Financial Stability Report Press Conference
11 July 2019
Opening remarks by the Governor

The FPC aims to ensure the UK financial system is prepared for the wide range of risks it could face so that the system can serve households and businesses in bad times as well as good.

This means identifying near-term, medium-term and longer-term risks to UK financial stability and taking action to address them.

Near-term vulnerabilities

The resilience of the UK financial system to Brexit

The single most important determinant of the UK's economic outlook remains the nature and timing of Brexit.

The perceived likelihood of a no-deal Brexit has increased since the end of last year, and although the degree of preparedness for such a scenario has improved, material risks remain.

Most risks to UK financial stability from disruption to cross-border financial services in a no-deal Brexit have been mitigated.

However, it is still the case that, in the absence of further action by EU authorities, some disruption to cross-border financial services is possible, and though such disruption would primarily affect EU households and businesses, it could amplify volatility and spill back to the UK in ways that cannot be fully anticipated or mitigated.

And, though the readiness of the UK economy for No Deal has improved since the last FSR in November, material risks of economic disruption remain.

All of these risks must be weighed against the resilience of the core of the UK financial system to the wide range of economic and financial shocks that could be associated with Brexit.

Taking into account:

- The progress in addressing major cross-border financial risks;
- The results of the Bank of England's 2018 stress test of major UK banks, which encompassed even a worst-case disorderly Brexit scenario;
- The fact that major UK banks have maintained Tier 1 capital levels of around 17% of risk-weighted assets since the stress test (over three times higher than before the global financial crisis),
- That major UK banks have built over £1 trillion of high-quality liquid assets, enabling them to meet their maturing obligations for many months without accessing markets; and
- The prepositioning of sufficient collateral to be able to borrow up to an additional £300 billion through the Bank of England's regular facilities;

The FPC continues to judge that the financial system is ready for Brexit, whatever form it takes.

But financial stability is not the same as market stability.

In a disorderly Brexit a range of UK asset prices would be expected to adjust sharply, tightening financial conditions for UK households and businesses.

If a major economic stress were to materialise, the FPC is prepared to cut the CCyB rate, as it did in July 2016, which could preserve banks' capacity to lend to UK households and businesses by around £250bn.

Global risks

Brexit developments are taking place against a backdrop of increasing risks to the global outlook.

Global business confidence has been hit by the possibility that trade tensions become more pervasive, persistent and damaging.

Financial markets are pricing in lower growth, with risk-free interest rates falling markedly and corporate earnings expectations declining sharply.

Were trade tensions to crystallise, their impact on the global economy would be amplified by underlying financial vulnerabilities. In particular, history shows that private sector credit balances are among the best indicators of whether a shock turns to a slump. It is noteworthy that,

- Credit growth in China continues to outpace nominal income growth, and non-financial private debt is more than 200% of GDP.
- Some emerging market economies with large current account deficits or high levels of foreign currency debt remain vulnerable to renewed capital outflows; and
- US corporate debt is above pre-crisis levels as a share of GDP and lending to riskier corporates is growing rapidly.

Overall, the FPC judges that while global vulnerabilities are material, the core of the UK banking system remains resilient to these risks.

Recall that major UK banks were resilient to a severe scenario for the global economy in the 2018 stress test, in which world GDP fell by 2.4% over the first year. This is worse than the fall in the Global Financial Crisis and significantly more severe than our estimated impact of a global trade war.

Indeed, even if a protectionist-driven global slowdown were to spill over to the UK at the same time as a worst-case disorderly Brexit, the FPC judges that the core UK banking system would be strong enough to absorb, rather than amplify, the resulting economic shocks.

Medium-term structural risks in financial markets

Tackling vulnerabilities in open-ended funds

Since 2008, market-based finance has accounted for all of the net increase in the debt finance of UK non-financial businesses.

There are benefits from this diversification of funding sources; however there are also new risks.

Globally, more than $30 trillion of assets are held in open-ended funds that offer daily redemptions while investing in assets that typically take weeks or months to sell in an orderly way. Under stress, open-ended funds may need to sell assets quickly, creating an incentive for investors to redeem when they expect others to do so.

This self-reinforcing dynamic can trigger a jump to suspension by the fund. And more broadly the ability of market to absorb asset sales asset sales could tested, amplifying price moves, transmitting stress to other parts of the system, and disrupting the availability of finance in the real economy.

For several years, the FPC has highlighted this vulnerability. And evidence is growing that this goes beyond any single market or fund type. The more important open-ended funds become, and the more illiquid their underlying investments are, the greater the potential risks to financial stability.

Because this is a global issue, the FPC supported the FSB's 2017 recommendation that funds' assets and investment strategies should be consistent with their redemption terms. Unfortunately, subsequent work by IOSCO did not prescribe how this should be achieved and it left implementation to national authorities and funds themselves.

The Bank and the FCA will work together to assess how funds' redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks without compromising the supply of productive finance. The review will also assess the effectiveness of measures that are already used to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions.

The transition away from Libor

The continued reliance of global financial markets on Libor poses risks to financial stability that can be reduced only through a transition to alternative benchmark rates by end-2021.

The FPC is clear: there is no justification for firms continuing to increase their exposures to Libor. The pace of market participants' transition efforts now needs to accelerate, and we will monitor progress closely.

The smoothest transition will be one in which market participants:

- Cease new issuance of Libor-linked contracts;
- Identify all existing contracts without appropriate fall-back clauses;
- Rectify these to the greatest extent possible; and
- Actively reduce legacy exposures by negotiating their transition to new rates.

Well-managed firms are expected to lead the transition and renegotiate their contracts to refer to alternative reference rates well in advance of end-2021.

Longer-term risks

Exploring the UK financial system's resilience to the financial stability risks of climate change

Last month the UK Parliament passed legislation making the UK the first G7 country to commit to net zero emissions by 2050. This will require a massive reallocation of capital creating unprecedented risks and opportunities.

Firms that align their business models to the transition to a carbon-neutral world will be rewarded handsomely; those that fail to adapt will cease to exist.

More broadly, the move to a carbon-neutral economy with the associated changes in policies, technologies and physical risks will prompt a reassessment of the value of a large range of assets.

It is important that the financial system can do its part to support a smooth transition to a carbon-neutral economy.

To that end, in the 2021 Biennial Exploratory Scenario (BES), the Bank will stress test the UK financial system's resilience to the physical and transition risks of climate change.

The 2021 BES will be the first of its kind to integrate fully climate scenarios with macroeconomic and financial system models. It will motivate firms to address data gaps and to develop cutting-edge risk management consistent with a range of possible climate pathways ranging from early and orderly to late and disruptive.

The Bank will publish a discussion paper this autumn, well in advance of the exercise, to gather views on its design from risk specialists from across the financial sector, industry experts and other informed stakeholders.

Conclusion

To summarise:

The core of the UK financial system is ready for Brexit, whatever form it takes.

Moreover, the system would continue to serve UK households and businesses even if worst-case disorderly Brexit occurred at the same time as a global slowdown triggered by a trade war.

The FPC is monitoring and addressing the impact of significant structural changes that could give rise to medium and longer-term risks, including

- Tackling vulnerabilities in open-ended funds as they grow in importance, so that they support growth but minimise risks to financial stability;

- Closely monitoring the necessary transition away from LIBOR;

- And developing the first exercise globally that will fully integrate climate scenarios with stress testing technologies to help the private sector manage financial stability risks from climate change and the transition to a carbon-neutral economy.

By addressing such risks to financial stability in the near, medium and longer terms, the FPC is doing its part to promote the good of the people of the United Kingdom.