

FINANCIAL STABILITY REPORT PRESS CONFERENCE

Tuesday 13 July 2021

Opening Remarks by Andrew Bailey, Governor

Hello, this is Andrew Bailey.

Welcome to this presentation of the Bank's July Financial Stability Report.

The financial system has supported the economy through the Covid pandemic and can continue to do so

The UK financial system has provided support to households and businesses to weather the economic disruption from the Covid pandemic. This has been the first big test of the post financial crisis reforms, notably to the resilience of banks, and so far the results have been encouraging.

In recent months, the rapid rollout of the UK's vaccination programme has led to an improvement in the UK economic outlook. But risks to the recovery remain.

And households and businesses will need continuing support from the financial system as the economy recovers.

The UK banking system has the capacity to continue to provide the support that households and businesses need. Major UK banks' and building societies' capital and liquidity positions have remained strong.

The FPC reaffirms its judgement that the banking sector remains resilient to severely adverse paths for the economy, supported by the interim results of this year's solvency stress test.

The FPC expects banks to use all elements of capital buffers as necessary to support the economy through the recovery. To support this, the FPC expects to maintain the UK countercyclical capital buffer rate at 0% until at least December this year. To inform its decision around when to increase the CCyB, the Committee will monitor a range of factors, including the evolution of the economic recovery, prevailing financial conditions, and the outlook for banks' capital.

The FPC supports the PRC's decision that extraordinary guardrails on shareholder distributions are no longer necessary, consistent with the return to the PRA's standard approach to capital-setting and shareholder distributions this year. The FPC also judges that the interim results of this year's solvency stress test, together with the central outlook, are consistent with the PRC's decision.

As the economy recovers, the FPC will remain vigilant to risks and debt vulnerabilities

Through the pandemic, UK corporate debt levels have increased modestly, although the increase in indebtedness has been more substantial in some sectors and among SMEs. Support from the financial system and the Government has helped keep business insolvencies relatively low. However, companies with weaker balance sheets, particularly in sectors most affected by restrictions on economic activity and SMEs, will be more vulnerable to increases in financing costs.

The share of households with high debt-servicing burdens has increased slightly during the course of the pandemic, but remains significantly below its level prior to the global financial crisis. House price growth and housing market activity in the first half of this year have been at their highest levels in over a decade, reflecting a mix of temporary policy support and structural factors. However, there has only been a small increase in mortgage borrowing relative to income in aggregate and debt-servicing ratios remain low. The FPC's mortgage market measures are in place and aim to limit any rapid build-up in aggregate indebtedness and in the share of highly indebted households. The FPC is continuing its review of the calibration of its mortgage market measures.

Risk-taking in global financial markets

Risky asset prices have continued to increase, and in some markets asset valuations appear elevated relative to historical norms. This partly reflects the improved economic outlook but may also reflect a 'search for yield' in a low interest rate environment and higher risk-taking.

The proportion of corporate bonds issued that are high-yield is currently at its highest level in the past decade, and there is evidence of loosening underwriting standards, especially in leveraged loan markets. This could increase potential losses in a future stress, and highly leveraged firms have also been shown to amplify downturns in the real economy.

Asset valuations could correct sharply if, for example, market participants re-evaluate the prospects for growth or inflation, and therefore interest rates. Any such correction could be amplified by vulnerabilities in market-based finance.

Building resilience of the financial system for the future

The FPC remains focused on building a stronger and safer system for the future.

First, the FPC is fully engaged in and supportive of the international work to tackle the vulnerabilities in market-based finance exposed during the 'dash for cash' in March of last year. It is important that market-based finance is resilient to, and does not amplify, shocks. The FPC has previously identified a number of vulnerabilities in the sector and supports the recent progress to address these. As part of this, the FPC has published today its response to a request from HM Treasury to assess the oversight and mitigation of risks to financial stability from the non-bank financial sector.

The FPC has also fully endorsed the proposals from the joint Bank and FCA review on liquidity risk management and swing pricing in open-ended funds and views them as an important contribution to the international work currently in train to reduce financial stability risks arising from liquidity mismatches in open ended funds.

As the FPC has noted previously, the mismatch between redemption terms and the liquidity of some funds' assets means there is an incentive for investors to redeem ahead of others, particularly in a stress. This first-mover advantage has the potential to become a systemic risk by creating run dynamics, and thus disrupting the supply of credit to the economy.

Further work is needed to consider how these proposals could be applied, and a number of operational challenges will need to be addressed before any final policy is designed and implemented but we view them as an important contribution to the debate.

Second, with most new use of Libor due to stop by the end of 2021, the FPC emphasises that market participants should use the most robust alternative benchmarks available in transitioning away from the use of Libor to minimise future risks to financial stability.

Third, the increasing reliance on a small number of Cloud Service Providers and other critical third parties could increase financial stability risks without greater direct oversight of the resilience of the services they provide. Although the PRA and FCA have recently strengthened the regulation of firms' operational resilience and third party risk management, additional policy measures to mitigate financial stability risks in this area are needed, and the FPC welcomes the Bank, FCA and HM Treasury engagement on how to tackle these risks.

Conclusion

Let me finish, by reiterating that the FPC aims to ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face.

As I have outlined today – and is covered in the Financial Stability Report – the UK banking system is strong enough to provide the support households and businesses need as the economy recovers.

We are also working to strengthen financial markets so they can support the economy in bad times as well as good.

Thank you