FINANCIAL STABILITY PRESS CONFERENCE Tuesday 5 July 2022 Opening Remarks by Andrew Bailey, Governor

Welcome to the press conference for the July Financial Stability Report.

Before answering questions, I would like to highlight some key themes from the Report and the FPC's Q2 policy meeting. In particular, I would like to draw out the FPC's decision on the countercyclical capital buffer and the 2022 stress test, as well as our monitoring of financial stability risks from commodity markets.

Recent developments

I will first say a few words about the backdrop to the latest report.

As you would expect, given the focus of today's press conference, I will not be discussing monetary policy.

Since the last FSR in December 2021, the global economic outlook has deteriorated materially.

Global financial conditions as a whole have tightened significantly. This is in part due to central banks across the world having tightened monetary policy in response to the outlook for inflation. Market interest rates and corporate bond spreads have also risen, in part reflecting expectations of further tightening.

Developments in Russia's invasion of Ukraine are a key factor that will affect the global outlook.

The downside risks relevant to the assessment of financial stability include:

- Weaker economic growth globally;
- A further sharp tightening in global financial conditions;
- And the potential for further volatility and stress in financial markets.

Despite the weaker outlook, the UK banking system remains strong. In line with expectations, capital ratios declined in 2022 Q1 and are expected to fall back slightly over coming quarters.

That said, banks continue to hold overall capital and liquidity resources sufficient to support lending to the UK economy, even in severe economic outcomes.

The UK Countercyclical Capital Buffer (CCyB) rate decision

At the end of last year, the FPC judged that it was minded to announce in Q2 2022 this year the UK CCyB rate would increase to 2%.

This was because the vulnerabilities that could amplify economic shocks had returned to prepandemic levels.

This decision would bring the CCyB back to the level it was due to reach before the pandemic, and is still consistent with the slight decline seen in overall capital ratios.

It is the right time to lock in resilience so that we are well prepared for future possible shocks.

Therefore, consistent with its December judgement, today the FPC is increasing the CCyB rate to 2%. As required, this rate will come into effect in July 2023.

Given considerable uncertainty around the outlook, the FPC will continue to monitor the situation closely. We stand ready to vary the UK CCyB rate – in either direction – depending on how risks develop.

The 2022 stress test

We are also setting out today that the Bank of England will launch its next stress test in September.

This exercise will support the FPC's monitoring and assessment of the resilience of the UK banking system to several potential downside risks, including:

- Deep simultaneous recessions in the UK and global economies
- · Real income shocks
- · Large falls in asset prices
- Higher global interest rates

The results of the stress test will be published by mid-2023.

Commodity market vulnerabilities

<u>Finally, today's FSR also highlights some of the financial stability risks posed by the recent volatility in global commodity markets.</u>

Since the Russian invasion of Ukraine, there have been sharp spikes in the prices of gas and other commodities such as food. These spikes have led to steep increases in margin requirements for the financial contracts used by commodity suppliers to hedge their risks.

Margin requirements are an essential tool for reducing risks in the financial system.

In the early period after Russia's invasion, the sharp and sudden increases in these requirements made it harder for some commodity market participants to meet them.

This put pressure on some commodity firms' liquidity positions. As a result, banks faced significant calls from their commodity firm clients to lend to them in order to then fund their higher margin requirements.

Despite this price volatility, commodity and wider financial markets overall have continued to function.

However, in one particular instance in March, the London Metal Exchange temporarily suspended trading in nickel contracts and cancelled trades due to a specific set of circumstances that contributed to an extremely sharp price spike.

Looking forward, the uncertainty surrounding the Russian invasion of Ukraine means that there remain significant risks of further disruption in commodity markets.

The recent disruption has highlighted how vulnerabilities within commodity markets – and interconnections with the wider financial system – could amplify shocks to the real economy.

Some of these vulnerabilities are similar to those in the wider system of market-based finance. Quantifying the size and scale of these fragilities and interconnections remains challenging for a number of reasons.

- There is considerable opacity and a lack of data in some markets;
- And some of these fragilities relate to physical markets, non-financial entities, or entities in other countries and outside the UK financial system.

Therefore, addressing them will require engagement from a broad range of financial and non-financial authorities, both domestic and global.

Given this, the global Financial Stability Board is undertaking in-depth analysis and assessment of vulnerabilities in commodity markets. The FPC welcomes and supports this work.

Today the FSR outlines a number of improvements that could be made to current data reporting. These include in relation to transactions and market participants. They should be done in a coordinated manner globally to enable enhanced surveillance of these markets by authorities.

The FPC continues to monitor the sector. We stand ready to engage with other authorities as necessary to ensure the resilience of the financial system to a stress in these markets. In summary, financial markets, particularly for commodities, have been volatile in recent weeks, but they are functioning. The economic outlook is uncertain and undoubtedly a very challenging one for many households and businesses. The banking system is resilient to that outlook, however, or even a much worse one. In sharp contrast to the financial crisis, it is in a position to cushion the economic shocks, not add to them.

Thank you.