of underlying vulnerabilities, the FPC agreed to maintain the UK CCyB rate at 2%. This rate would come into effect on 5 July 2023, in line with the generally required 12-month implementation period.[3]

58. Noting the uncertainty around the economic outlook, the Committee reiterated that it would continue to monitor the situation closely and stood ready to vary the UK CCyB rate – in either direction – in line with the evolution of economic conditions, underlying vulnerabilities and the overall risk environment. If vulnerabilities that could amplify economic shocks increased to an elevated level, the FPC would be prepared to raise the UK CCyB rate above 2%. If economic conditions deteriorated by significantly more than currently expected, in a manner that might otherwise lead banks to restrict lending, the FPC would be prepared to cut the UK CCyB rate as necessary. This would enable banks to use the released buffer to absorb losses and provisions – which, all else equal, would now be recognised earlier in a stress under International Financial Reporting Standard 9 (IFRS 9) – and so be able to support lending.

Stress testing the UK banking system: the 2022 annual cyclical scenario

59. The Committee welcomed the launch of the 2022 annual cyclical scenario (ACS) stress-test, following two years of Covid pandemic crisis-related stress testing and its decision to postpone the test in March following Russia's invasion of Ukraine. The Bank's 2022 ACS will test the resilience of the UK banking system to deep simultaneous recessions in the UK and global economies, large falls in asset prices and higher global interest rates, and a separate stress of misconduct costs. The results of the 2022 ACS were expected to be published in summer 2023.

60. Committee members agreed the ACS scenario by written procedure ahead of the publication of the 'Key elements of the 2022 ACS' on 26 September 2022.

Cryptoassets

61. The FPC reviewed the latest evidence on risks to financial stability that could arise from cryptoassets, their associated markets and the adoption of the underlying technology, consistent with its ongoing commitment to do so.

62.The FPC continued to judge that direct risks to the stability of the UK financial system from cryptoassets and their associated markets and activities, including decentralised finance, were currently limited, reflecting their limited size and interconnectedness with the

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[3] See **here** for details of the FPC's approach to setting the CCyB and the CCyB core indicators

wider financial system. However, systemic risks would emerge if cryptoasset activity and its interconnectedness with the wider financial system continued to develop, unless addressed through an effective regulatory framework developed at a domestic and global level. Risks would also need to be managed as banks and other traditional financial institutions adopted the technology underlying cryptoasset markets.

63.On risks to systemic financial institutions, the PRA had issued a Dear CEO letter in March reminding firms of their obligations with respect to cryptoasset exposures, and launched a survey of firms covering existing cryptoasset exposures and future plans for 2022. The results of the survey indicated that firms' existing exposures to cryptoasset activities and associated markets remained limited, but a number of banks were planning to increase their activity over 2022. Since the survey had taken place, there had been a sharp fall in cryptoasset valuations. Nonetheless, more recent discussions with firms had confirmed that they had not materially altered their plans for the coming years.

64. On risks to core financial markets, while current holdings of institutional investors remained limited, investments related to cryptoassets were becoming more integrated into their portfolios. A PwC survey conducted in 2022 Q1 and published in June had found that 38% of traditional hedge funds were invested in cryptoassets, up from 21% a year earlier, and the average level of cryptoasset allocation had increased from 3% to 4% of AUM. More recent discussions with market participants had highlighted that, although the volume of trading activity had fallen relative to 2021, demand for exposure to the asset class and the underlying technologies remained.

65. On risks to the ability to make payments, supervisory intelligence indicated that payments for goods and services funded by cryptoassets (but converted to fiat currency for the merchant) remained a very small fraction of UK transactions, but were growing. There was no widespread evidence of stablecoins being accepted by UK businesses for goods and services, but stablecoins were playing a crucial role in the wider cryptoasset market, including as a means of payment for other cryptoassets.

66. Regarding the impact on real economy balance sheets, the risks from cryptoassets and associated markets via household spending remained limited. HMRC had published new research in July 2022, conducted between February 2021 and June 2021, which indicated that around 8% of adults in the UK owned cryptoassets, with a median holding of around £200. Households' exposures to cryptoassets would also have been affected by the sharp fall in valuations over the summer.

67. In addition, the Committee noted that the technology underlying cryptoassets had the potential to reshape activity currently taking place in the traditional financial sector. A number of banks and other financial institutions were actively exploring use cases of the technology,

including the trading of tokenised financial securities and settlement assets. This could bring a number of benefits, such as greater efficiency and a simplification of the network of relationships needed in financial markets. However, it could also bring a number of risks including: new forms of operational risk for financial institutions and potential changes in market structure that could potentially impact market resilience. As the technology was adopted, these risks would also need to be managed in a way that ensured that new approaches delivered the same level of resilience that was expected of the existing system.

68. The FPC continued to judge that, where crypto technology was performing an equivalent economic function to one performed in the traditional financial sector, this should take place within existing regulatory arrangements, and that the regulatory perimeter be adapted as necessary to ensure an equivalent regulatory outcome.

69. The FPC also judged that the international nature and novel governance structures of both these markets and their underlying infrastructure raised the potential for regulatory gaps, fragmentation or arbitrage. It was therefore appropriate that enhanced regulatory and law enforcement frameworks were being developed, both domestically and at a global level, to address developments in these fast growing markets and activities in order to manage risks, to encourage sustainable innovation, and to maintain broader trust and integrity in the financial system.

70. The FPC supported international work on these issues, including that of the FSB in its role co-ordinating the international approach to cryptoassets, and the work of international standard-setting bodies. In June, the Basel Committee on Bank Supervision had published its second public consultation on the prudential treatment of banks' cryptoasset exposures. In July, CPMI-IOSCO had published guidance confirming that the Principles for Financial Market Infrastructures apply to systemically important stablecoin arrangements that transfer stablecoins. The FSB would report on regulatory and supervisory approaches to stablecoins and other cryptoassets to the G20 Finance Ministers and Central Bank Governors meeting in October.

71. Domestically, the FPC was supportive of the work of the HM Treasury-FCA-Bank Cryptoassets Taskforce on assessing the regulatory approach to unbacked cryptoassets and their associated markets and activities. In April, HM Treasury had announced that the government would consult on wider regulation of the cryptoasset sector later in 2022. In July, HM Treasury had introduced legislation into Parliament which would give UK regulators powers to regulate stablecoins as used for payments in line with their respective objectives. Alongside this, the Bank was designing a regulatory framework that could meet the FPC’s expectations for systemic stablecoins and would publish a consultation in due course.

72.The FPC would continue to pay close attention to developments in this area and would thereby seek to ensure that the UK financial system was resilient to systemic risks that may arise from cryptoassets, associated markets and the adoption of the underlying technology.

2022 review of the FPC's Leverage Ratio Direction

73. In line with its statutory obligations, the FPC reviewed its Direction to the PRA over the leverage ratio. The Direction had been issued in September 2021 following a comprehensive review of the UK leverage ratio framework.

74. The FPC continued to consider a leverage ratio to be an essential part of the framework of capital requirements for the UK banking system, and judged that the aspects of the leverage ratio set out in the 2021 Direction remained appropriate. The FPC judged that the UK leverage ratio framework, including the changes made following the 2021 review, continued to advance the FPC's primary objective, in ways that as far as possible were effective in also achieving the FPC's secondary objective.

75. Specifically, the FPC continued to consider that the design and calibration of the leverage minimum and buffers played a strong complementary role to the risk-weighted framework, while not binding on most firms most of the time. The FPC confirmed that the scope of application of the minimum leverage ratio requirement, as broadened as part of the 2021 review, would allow it to capture firms with complex business models, and firms that could be very large participants in UK financial markets – consistent with the FPC's intentions in 2021. The Committee also continued to consider that broadening the scope of the minimum requirement any further would be disproportionate, in light of its secondary objective. Having regard to the interaction between monetary and macroprudential policy, the Committee also confirmed the appropriateness of continuing to exclude central bank claims from the leverage ratio, and of not recalibrating the minimum to reflect an increase in reserves since 2016.

76. As part of its review, the FPC took stock of relevant developments, and noted that new arrangements were emerging for firms to hold reserves at central banks, known as 'omnibus' accounts. In these types of accounts, the funds of different firms are co-mingled in one account, in order to support payments provided by non-bank payment system operators.[4] The FPC had not identified any material financial stability risks that would arise from excluding liability-matched reserves on omnibus accounts from the leverage ratio. The

[4] The Bank of England offers an omnibus account model to UK recognised payment system operators. Only firms that are participants in the Sterling Monetary Framework, and hold reserves accounts at the Bank of England, are eligible for participation in these omnibus accounts.

Committee would continue to monitor developments in this area, as part of its future regular reviews of the leverage ratio Direction.

77. The FPC recognised that the PRA may wish to consider the exclusion of central bank reserves on omnibus accounts from the leverage ratio. To ensure the PRA can respond as required, and in a way consistent with its objectives, including safety and soundness, the FPC considered it appropriate to give the PRA discretion to apply additional conditions to the existing central bank claims exclusion, where consistent with the original purpose of the exclusion.

78. The FPC therefore revoked its existing Direction to the PRA in relation to the leverage ratio regime, and issued a new Direction on the same terms as in September 2021 with the addition of discretion for the PRA to set additional conditions to the central bank claims exclusion.[5] The FPC would continue to conduct regular reviews of the leverage ratio framework in line with its statutory obligations.

79. The FPC welcomed a forthcoming PRA consultation on measures to identify, monitor and manage contingent leverage risk – the risk that a firm's leverage ratio might fall, in a stress for example, if it becomes less able to use certain trades that require lower capital to be held against them under the leverage ratio framework.[6] The PRA's proposals would be published for consultation on the same day as the Record. The FPC judged that the PRA's proposed measures would help safeguard the robustness of the UK leverage ratio framework.

The Future Regulatory Framework

80.On 20 July, HM Government published the Financial Services and Markets (FSM) Bill. The FSM Bill would, among other things, implement the outcomes of the Future Regulatory Framework (FRF) Review, which was established by the previous Government to consider how the UK's financial services regulatory framework should adapt for the future, and in particular to reflect the UK's position outside the European Union.

81.The FPC continued to judge that UK financial stability will require levels of resilience at least as great as those put in place since the GFC and required by international baseline standards, and - recognising the importance of the United Kingdom as a global financial centre - in some cases greater. Actions of UK authorities to set standards, and its leadership

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[5] The full text of the FPC's new Direction to the PRA on the leverage ratio is set out in the Annex of this Record, together with the original Recommendation (now implemented). Also see the 2021 **cost benefit analysis** of the costs and benefits of the FPC's and PRC's changes to the UK leverage ratio framework.
[6] See **CP12/22 – Risks from contingent leverage | Bank of England**

in setting global standards, contributed to international as well as domestic financial stability. In this context, the FPC noted in particular that the Bill introduced a new secondary objective for the PRA and FCA to facilitate, subject to aligning with international standards, the international competitiveness of the UK economy and its growth in the medium to long-term. The FPC stressed the importance for UK financial stability of alignment with international standards within that objective.

82. The FPC also supported the proposals for regulators to have increased responsibility for setting regulatory requirements, acting within a strong policy and accountability framework set and overseen by Parliament.

83. The FPC noted that the stability and predictability of the UK's regulatory regime would continue to be critical given the size of the UK financial system and its importance as a global financial centre. The UK's institutions and markets must be a source of strength for the global system and able to be relied upon by others. The IMF considered the stability of the UK financial system to be a global public good. Strong standards and a resilient financial system also support the UK's competitiveness by providing firms, customers and counterparties with reassurance that they can do business here with confidence.

84. The FPC welcomed the FRF measures contained in the Bill introduced into Parliament. The Committee noted that the Bank, as part of fulfilling its statutory financial stability objective, already aims to ensure a fit for purpose UK regulatory regime that underpins a resilient and dynamic international financial sector that would continue to be safely open to the rest of the world. And the FPC, in meeting its primary objective to protect and enhance the stability of the UK's financial system, and its secondary objective to support the economic policy of the Government, would continue to seek to ensure that the resilience the UK financial system needed was delivered efficiently, so as not to hamper the ability of the system to serve the real economy. The FPC has, and will continue to take, both of its objectives seriously.

85. The Bill passed its second reading on 7 September. During that reading, the Economic Secretary to the Treasury stated the Government's intention to include an amendment to introduce an intervention power that would enable HM Treasury to direct a regulator to make, amend or revoke rules where there are matters of significant public interest. The FPC considered that the operational independence of regulators was an essential part of the regulatory regime in support of both its public interest objectives, namely, to deliver UK financial stability and strong, sustainable, and balanced growth. The FPC would continue to monitor the Bill's progress through Parliament and would consider the implications of all relevant amendments once details were available.

Critical Third Parties including cloud service providers

86. The FPC welcomed the publication of the joint Bank, PRA and FCA Discussion Paper on potential ways for the regulators to manage systematic risks posed by critical third parties (CTPs) to the UK financial sector. [7]

87. The FPC also welcomed the inclusion of proposed powers in the FSM Bill to enable the regulators to deliver the proposed CTP regime. The FPC previously highlighted that the financial sector's increasing reliance on CTPs, including but not limited to cloud service providers (CSPs), could increase UK financial stability risks in the absence of greater direct regulatory oversight of the resilience of the services they provided. Consequently, the FPC judged that additional policy measures, some potentially requiring legislative change, would be needed to mitigate financial stability risks from CTPs.

88. The FPC also encouraged the Bank, PRA and FCA to continue engaging with overseas financial regulators; international standard-setting bodies such as the FSB; and relevant UK public authorities such as those responsible for competition, data protection and telecoms, in order to explore ways of strengthening cross-sectoral and international supervisory cooperation in respect of CTPs.

UK Central Counterparties Supervisory Stress Test

89. The FPC discussed the results of the Bank's first public Supervisory Stress Test of UK CCPs. The record of that discussion would follow in due course, alongside publication of the results.

[7] DP3/22 – Operational resilience: Critical third parties to the UK financial sector | Bank of England

The following members of the Committee were present:

Andrew Bailey, Governor
Sarah Breeden
Ben Broadbent
Jon Cunliffe
Jon Hall
Colette Bowe
Anil Kashyap
Dave Ramsden
Nikhil Rathi
Elisabeth Stheeman
Carolyn Wilkins
Sam Woods
Nikhil Rathi

Gwyneth Nurse attended as the Treasury member in a non-voting capacity.

Andrew Bailey and the rest of the Committee recorded their thanks to Anil Kashyap for his service to the Financial Policy Committee.

In accordance with the relevant provisions of the Bank of England Act 1998, Jon Hall had notified the Committee of his shareholding at Guardtime (a blockchain based information security provider). It was agreed that he would recuse himself from discussions on cryptoassets, and that he would not receive the related papers.

Annex: Financial Policy Committee policy decisions

Outstanding FPC Recommendations and Directions (as at the date of the FPC's meeting on 30 September 2022)

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

FPC Recommendations implemented since the 16 June 2022 Policy meeting

On 28 September, the Bank of England's Financial Policy Committee noted the risks to UK financial stability from dysfunction in the gilt market. It recommended that the Bank take action, and welcomed the Bank's plans for temporary and targeted purchases in the gilt market on financial stability grounds at an urgent pace. The decision was taken by written procedure.

Other FPC policy decisions which remain in place

The following text 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.

Countercyclical capital buffer rate

The FPC maintained the UK CCyB rate at 2% on 30 September 2022, with binding effect from 5 July 2023. 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.[8] 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 PRA and the 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

[8] See the Financial Stability section of the Bank's website: www.bankofengland.co.uk/financial-stability.

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,[9] and the FCA has issued general guidance.[10]

Leverage Ratio

The FPC directs the PRA to implement the following measures (the 'leverage measures') in relation to the following firms (each a 'relevant firm'):

- each major UK bank, building society or investment firm;
- each UK bank, building society or investment firm with significant non-UK assets; and
- any holding company approved or designated by the PRA whose consolidated situation (including, where that holding company is part of a ring-fenced bank (RFB) sub-group, the consolidated situation of that sub-group) is comparable to any other relevant firm.

The leverage measures are to:

- require each relevant firm to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3.25%;
- secure that each relevant firm ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific CCyB rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points;
- secure that if a relevant firm is a G-SII it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate; and
- secure that if the relevant firm is a relevant O-SII it ordinarily holds sufficient Tier 1 capital to satisfy a O-SII additional leverage ratio buffer rate of 35% of its O-SII buffer rate.

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[9] See PRA Policy Statement PS9/14, 'Implementing the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending', October 2014: www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf.
[10] See www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending.

The leverage measures are to be applied:

- on a consolidated basis in respect of the UK consolidation group of the relevant firm;
- on a sub-consolidated basis in respect of any RFB sub-group that contains a relevant firm (‘RFB sub-consolidated basis’); and
- on an individual basis or, at the PRA’s discretion, on a sub-consolidated basis (in respect of the relevant firm and one or more of its subsidiaries), for relevant firms that are not subject to the leverage measures on the basis of their consolidated situation pursuant to the preceding bullet points.

Where the leverage measures are to be applied on a consolidated or RFB sub-consolidated basis, they may be applied to a holding company approved or designated by the PRA, as appropriate.

In designing its approach to exercising its discretion over the appropriate level of consolidation at which to implement the leverage measures, the PRA should have regard to, among other things:

- the desirability of alignment between the levels of application of the leverage measures and measures under the risk weighted capital framework; and
- the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

For the purposes of the leverage measures, the FPC specifies the following:

- The total exposure measure shall exclude assets constituting claims on central banks, where they are matched by liabilities accepted by the firm that are denominated in the same currency and of identical or longer maturity and subject to such additional conditions as the PRA may determine from time to time, having regard to the purpose of this exclusion.
- The minimum proportion of common equity Tier 1 that shall be held is:
  - 75% in respect of the minimum leverage ratio requirement;
  - 100% in respect of the countercyclical leverage ratio buffer; and
  - 100% in respect of the G-SII and O-SII additional leverage ratio buffers.

The FPC recommends to the PRA that in implementing the minimum leverage ratio requirement it specifies that additional Tier 1 capital should only count towards Tier 1 capital for these purposes if the relevant capital instruments specify a trigger event that occurs when

the common equity Tier 1 capital ratio of the institution falls below a figure of not less than 7%.

The PRA has published its approach to implementing this direction and recommendation[11].

[11] **PS21/21 | CP14/21- The UK leverage ratio framework | Bank of England**