Bank of England

Financial Policy Summary and Record of the Financial Policy Committee meetings on 9 and 18 March 2022

24 March 2022

This is the record of the Financial Policy Committee meetings held on 9 and 18 March 2022

It is also available on the Financial Policy Summary and Record page of our website:
www.bankofengland.co.uk/financial-policy-summary-and-record/2022/march-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 Her 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 16 June 2022 and the record of that meeting will be published on 5 July 2022.

Financial Policy Summary

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 can serve UK households and businesses in bad times as well as good.

The outlook for UK financial stability

UK financial stability and the Russian invasion of Ukraine

The Bank of England condemns Russia's unprovoked invasion and the suffering inflicted on Ukraine. The Bank is working closely with the Government to support its response in coordination with the FCA and other UK and international authorities. The FPC supports this condemnation and welcomes these actions. In addition, the FPC welcomes international coordination to ensure alignment of financial sanctions, as well as industry engagement, to minimise the potential for unintended operational consequences.

Global financial markets, particularly for commodities, have been volatile and uncertainty over the economic outlook has increased significantly. Consistent with its remit, the FPC's role is to assess the impact of these developments on UK financial stability and take action as appropriate.

The UK's direct linkages to Russia are limited; trade links and the direct exposures of UK banks to Russia are low. There are, however, indirect channels through which the invasion could potentially pose risks to the UK financial system, and disruption to global supply chains could continue to affect activity and the economic outlook in the UK and elsewhere.

Major UK banks' capital and liquidity positions remain strong. Their aggregate Common Equity Tier 1 capital ratio stood at 16.3% at end-2021. The FPC has tested the resilience of the UK banking system against a range of severe economic scenarios, and remains of the view that major UK banks are able to withstand severe market and economic disruption.

Financial markets have in general continued to function despite the high volatility, although bid-offer spreads have widened in certain bond markets, suggesting that market liquidity has been impacted. Risky asset prices have fallen, and global financial conditions have tightened with, for example, materially lower primary issuance in corporate debt and leveraged loan markets in recent weeks. Energy prices have risen sharply, as have the prices of other commodities where Russia and Ukraine are important producers, and volatility has been exceptionally high.

Given the need to safeguard against counterparty credit risks for both regulated and unregulated entities, and consistent with these moves, margin calls on derivatives positions in over-the-counter and exchange-traded markets rose significantly. The invasion has led to significant stress in a range of commodity markets. In particular, the London Metal Exchange had temporarily suspended trading in the nickel market and cancelled trades over a short time period following a sharp spike in prices.

Market dynamics have reflected both a ‘flight to safety’ in response to a deterioration in the geopolitical and economic outlook, as well as concerns about rising inflation, leading to portfolio adjustments and a repricing of risks. A key uncertainty is whether interconnections within the financial system – for example between energy and other commodity markets, wider financial markets and the real economy – might create feedback loops and amplification mechanisms across the financial system more broadly.

The economic implications of the invasion could also interact with risks associated with high levels of global debt. Sustained increases in energy prices resulting from the conflict are likely to put further pressure on real incomes and earnings for households and businesses.

There is heightened risk from cyber threats. The FPC welcomes the National Cyber Security Centre’s actions to ensure the UK financial system is well prepared for such attacks. The Bank and Prudential Regulation Authority (PRA) use a range of approaches to assess the cyber resilience of firms. Cyber stress testing tests firms’ abilities to restore vital financial services after a hypothetical cyber incident. Other tests and exercises such as CBEST (threat-led penetration tests) and SIMEX (sector cyber simulation exercises), as well as industry exercises and engagement with international partners, form a part of the overall toolkit to assess the cyber resilience of firms.

There is considerable uncertainty about future developments in Ukraine and Russia. Further geopolitical developments could pose additional risks. As discussed by the Monetary Policy Committee (MPC) at its March meeting, the global economic outlook has deteriorated significantly, and global inflationary pressures will strengthen considerably over the coming months. The possibility of further second-order spillover effects impacting upon the UK financial system cannot be discounted.

The FPC will continue to monitor developments closely and stands ready to take any measures necessary to help ensure UK financial stability, in line with its statutory responsibilities.

The resilience of the UK financial system to other domestic and global vulnerabilities

Domestic debt vulnerabilities

Prior to the Russian invasion of Ukraine, UK and global economic activity had returned to their pre-pandemic levels, despite the ongoing impact of Covid. Since then, the global economic outlook has deteriorated significantly, although, at present, domestic resilience has not been materially affected.

While UK house price inflation has continued to be strong, there is little evidence so far of a deterioration in lending standards or a material increase in the number of highly indebted households. Aggregate household debt relative to income has remained broadly flat, following slight increases earlier in the pandemic. And the share of households with a mortgage debt-servicing ratio at or above 40% – a level beyond which households are typically much more likely to experience repayment difficulties – remains broadly in line with 2017–19 averages and significantly below levels seen just prior to the global financial crisis.

However, an increase in the cost of living, partly due to rising energy and other import prices, is likely to affect household resilience across the income distribution, with a larger impact on lower income households that spend a greater share of their income on energy and other essential items. Although these price rises are unlikely to significantly affect the ability of mortgagors to make debt repayments, they will increase the pressure on household balance sheets, particularly if there is a larger than expected impact on growth.

There had been little reported need by UK corporates for additional liquidity or widespread distress as a result of the impact of Omicron. Quarterly insolvencies returned to pre-Covid levels in 2021 Q4, but cumulative insolvencies remain significantly below what might have been expected over the pandemic. Debt-servicing remains affordable for most UK businesses.

Following the Russian invasion of Ukraine, uncertainty around, and downside risks to, the economic outlook have increased, with implications for corporate earnings. Small and medium sized enterprises, which were disproportionally impacted by the pandemic, have increased their debt more than larger companies and are more vulnerable than they were pre-Covid. Companies in sectors most affected by rising energy prices will also face a greater cost shock. Nonetheless, as the FPC has noted previously, it would take large increases in borrowing costs or severe shocks to earnings to impair businesses’ ability to service their debt in aggregate.

Global vulnerabilities

The global economic outlook has deteriorated significantly following Russia's invasion of Ukraine, and the associated material increase in the prices of energy and raw materials. The impact is likely to be especially felt in Europe where, for example, some countries are particularly reliant on Russian energy. Disruptions to global supply chains could also affect a wide range of countries given the significant role of Russia and Ukraine in the production of commodities including metals and wheat. Although risks remain, there has been little sign of financial market contagion to other emerging markets outside of Europe so far.

In addition, there remain a number of other vulnerabilities in the global economy that could further amplify shocks. As the FPC has previously highlighted, long-standing vulnerabilities in the Chinese property sector have re-emerged, amidst high and rising debt levels in China and Hong Kong. Restrictions to contain further Covid outbreaks, including in China given its zero-Covid policy, could further disrupt global supply chains and impact corporate earnings. Risks in leveraged loan markets globally also remain high.

Against the backdrop of a tightening in global financial conditions in recent months, and in light of recent events, a sharper increase in the financing costs facing households and businesses could pose risks given existing global debt vulnerabilities. In addition, tighter overseas credit conditions could affect UK businesses' ability to raise or roll over finance in both overseas and domestic markets.

The UK Countercyclical Capital Buffer (CCyB) rate decision

The FPC is maintaining the UK Countercyclical Capital Buffer (CCyB) rate at 1%. The rate will come into effect from 13 December 2022 in line with the 12-month implementation period.

The Committee stated in December that if the UK outlook proceeded broadly in line with the MPC's central projections in the November Monetary Policy Report, and absent a material change in the outlook for UK financial stability, the FPC would expect to increase the rate further to 2% in 2022 Q2.

While domestic vulnerabilities that could amplify economic shocks have not changed materially since the December 2021 Financial Stability Report, uncertainty around, and downside risks to, the economic outlook have increased significantly following Russia's invasion of Ukraine.

Given this uncertainty, the Committee will continue to monitor the situation closely and stands ready to vary the UK CCyB rate – in either direction – in line with evolution of economic conditions, underlying vulnerabilities and the overall risk environment. When taking its Q2 UK CCyB rate decision, the FPC will consider a full evaluation of the economic outlook, including the MPC's projections in the May 2022 Monetary Policy Report.

Building the resilience of the financial system

The resilience of market-based finance

Despite the recent falls seen in risky asset prices, some asset valuations remain vulnerable to a further re-assessment of economic prospects and potential rises in risk-free rates. Corrections in asset prices and volatility in markets could be amplified by existing vulnerabilities in market-based finance that were highlighted in March 2020, and risk further tightening financial conditions for households and businesses.

The FPC strongly supports the ongoing international work to address vulnerabilities in market-based finance, led and coordinated by the Financial Stability Board (FSB). The work planned by the FSB this year represents an important opportunity to develop policies to address these vulnerabilities. Absent implementation of those policy measures and an increase in the resilience of non-bank financial institutions, the financial stability risks exposed in March 2020 remain.

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

The Bank will return to its annual cyclical scenario (ACS) stress testing framework in 2022, following two years of Covid pandemic crisis-related stress testing. The 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. In light of uncertainty related to the Russian invasion of Ukraine, and in order to help lenders focus on managing the ongoing financial markets disruption associated with the invasion, the FPC and the Prudential Regulation Committee (PRC) will delay the launch of the 2022 ACS. The FPC and the PRC intend to announce a revised timeline, which accounts for this delay, during Q2 2022.

Risks from cryptoassets and decentralised finance

The underlying technologies behind cryptoassets and decentralised finance could bring a number of benefits including lower transaction costs, higher payment system interoperability and more choice for users. These benefits can only be realised and innovation can only be sustainable if it is undertaken safely and accompanied by effective public policy frameworks that mitigate risks and maintain broader trust and integrity in the financial system.

Since the start of the Russian invasion of Ukraine, there has been heightened activity in cryptoasset markets. While cryptoassets are unlikely to provide a feasible way to circumvent sanctions at scale currently, the possibility of such behaviour underscores the importance of ensuring innovation in cryptoassets is accompanied by effective public policy frameworks to mitigate risks to consumer protection, market integrity, money laundering and terrorist financing, and maintain broader trust and integrity in the financial system. The FPC welcomes the **joint statement** by UK financial regulation authorities regarding the application of sanctions to cryptoassets.

As set out in the accompanying Financial Stability in Focus, the FPC is monitoring a number of channels through which risks to financial stability could arise from cryptoassets and decentralised finance. These include: risks to systemic financial institutions; risks to core financial markets, including through the use of leverage; risks to the ability to make payments; and the impact on real economy balance sheets.

The FPC continues to judge that direct risks to the stability of the UK financial system from cryptoassets are currently limited, reflecting their limited size and interconnectedness with the wider financial system. However if the pace of growth seen in recent years continues, and as these assets become more interconnected with the wider financial system, cryptoassets will present a number of financial stability risks in the future.

Enhanced regulatory and law enforcement frameworks are needed, both domestically and at a global level, to address developments in these markets and activities. Where crypto technology is performing an equivalent economic function to one performed in the traditional financial sector, the FPC judges that this should take place within existing regulatory arrangements, and that the regulatory perimeter be adapted as necessary to ensure an equivalent regulatory outcome. This would likely require the expansion of the role of existing macro and microprudential, conduct, and market integrity regulators, and close co-ordination amongst them. The FPC will, where necessary, make Recommendations to HM Treasury regarding gaps in the regulatory perimeter, consistent with its statutory responsibilities; decisions on adapting the regulatory perimeter would be for the Government to take.

The FPC supports the work of the FSB as it coordinates the international approach to unbacked cryptoassets. Domestically, the FPC supports the work of the HM Treasury-FCA-Bank Cryptoassets Taskforce on assessing the regulatory approach to unbacked cryptoassets and their associated markets. The FPC also welcomes the Dear CEO letter issued by the PRA reminding banks of their obligations with respect to cryptoasset exposures, and the FCA statement reminding firms of their obligations when interacting with or exposed to cryptoassets. Such actions are important given the pace of growth in this area.

The FPC will continue to pay close attention to developments and will seek to ensure that the UK financial system is resilient to risks that may arise from cryptoassets.

Systemic stablecoins

Stablecoins are digital tokens that claim to maintain a stable value at all times, primarily in relation to existing national currencies. They could provide benefits to users but will be adopted widely and become successful as a means of payment only if they meet appropriate standards and confidence in their value is assured.

The FPC has previously set out its expectation that stablecoins used in systemic payments systems should meet equivalent standards to those that apply for commercial bank money. The FPC noted HM Treasury's proposal for a regulatory regime for stablecoins, including bringing systemic stablecoins into the Bank's regulatory remit.

The Bank has published a summary of responses to its Discussion Paper (DP) on new forms of digital money, and is currently considering the possible regulatory models discussed in light of these responses. With this in mind, the FPC has considered how a non-bank stablecoin could meet its expectations in the absence of a 'backstop' to compensate depositors in the event of failure. For banks, backstops include a resolution regime and the Financial Services Compensation Scheme (FSCS) deposit guarantee scheme, but such arrangements are generally not available for non-banks.

In the absence of such a backstop, regulatory safeguards will be needed for a non-bank systemic stablecoin to ensure that the coin issuance is fully backed with high quality and liquid assets, alongside loss absorbing capital as necessary, to compensate coinholders in the event that the stablecoin fails. In addition, the regulatory regime will need to mitigate operational risks (such as fraud or technological failure). These risks could result in a shortfall of backing assets relative to the coins in issuance, or prevent funds from being returned rapidly to coinholders.

On balance, the FPC judges that a systemic stablecoin issued by a non-bank without a resolution regime and deposit guarantee scheme could meet its expectations, provided the Bank applies a regulatory framework that is designed to mitigate these risks to financial stability.

It is likely some non-systemic stablecoin issuers will adopt a model in which coins are backed with deposits at a commercial bank. This model poses significant financial stability risks if pursued at scale. **The FPC judges that a systemic stablecoin that is backed by a deposit with a commercial bank would introduce undesirable financial stability risks.** The Bank and FCA intend to carry out further work on the regulatory framework for stablecoins, and subject to the outcome of HM Treasury's consultation, the Bank intends to consult on its proposed regulatory model for systemic stablecoins in 2023.

Record of the Financial Policy Committee meetings on 9 and 18 March 2022

1. The Committee met on 9 and 18 March 2022[1] to agree its view on the outlook for UK financial stability and, on the basis of that, 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. Its aim was to ensure the UK financial system was prepared for, and resilient to, the wide range of risks it could face – so that the system could serve UK households and businesses in bad times as well as good.

Overview of risks to the UK financial system

2. **Prior to the Russian invasion of Ukraine**, UK and global economic activity had returned to their pre-pandemic levels, despite the ongoing impacts of Covid, including from the emergence of the Omicron variant. The Committee noted the Monetary Policy Committee's (MPC's) central forecast for UK GDP, inflation and the outlook for world activity set out in the February 2022 Monetary Policy Report (MPR). UK GDP growth was expected to slow in large part on account of the adverse impact of the previous, already large, increases in global energy and tradable goods prices on UK real aggregate income and spending.

3. In that context, and prior to the Russian invasion of Ukraine, the FPC judged that domestic vulnerabilities that could amplify economic shocks had not changed materially since the December 2021 *Financial Stability Report (FSR)*, and were broadly at pre-pandemic levels. Global vulnerabilities remained at a material level overall on account of high and rising debt levels in China and Hong Kong, and heightened risk taking in global capital markets.

4. **Following the Russian invasion of Ukraine** on 24 February, uncertainty around the outlook had increased significantly. The conflict would impact the macroeconomic outlook and posed risks to market confidence. The economic implications of the invasion could also interact with risks associated with high levels of global debt. Risks to global activity were skewed to the downside, and increases in global energy and tradable goods prices were likely to weigh on UK real aggregate income. It was likely there would be further market volatility.

[1] **Judgements on the topics from Cryptoassets and Decentralised Finance onwards were taken on 9 March; judgements on all other topics were taken on 18 March.**

5. The FPC would remain vigilant to vulnerabilities in the economy that could amplify risks to financial stability, and would continue to monitor the implications of the Russian invasion of Ukraine for the UK financial system.

Russian invasion of Ukraine

6. The Bank of England had condemned Russia's unprovoked invasion and the suffering inflicted on Ukraine. The Bank was working closely with the Government to support its response in coordination with the FCA and other UK and international authorities. The FPC supported this condemnation and welcomed these actions. In addition, the FPC welcomed the international coordination to ensure alignment of financial sanctions, as well as industry engagement, to minimise the potential for unintended operational consequences.

7. Global financial markets, particularly for commodities, had been volatile, and uncertainty over the economic outlook had increased significantly. Consistent with its remit, the FPC's role was to assess the impacts of these developments on UK financial stability and take action as appropriate, including to help to ensure that the UK financial system could continue to support households and businesses through this period.

8. While the UK's direct linkages to Russia were limited, there were indirect channels through which the invasion could potentially pose risks to UK financial stability. The direct exposures of UK banks to Russia were low (amounting to around 1% of CET1 at end-2021), as were direct trade links (UK exports to Russia account for 0.2% of UK GDP). However, the invasion had affected a number of globally-traded commodities. Energy prices had risen sharply, as had the prices of other commodities where Russia and Ukraine were important producers, and volatility had been exceptionally high. Higher prices for energy and other commodities, if sustained, could affect the resilience of borrowers by further squeezing real incomes, particularly if this was accompanied by a further tightening in global financial conditions.

9. Disruption to supply chains could also affect production in the UK and elsewhere, putting pressure on corporate earnings. For example, Ukraine and Russia were major wheat producers and accounted for a significant share of the global production of some metals and other inputs to production processes such as neon, which was used in semiconductor production. Volatility in commodity prices could also place strains on the markets in which they were traded. Margin calls on derivative positions had risen significantly, and the London Metal Exchange had temporarily suspended trading in the nickel market and cancelled trades over a short time period following a sharp spike in prices.

10. Risky asset prices had fallen, and global financial conditions had tightened. Given the need to safeguard against counterparty credit risks for both regulated and unregulated counterparties, and

consistent with these moves, margin calls on derivatives positions, in over-the-counter and exchange traded markets, had risen significantly. Financial markets had in general continued to function despite the high volatility, although bid-offer spreads had widened in certain bond markets suggesting that market liquidity had been impacted. There had been materially lower primary issuance in corporate debt and leveraged loan markets in recent weeks.

11. Market dynamics had reflected both a ‘flight to safety’ in response to a deterioration in the geopolitical and economic outlook, as well as concerns about rising inflation, leading to portfolio adjustments and a repricing of risks.

12. There was heightened risk of cyber threats. The FPC welcomed the National Cyber Security Centre’s actions aimed at ensuring that the UK financial system was well prepared for such attacks. The FPC noted the Bank and Prudential Regulation Authority (PRA) used a range of approaches to assess the cyber resilience of firms. Cyber stress testing tests firms’ abilities to restore vital financial services after a hypothetical cyber incident. Other tests and exercises such as CBEST (threat-led penetration tests) and SIMEX (sector cyber simulation exercises), as well as industry exercises and engagement with international partners, forms a part of the overall toolkit to assess the cyber resilience of firms.

13. The FPC also considered the impact of the conflict on insurer resilience. Overall, exposure in the London market to Russia and Ukraine was considered to be manageable provided that UK and EU sanctions were aligned as far as possible, in order to minimise unintended consequences.

14. There was considerable uncertainty about future developments in Ukraine and Russia and the Committee noted that further geopolitical developments could pose additional risks. As discussed by the MPC at their March meeting, the global economic outlook had deteriorated significantly, and global inflationary pressures would strengthen considerably over the coming months. The possibility of further second-order spillover effects impacting upon the UK financial system could not be discounted.

15. Major UK banks’ capital and liquidity positions remained strong. In recent years, the FPC had tested the resilience of the UK banking system against a range of severe economic scenarios, and remained of the view that major UK banks were able to withstand severe market and economic disruption; and continue to provide services to customers.

16. The FPC would continue to monitor developments closely and stood ready to take any measures necessary to help ensure UK financial stability, in line with its statutory responsibilities.

Financial markets and market-based finance resilience

17. Financial markets had experienced significant volatility since the December 2021 *FSR.* At that time, the FPC had judged that asset valuations in some markets, such as US equities and advanced economy corporate bonds, appeared elevated relative to historical norms.

18. Prior to the Russian invasion of Ukraine, advanced economy equity prices had already fallen, corporate bond spreads widened and government bond yields had increased materially, resulting in tighter financial conditions. For example, US equities were down c. 9%, while UK ten-year government bond yields had increased c. 80 basis points since the December *FSR*. Advanced economy investment grade corporate bond spreads had widened around 25-35bps. The FPC judged that these moves reflected market participants adjusting their inflation and interest rate expectations in the light of upside inflation surprises, related central bank communications and receding Omicron concerns. The FPC noted that this adjustment had been largely orderly, with some markets experiencing higher volatility and somewhat reduced liquidity.

19. The Committee noted that following the Russian invasion of Ukraine, financial market moves had initially reflected some ‘flight-to-safety’ dynamics, amidst widening of corporate bond spreads, volatile equity prices and strong demand for ‘safe haven’ assets such as government bonds and the US dollar. But since then concerns around inflation had intensified, including reflecting the dynamics of energy prices, with government bond yields rising to above pre-invasion levels. In addition, market volatility had increased and liquidity across markets had deteriorated, as manifested in wider bid-ask spreads, falls in measures of market depth and lower primary issuance in corporate debt and leveraged loan markets. However, the FPC judged that most financial markets had largely remained functional with participants able to execute trades, with the exception of Russian and Ukrainian assets which had become increasingly more difficult to price and trade.

20. Energy and commodity markets had experienced significant volatility since the Russian invasion of Ukraine, including in response to the sanctions placed on the Russian economy, with commodity prices rising sharply. Oil prices had risen by a third in the two weeks following the invasion, while UK and European gas prices had increased by as much as 150%. Both had since retraced these initial moves, with oil prices around 10% higher than pre-invasion levels and gas prices around 20% higher. Margin calls on energy and other commodity derivatives had increased substantially, exceeding December 2021 peaks as well as levels seen during March and April 2020. The FPC noted that further sharp price moves in commodity markets and the associated margin calls could put pressure on participants in those markets, potentially increasing their demand for liquidity, including via bank credit lines. The FPC stressed that central counterparties (CCPs) and the collection of margin on derivative contracts reduced systemic risks and remained a critical safeguard in financial markets, as had been demonstrated during this market turbulence when concerns about counterparty credit risks had not affected market functioning.

21. In addition to the developments in commodity derivatives markets, the Committee noted suspensions at several investment funds with material exposure to Russian assets, resulting from difficulties in valuation and a significantly increased probability of defaults. The FPC noted that while pressures could be observed in some parts of the financial system, they were not broad-based at this stage. There had not been signs of widespread forced selling of risky assets or demand for cash manifested in forced sales of government bonds or elevated demand for repo borrowing that had led to disruption of those markets in March 2020. The FPC noted that the key uncertainty was whether interconnections within the financial system – for example between energy and other commodity markets, wider financial markets and the real economy – might create feedback loops and amplification mechanisms across the financial system more broadly. The FPC would continue to remain vigilant to these issues, including by assessing potential linkages between commodity markets and the broader financial system. The FPC noted that the assessment of risks was made more difficult by the relative opacity of commodity derivatives markets. For example, some material physically settled transactions are not reportable to trade repositories, and some important counterparties may not be subject to reporting obligations under UK European Market Infrastructure Regulation (EMIR).

22. The Committee judged that given current economic and geopolitical environments, risks of wider market disruption remained elevated, especially if high volatility and further sharp moves in prices persisted across markets. The FPC highlighted that risky asset prices remained particularly vulnerable to further downward adjustment, in the light of downside risks to the macroeconomic outlook, including due to the impact of higher energy prices on real aggregate income. In addition, rising energy prices continued to impact expected inflation and put further upwards pressure on government bond yields, which might exacerbate any falls in risky asset prices. The FPC further noted that the vulnerabilities in market-based finance that led to market disruption during March 2020 largely remained and could amplify any adjustments in market prices triggered by geopolitical developments, including those originating in commodity markets.

23. The FPC reiterated its strong support for the international work, led and co-ordinated by the Financial Stability Board (FSB), to assess and develop policy responses to address the underlying vulnerabilities in market-based finance that had amplified the 2020 dash for cash. The work planned by the FSB this year therefore represented an important opportunity to develop policies to address those vulnerabilities. Absent implementation of those policy measures and an increase in the resilience of non-bank financial institutions (NBFIs), the financial stability risks exposed in March 2020 remained.

Global vulnerabilities

24. The Committee discussed a range of international risks that could be relevant for UK financial stability. As discussed by the MPC at their March meeting, the global economic outlook had deteriorated significantly following Russia's invasion of Ukraine, and the associated material increase in the prices of energy and raw materials. The impact was likely to be especially felt in Europe where, for example, some countries were particularly reliant on Russian energy. Disruptions to global supply chains could also affect a wide range of countries given the significant role of Russia and Ukraine in the production of commodities including metals, wheat and other inputs to production processes.

25. Although risks remained, there had been little sign of financial market contagion to other emerging markets outside of Europe so far. Despite sharp falls in Russian equity prices and the value of the rouble, movements in equity prices and exchange rates in other major emerging market economies had been limited.

26. In addition to the risks associated with the Russian invasion of Ukraine, there remained a number of vulnerabilities in the global economy that could further amplify shocks. Overall, global debt vulnerabilities remained material. The FPC noted that the pandemic had represented a substantial shock to households and businesses in other countries, as in the UK. Restrictions to contain further Covid outbreaks, including in China given its zero-Covid policy, could further disrupt global supply chains and impact corporate earnings. Across advanced and emerging market economies corporate debt-to-GDP ratios had generally increased since the start of the pandemic. As the FPC had previously highlighted, long-standing vulnerabilities in the Chinese property sector had re-emerged, amidst high and rising debt levels in China and Hong Kong. Private non-financial debt as a share of GDP in China had risen by 50% over the past decade to 217%. The property market in China had slowed in recent months as a number of highly-leveraged property developers faced liquidity stresses. House prices had declined for the first time since 2015 and real estate investment had fallen by around a fifth compared to the first half of 2021. The real estate sector had been a significant contributor to growth in China over recent years, and was estimated to account for around a quarter of Chinese GDP.

27. Risks in leveraged loan markets globally remained high. Strong issuance in leveraged loan markets, particularly in the United States, had been accompanied in recent years by weakening loan documentation and rising leverage. Leverage in this market was at a record high globally, as was the share of new issuance that had few financial maintenance covenants (so-called 'covenant-lite' lending). Separately, in the euro area there were pockets of high public debt levels and interlinkages between banks and sovereigns.

28. Against the backdrop of a tightening in global financial conditions in recent months, and in light of recent events, a sharper increase in the financing costs facing households and businesses could pose risks given existing global debt vulnerabilities. Volatility in financial markets could be associated

with market dysfunction, and borrowers might find it harder to service their debt or face reduced credit availability. As set out in the October 2021 *Financial Stability in Focus (FSiF)*, companies in the US and the euro area appeared resilient to significant increases in interest rates, although recent increases in the prices of energy and a range of other goods would also affect their ability to service debt. Riskier borrowers, such as those taking on leveraged loans, might be particularly vulnerable. Some emerging market economies also remained vulnerable to capital outflows, despite improvements in current account positions and increases in foreign exchange reserves in many countries over the past decade.

29. Crystallisation of these global debt vulnerabilities could spill over to the UK through a number of channels. For example, a downturn abroad could lead to reduced demand for UK exports. Strong credit growth abroad could directly increase risks to the UK financial system via UK banks' foreign exposures. And tighter overseas credit conditions could affect UK businesses' ability to raise or roll over finance in both overseas and domestic markets.

Domestic vulnerabilities

30. Although the global economic outlook had deteriorated significantly following Russia's invasion of Ukraine, at present, domestic resilience had not been materially affected.

UK Corporate resilience

31. The FPC noted that there had been little reported need by UK corporates for additional liquidity or widespread distress as a result of the impact of Omicron. Bank lending conditions to businesses in the UK had remained generally supportive and banks' risk appetites had largely returned to pre-pandemic levels.

32. The phased removal of government moratoria on winding-up was, as expected, leading to an increase in insolvencies. Cumulative insolvencies remained significantly below what might have been expected over the pandemic. But quarterly insolvencies had returned to pre-Covid levels in 2021 Q4 and were expected to rise further in 2022 following the planned removal of restrictions on creditor actions at end-March. The FPC would continue to monitor numbers of insolvencies on a quarterly basis.

33. The FPC observed that, in aggregate, net finance raised by UK corporates had declined sharply in 2021, following very strong borrowing and equity issuance in 2020. Corporates had made net repayments of around £8 billion in 2021, the highest annual total since 2010. The increase in corporate debt from 2019 Q4 to 2021 Q3 was now at £55 billion, representing a relatively modest increase of 4.1% on the debt stock. This had left the UK's corporate debt-to-GDP level at 61%, up

marginally from its pre-pandemic level of 59%. The UK's corporate debt-to-earnings ratio was broadly similar to its pre-pandemic level at 327%.

34. Post the Russian invasion, uncertainty around the outlook had increased relative to Q4. Capital market conditions had worsened and the outlook for both corporate earnings and the cost of debt had deteriorated. Risks to UK and global activity were skewed to the downside. A reassessment of investor risk sentiment could push up funding spreads, and further inflationary shocks could also trigger a larger, faster and possibly more persistent increase in interest rates. Small and medium sized enterprises were more likely to face pressures. UK SMEs were more exposed to rising borrowing costs than larger corporates, and were more vulnerable than they were pre-Covid having been disproportionately impacted by the pandemic, and having increased their debt more than larger companies over that period. However, the vast majority of this new debt had been issued via government-backed schemes, which would limit risks to lenders. And most of these loans had low interest rates that were fixed for the duration of the loan, which would limit the burden on borrowers.

35. Despite this uncertainty, the FPC judged that debt servicing remained affordable for most UK businesses. For example, the share of large listed businesses with interest coverage ratios (ICRs) below 2.5 was broadly unchanged in 2020 at 29.1%, from 28.4% in 2019, and remained far below its historical high in 2001 of 59%. It would take large increases in borrowing costs or severe shocks to earnings to impair businesses' ability to service their debt in aggregate. Specifically, it would take a 400bps increase in borrowing costs to return the share of large businesses with an ICR below 2.5 to its historical maximum. And it would take a negative shock to earnings before interest and taxes (EBIT) of around 35% to return the share with an ICR below 2.5 to the level seen around the time of the Global Financial Crisis (GFC). However, the impact on corporate earnings would likely vary significantly by sector with companies in sectors most exposed to energy price rises likely to experience the largest shocks.

UK Household resilience

36. The FPC noted that an increase in the cost of living, partly due to rising energy and other import prices, would put increased pressure on household finances.

37. The rise in living costs was likely to affect household resilience across the income distribution, with a larger impact on lower income households that spend a greater share of their income on energy and other essential items. Although these price rises were unlikely to significantly affect the ability of mortgagors to make debt repayments, they would increase the pressure on household balance sheets, particularly if there was a larger than expected impact on growth.

38. The FPC noted that UK house price inflation, while still strong, had slowed from the high levels seen in 2021. This was likely to have been driven by the slowing down of Covid-related factors.

Analysis of 'race for space' factors suggested these could have accounted for around half of the growth during 2020 and 2021.

39. The FPC noted that so far there had been little evidence of a deterioration in mortgage lending standards. Risky lending at high LTIs and LTVs had remained slightly below pre-Covid levels and mortgage market activity seemed to have returned to pre-pandemic levels. Aggregate household debt relative to income had remained broadly flat following slight increases earlier in the pandemic. Latest data from 2021 Q3 showed that the share of households with a mortgage debt-servicing ratio at or above 40% – a level beyond which households are typically much more likely to experience repayment difficulties – remained broadly in line with 2017–19 averages and significantly below levels seen just prior to the GFC.

The resilience of the UK banking system

40. The FPC discussed the resilience of the UK banking system, including its ability to withstand shocks and maintain credit supply.

41. While uncertainty over the economic outlook had increased, UK banks' capital and liquidity positions remained strong. Their aggregate Common Equity Tier 1 (CET1) ratio fell modestly in Q4 to 16.3%, from 16.5% in Q3. Banks' liquidity coverage ratios continued to comfortably exceed regulatory guidelines.

42. The FPC noted that UK banks' capital ratios were expected to continue to fall back towards pre-pandemic levels of around 14% over the coming quarters because of distributions to shareholders and a range of regulatory changes. For example, in early 2022, the treatment of software assets for regulatory capital had been updated, requiring all intangible software assets to be fully deducted from regulatory capital resources. And risk-weighted assets had changed including due to the implementation of hybrid models for mortgages. The impact of these regulatory changes had reduced the CET1 ratio as of 1 January 2022 to around 15%, but it was still higher than its pre-pandemic level of 14.8% in 2019 Q4.

43. UK banks' profitability had increased further in Q4, supported by further releases of credit provisions. Major UK banks' return on equity had increased from approximately 2% in 2020 to 8% in 2021, driven by a £4bn aggregate credit provision release. The FPC noted that banks had upgraded their profitability targets, in part driven by the rising interest rate environment and the positive impact on net interest income.

44. UK banks' commercial and retail lending risk appetites had continued to normalise from lowered levels during the pandemic as asset quality had remained stable, although the outlook remained

uncertain. There were some early signs that some banks might be considering selectively reducing their lending appetite in some segments in response to recent events.

The UK Countercyclical Capital Buffer (CCyB) rate

45. The FPC judged that domestic vulnerabilities that could amplify economic shocks had not changed materially since Q4, and were around a standard level overall, as was the case just before the pandemic. The FPC reiterated that its policy was to vary the UK Countercyclical Capital Buffer (‘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 those vulnerabilities were judged to be around a standard level. This approach aimed to ensure that the buffer was large enough to create capacity for banks to lend through downturns, while also absorbing losses.

46. The FPC judged that uncertainty around the economic outlook had increased significantly since Q4. Risks to economic activity were skewed to the downside, and increases in global energy and tradable goods prices were likely to push down on UK real aggregate income. The invasion of Ukraine by Russia had also led to volatility in global financial and commodity markets, and could further impact energy prices and market confidence. The FPC’s role was to assess any impacts of these developments on UK financial stability and take action as appropriate. The UK financial system’s direct linkages to Russia were limited but the FPC judged that UK financial stability could be affected by indirect channels. The FPC would continue to monitor developments closely and remained vigilant to any emerging financial stability risks.

47. Aggregate debt in the UK corporate sector was close to its pre-Covid level. Aggregate measures of household indebtedness also remained broadly flat. The FPC judged that risky asset prices remained vulnerable to further downwards adjustment, given downside risks to the macroeconomic outlook. Global debt vulnerabilities remained material.

48. Taking into account its discussion on the economy and the financial system, the FPC agreed that it was appropriate to maintain the UK CCyB rate at 1% in 2022 Q1[2]. The Committee had stated in Q4 that if the UK economic recovery proceeded broadly in line with the MPC’s central projections in the November MPR, and absent a material change in the outlook for UK financial stability, the FPC expected to increase the UK CCyB rate further to 2% in 2022 Q2. Any subsequent increase would not be expected to take effect until after the usual 12-month implementation period.

49. Noting that the uncertainty around the economic outlook had increased since Q4, the Committee agreed to continue to monitor the situation closely and stood ready to vary the UK CCyB rate – in either direction – in line with evolution of economic conditions, underlying vulnerabilities and the

[2] **See here for details of the FPC’s approach to setting the CCyB and the CCyB core indicators.**

overall risk environment. When taking its Q2 UK CCyB rate decision, the FPC would consider a full evaluation of the economic outlook, including the MPC's projections in the May 2022 *MPR*.

Annual Cyclical Scenario 2022

50. The FPC and PRC use stress tests to assess bank balance sheets and the resilience of the UK banking system. By using stress tests to determine banks' ability to withstand an adverse scenario, the Bank aimed to ensure they would be able to continue to lend to households and businesses in bad times as well as good.

51. The FPC noted that the Bank was returning to its annual cyclical scenario (ACS) stress testing framework in 2022, following two years of Covid crisis-related stress testing. The Bank's 2022 ACS would 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. In light of the uncertainty related to the Russian invasion of Ukraine, and in order to help lenders focus on managing the ongoing financial markets disruption associated with the invasion, the FPC and the Prudential Regulation Committee (PRC) had decided to delay the launch of the 2022 ACS. The FPC and the PRC expected to announce a revised timeline, which accounted for this delay, during Q2 2022.

52. The FPC discussed the scenario for the 2022 ACS. The Committee noted that the stress applied under the 2022 ACS was not a forecast of macroeconomic and financial conditions in the UK or abroad resulting from the current geopolitical situation. It was not a set of events that was expected, or likely, to materialise. Rather, as per previous ACS scenarios, it was a coherent 'tail risk' scenario designed to be severe and broad enough to assess the resilience of UK banks to a range of adverse shocks.

53. While previous stress tests have incorporated the impact of higher interest rates in the UK, the 2022 ACS would for the first time test UK banks' resilience to higher global interest rates, in the face of a persistent series of inflationary cost shocks.

54. The 2022 ACS would also assess the ring-fenced subgroups of the existing participating banks on a standalone basis, where these differed materially from the group as a whole.

55. Banks would continue to be assessed on an International Financial Reporting Standards 9 (IFRS 9) transitional basis and the associated hurdle rate adjustment would continue to apply. Nevertheless, the FPC noted that at the beginning of a real stress under IFRS 9 there would be the potential for large capital drawdowns due to earlier provisioning, and thus risks to banks' resilience. The FPC observed that the Bank continued to consider its approach for an enduring treatment for IFRS 9 beyond the 2022 ACS, and intended during 2022 to engage with the ACS banks to investigate any

options they may have to factor the level of credit loss provisions required by IFRS 9 into their future planning.

Cryptoassets and Decentralised Finance

56. The FPC noted that the underlying technologies behind cryptoassets and decentralised finance could bring a number of benefits, including lower transaction costs, higher payment system interoperability and more choice for users. These benefits could only be realised and innovation could only be sustainable if it was undertaken safely and accompanied by effective public policy frameworks that mitigated risks and maintained broader trust and integrity in the financial system.

57. The FPC discussed recent developments in cryptoasset markets. The market capitalisation of cryptoassets had grown fifteen fold between early 2020 and November 2021, peaking at $2.9 trillion, and had fallen back to around $1.7 trillion in February 2022, representing around 0.4% of global financial assets.

58. Since the start of the Russian invasion of Ukraine, there had been heightened activity in cryptoasset markets. The FPC noted that while cryptoassets were unlikely to provide a feasible way to circumvent sanctions at scale currently, the possibility of such behaviour would underscore the importance of ensuring innovation in cryptoassets was accompanied by effective public policy frameworks to mitigate risks to consumer protection, market integrity, money laundering and terrorist financing, and maintain broader trust and integrity in the financial system. The FPC welcomed the joint statement by UK financial regulation authorities regarding the application of sanctions to cryptoassets[3].

59. 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 size and interconnectedness with the wider financial system. However, if the pace of growth seen in recent years continued, and as these assets became more interconnected with the wider financial system, cryptoassets would present a number of financial stability risks in the future, and close monitoring and continued regulatory policy development would be needed.

60. Risks to UK financial stability from cryptoassets and their associated markets and activities, including decentralised finance, could arise both through their links to the wider financial system and through their provision of equivalent services. As set out in the Q1 *FSiF*, the FPC was monitoring a number of channels through which risks to financial stability could arise from cryptoassets and

[3] Joint Statement from UK Financial Regulatory Authorities: Sanctions and Cryptoassets - GOV.UK (www.gov.uk)

decentralised finance. These included: risks to systemic financial institutions; risks to core financial markets, including through the use of leverage; risks to the ability to make payments; and the impact on real economy balance sheets. If any of these risks were to materialise, it could also reduce confidence in cryptoassets and the UK financial system more broadly.

61. To help monitor these risks, and given the currently significant data gaps in cryptoasset markets, the FPC would use a range of indicators. These would be reviewed and adapted as the cryptoasset ecosystem developed, and in order to capture its changing nature and interconnectedness with the UK and global financial system. International effort and co-operation would be essential to remediate data gaps and monitor risks building across jurisdictions.

62. Many of the financial stability risks posed by cryptoassets and their associated markets and activities, including decentralised finance, were similar to those managed by the existing regulatory framework in other parts of the financial system. In some cases, the existing regulatory framework could be used to manage the risks. In other cases, further development of the regulatory framework might be needed to reflect the differing nature of the underlying technology and its impact on business models or the system more generally.

63. The FPC considered that enhanced regulatory and law enforcement frameworks were needed, 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.

64. The FPC judged that where crypto technology was performing an equivalent economic function to one performed in the traditional financial sector, this should take place within the existing regulatory arrangements, and that the regulatory perimeter should be adapted as necessary to ensure an equivalent regulatory outcome. This would likely require the expansion of the role of existing macro and microprudential, conduct, and market integrity regulators, and close co-ordination amongst them. The FPC would, where necessary, make Recommendations to HM Treasury regarding gaps in the regulatory perimeter consistent with its statutory responsibilities; decisions on adapting the regulatory perimeter would be for the Government to take.

65. The FPC supported international work on these issues, including that of the Financial Stability Board (FSB) in its role coordinating the international approach to unbacked cryptoassets. CPMI-IOSCO had already set out in October 2020 that systemically important stablecoin arrangements that performed systemically important payment system functions should meet the existing Principles for Financial Market Infrastructures (PFMIs) and were consulting on how the PFMIs applied to such stablecoin arrangements. Work was also under way internationally to clarify the treatment of cryptoassets under the prudential regime for banks.

66. Domestically, the FPC was supportive of the work of the HM Treasury-FCA-Bank Cryptoasset Taskforce on assessing the regulatory approach to unbacked cryptoassets and their associated markets and activities in order to shape developments in this space and support safe innovation. The FPC also welcomed the Dear CEO letter issued by the PRA reminding banks of their obligations with respect to cryptoasset exposures, and the FCA statement reminding firms of existing obligations when interacting with or exposed to cryptoassets. Such actions were important given the pace of growth in this area.

67. 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, and associated markets and services. The FPC considered that financial institutions should take an especially cautious and prudent approach to any adoption of these assets.

Systemic stablecoins

68. Stablecoins are digital tokens that claim to maintain a stable value, primarily in relation to existing national currencies. They have the potential to be attractive to users and to become widely used as a form of payment. The FPC judged that in order to maintain public confidence in money used for payments and support potential innovation, the regulatory framework needed to be adapted to ensure that providers of systemic stablecoins enabled users to redeem their money when they wanted to, and at face value, as they were able to do with existing widely used private money that was in circulation in the UK.

69. In the Record of its December 2019 meeting, the FPC had set out its second expectation that stablecoins that were used in systemic payment systems ("systemic stablecoins") as money-like instruments should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.

70. The FPC noted HM Treasury's proposal for a regulatory regime for stablecoins, including bringing systemic stablecoins into the Bank's regulatory remit[4]. The proposal, which would require legislation, would allow for a non-bank regulatory regime for stablecoins, but would not include a resolution regime or a deposit guarantee scheme. Systemic (non-bank) stablecoins that failed would instead be subject to a modified insolvency regime.

71. The FPC noted that the Bank would publish a summary of responses to its Discussion Paper (DP) [5] on new forms of digital money on the same day as the Record of its meeting. As the Bank had set

[4] https://www.gov.uk/government/consultations/uk-regulatory-approach-to-cryptoassets-and-stablecoins-consultation-and-call-for-evidence
[5] https://www.bankofengland.co.uk/paper/2021/new-forms-of-digital-money

out in its DP, one important protection for commercial bank money was the backstop, consisting of the resolution regime and the Financial Services Compensation Scheme (FSCS) deposit guarantee scheme, which ensured that depositors were compensated up to £85,000 if a bank failed, that there was continuity of critical economic functions for systemic banks and that financial stability was supported.

72. The Bank was considering the possible regulatory models for systemic stablecoins in light of responses to the DP. The FPC noted that one regulatory model was for stablecoins to be issued by banks as tokenised deposits, in which case the same protections as for bank depositors could be applied, including the backstop. Taking into consideration HMT's proposed regulatory regime, the FPC also considered how a non-bank stablecoin could meet its expectations in the absence of a backstop to compensate depositors in the event of failure, given that the backstop arrangements for banks were not available for non-banks.

73. The FPC considered that, in the absence of a resolution regime or deposit guarantee scheme, regulatory safeguards would be needed for a non-bank systemic stablecoin if the FPC's expectation were to be met. Regulation would need to ensure that coinholders' funds could be fully returned to them in the event the stablecoin fails.

74. The coin issuance would need to be fully backed with high quality and liquid assets, and capital requirements would need to be applied to mitigate financial risks. This could be achieved via regulatory requirements and supervisory measures that reflected both the requirements for uninsured bank deposits and risks that could be specific to stablecoins.

75. In addition, the regulatory regime would need to mitigate operational risks (such as fraud or technological failure). These risks could result in a shortfall of backing assets relative to the coins in issuance, or prevent funds from being returned to coinholders. The backing assets would need to be protected from the failure of the issuer or other significant parts of the stablecoin arrangement (e.g. wallets or custodians of backing assets), and funds would need to be paid out rapidly and fully to coinholders. Regulation would also need to ensure that there is a robust legal claim for redemption of coinholder funds.

76. On balance the FPC judged that, at this stage, a systemic stablecoin issued by a non-bank without a resolution regime and/or deposit guarantee scheme, could meet its expectations, provided the Bank applied a regulatory framework that was designed to mitigate the risks to financial stability.

77. It was likely some non-systemic stablecoin issuers would adopt a model in which coins were backed with deposits at a commercial bank, which was the model currently used by most e-money providers in the UK.

78. But, as noted in the Bank's DP, there are some significant disadvantages with this model when applied to systemic stablecoins, and the model posed significant financial stability risks if pursued at scale. A run on a stablecoin would cause it to withdraw funds from the safeguarding bank, potentially causing it to liquidate assets and transmitting a liquidity shock across systemically important firms. This kind of symbiotic relationship, known as 'tiering', could result in higher financial stability risks due to the interconnectedness between systemically important firms.

79. The FPC judged that a systemic stablecoin that is backed by a deposit with a commercial bank would introduce undesirable financial stability risks.

80. Further work was needed to assess the broader implications of systemic stablecoin regulatory models, including for the Bank's own balance sheet and for monetary stability. The Bank and the FCA intended to carry out further work on the regulatory framework for stablecoins, and subject to the outcome of HM Treasury's consultation, the Bank intended to consult on its proposed regulatory model for systemic stablecoins and systemic wallets in 2023.

The FPC's mortgage market Recommendations

81. In 2021 Q4, the FPC had discussed its two Recommendations relating to the owner-occupier segment of the mortgage market and announced that it would consult on withdrawing its affordability test Recommendation[6] in the first half of 2022.

82. Subsequently, following a discussion of the strategy for, and substance of, the FPC's consultation, the FPC agreed the contents of the Consultation Paper by written procedure on 17 February 2022. The Consultation Paper was published on 28 February.

IMF Financial Sector Assessment Program (FSAP)

83. The FPC welcomed and supported the IMF's 2021 Financial Sector Assessment Program (FSAP) that noted that the UK financial system benefited from a robust financial stability framework, including a proactive macroprudential stance. The report also acknowledged the many actions taken to increase the resilience of the financial system since the last FSAP in 2016.

84. In terms of recommendations, the report highlighted, amongst other things, the importance of work to address NBFI-related vulnerabilities and noted that success in this area relied on international cooperation.

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85. The FPC noted the findings of the IMF FSAP. It would consider the recommendations and be kept informed on the implementation of the recommendations by the UK authorities.

Libor transition

86. The FPC welcomed the smooth transition of sterling markets through the cessation of GBP panel bank Libor at the end of 2021, which reflected sustained and constructive engagement over a number of years between the UK authorities and the private sector. The Committee noted that the stock of legacy GBP Libor exposures had been managed through the successful completion of CCP conversion events of outstanding cleared derivatives, the implementation of the ISDA Fallbacks, active transition of contracts by renegotiation, and publication of synthetic versions of GBP Libor.

87. The FPC continued to support the view that synthetic versions of Libor were a temporary solution, and that active transition of legacy contracts provided the best route to certainty for parties to contracts referencing Libor.

88. The FPC emphasised that supervised firms should by, 1 January 2022, have ceased new use of continuing USD Libor benchmarks, with limited exceptions.

89. The FPC noted ongoing progress in the adoption of the Secured Overnight Financing Rate (SOFR) across US dollar markets, ahead of USD Libor panel cessation at end-June 2023. The Committee re-iterated its view that SOFR-based rates provided more robust alternatives than recently created US credit sensitive rates, and that it considered these latter rates to have the potential to reintroduce many of the financial stability risks associated with Libor.

Previously redacted Record text on Libor transition

90. In June/July 2019, the Committee discussed the risks to financial stability posed by the continued reliance on Libor beyond end-2021. This discussion included the potential for legislation to play a role in mitigating risks from a stock of 'tough legacy' contracts that had no or inappropriate alternatives and no realistic ability to be renegotiated or amended by end-2021. At that stage, the FPC had considered that it was against the public interest to publish its discussion, because it could precipitate the financial stability risks authorities were seeking to mitigate by raising expectations for a broader legislative solution going beyond this narrow range of contracts. The publication of the discussion was deferred under Section 9U of the Bank of England Act 1998.

91. The Committee reviewed whether to publish or keep redacted the June/July 2019 discussion on three occasions: October 2019, August 2020 and July 2021. On each of those occasions the Committee agreed that it remained against the public interest to publish its discussion of potential legislative solutions in the Record of its meeting, and decided to continue to defer publication. In

August 2020, although firm proposals by the UK government for a legislative solution for the legacy stock of contracts had entered the public domain, the Committee agreed it remained against the public interest to publish given that other jurisdictions had not yet made public how they intended to approach the cessation of Libor under their domestic legal regimes. In July 2021, although there had been material developments in legislative solutions in the UK, EU and US, there were still a number of further legislative steps under discussion in various jurisdictions. The Committee therefore agreed that it would review again in 2022 Q1, once the key transition milestones at the end of 2021 had passed, or sooner if there are further material developments in proposed legislative solutions for the stock of legacy contracts.

92. At its meeting on 9 March 2022, the Committee agreed that it was no longer in the public interest to defer publication. On 31 December 2021, publication of 24 Libor settings ended permanently, and the six most widely used sterling and Japanese yen settings were published on a synthetic basis under a changed methodology from 4 January 2022. It is estimated that less than 2% of pre-2022 legacy GBP Libor exposures have had to utilise the temporary synthetic GBP Libor rates. In the US, although legislation had not yet been passed at the federal level, the proposed scope of this legislation was fully in the public domain. In the EU, statutory replacement rates for certain Swiss franc settings had been designated and further plans for certain sterling and Japanese yen Libor settings were in the public domain. The Committee agreed that publishing the Record of its discussion on legislative solutions was unlikely to significantly impact the transition of 'tough' legacy contracts or existing USD Libor transition programmes and thus pose a risk to financial stability. The Records of its meetings in July 2021, August 2020, October 2019 and June/July 2019 would be updated to include the previously deferred text at the same time as the Record of this meeting was published. That text would be included in Annex 2 of this Record.

Cyber stress test

93. The FPC noted that the exploratory cyber stress test planned for 2022 would be used to explore firms' capabilities and the potential financial stability impact in a hypothetical scenario. The FPC expected that the findings of the stress test would be used by the Committee, supervisors and firms to understand and enhance response and recovery capabilities.

94. The FPC agreed with the scenario noting it would shed light on the potential financial stability impact of a data integrity disruption to retail payments. The Committee expected to report on thematic insights from this test in due course.

95. The FPC also noted that cyber stress testing was complementary to other ongoing work on threat-led penetration testing (CBEST), sector cyber simulation exercises (SIMEX), and industry exercises

and engagement, which formed part of the Bank and PRA's overall toolkit to assess the cyber resilience of firms.

Critical third parties (CTPs) including cloud service providers (CSPs)

96. The FPC had previously noted the increasing reliance by the financial system on CTPs, including CSPs.

97. The FPC recognised the potential benefits for individual firms, including financial market infrastructures (FMIs), of using cloud services (provided they configured and oversaw them properly), for example through better operational resilience than their on-site information communications technology (ICT) infrastructure. Outdated, on-site ICT systems could pose significant cyber and other operational risks for firms.

98. However, the increasing criticality of the services that CTPs provided to UK financial firms, and the fact that the provision of these services was often concentrated in a small number of third parties, which were very difficult to substitute, posed a threat to UK financial stability in the absence of greater direct regulatory oversight of the services they provide.

99. Regulated firms currently had, and would continue to have, primary responsibility for managing the risks stemming from their outsourcing and other third party dependencies. However, additional policy measures, some requiring legislative change, were likely to be needed to mitigate the financial stability risks stemming from concentration in the provision of some third party services to UK firms. The FPC had set out what those measures should include in its 2021 Q3 Record.

100. The FPC continued to welcome the engagement between the Bank, FCA and HMT on how to tackle these risks and the Bank's ongoing engagement with HM Treasury on the necessary legislative changes. The FPC supported the intention of the Bank, PRA and FCA to publish a joint Discussion Paper in 2022 in order to facilitate effective engagement with industry on measures to manage systemic risks posed by CTPs.

Climate BES

101. The FPC supported the Bank's decision to proceed with a second round of the Climate Biennial Exploratory Scenario (CBES) exercise in February 2022, which would focus on further exploring major UK banks' and insurers' prospective responses to the crystallisation of climate risks. The FPC noted that the Bank expected to publish results from the Climate BES in May 2022.

The following members of the Committee were present:

Andrew Bailey, Governor

Colette Bowe

Sarah Breeden

Ben Broadbent

Jon Cunliffe

Jon Hall

Anil Kashyap

Dave Ramsden

Nikhil Rathi[7]

Elisabeth Stheeman

Carolyn Wilkins

Sam Woods

Charles Roxburgh attended as the Treasury member in a non-voting capacity.

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 stablecoins, and that he would not receive the related papers.

Under the same provisions, Carolyn Wilkins had notified the Committee of her Non-Executive Directorship of Intact Financial Corporation (including holding company of Royal Sun Alliance Group). It was agreed that she would recuse herself from discussions on insurance firms, which for this round included the Climate BES, and that she would not receive the related papers.

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

[7] **Nikhil Rathi sent his apologies for all items which were discussed and recorded from paragraph 56 onwards.**

Annex: Financial Policy Committee policy decisions

ANNEX 1: Outstanding FPC Recommendations and Directions (as at the date of the FPC's meetings on 9 and 18 March 2022)

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

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 agreed to maintain the UK CCyB rate at 1% in March 2022, unchanged from November 2021. 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 Prudential Regulation Authority (PRA) and the Financial Conduct Authority (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 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]

Mortgage affordability

At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability test Recommendation to reference mortgage contract reversion rates: When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, their mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination (or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher

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

[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.

than the product rate at origination). This Recommendation is intended to be read together with the FCA requirements around considering the effect of future interest rate rises as set out in MCOB 11.6.18(2).

This Recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum.

At its meeting in September 2017, the FPC confirmed that the affordability Recommendation did not apply to any remortgaging where there is no increase in the amount of borrowing, whether done by the same or a different lender.

Leverage ratio

In September 2021, the FPC directed 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 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 countercyclical capital buffer 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.

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 specified the following:

- The total exposure measure shall exclude any 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.
- 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 also recommended 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]

ANNEX 2: Previously redacted text

Under Section 9U of the Bank of England Act 1998, the FPC can defer publication of some parts of its Records if it decides that publication at that point would be against the public interest. As set out in paragraph 95 of this Record, the FPC has decided to publish now the following text from the Record of its meetings on 13 July 2021, 2 October 2019 and 13 June / 4 July 2019. Those Records have been updated on the Bank's website.

July 2021 deferred text

69. In August 2020, the Committee agreed to continue to defer publication of Record text discussing Libor transition risks from legacy contracts. It agreed that it would review this decision again in 2021 Q4, or earlier if there were material developments in proposed legislative solutions for the legacy stock of contracts.

[11] See PRA Policy Statement PS21/21 and Consultation Paper CP14/21 'Changes to the UK leverage ratio framework': www.bankofengland.co.uk/prudential-regulation/publication/2021/june/changes-to-the-uk-leverage-ratio-framework.

70. In February 2021 the European Commission gained powers to designate a rate which would replace all references to a benchmark that will no longer be published[12], while in April 2021 UK powers were agreed by Parliament and NY state legislation was passed. Following these material developments in legislative solutions, at its June meeting, the Committee again reviewed whether to publish or continue to defer publication of its previous discussion of legislative solutions from the Q2 2020, Q3 2019 and Q2 2019 Records.

71. Given a number of further legislative steps were still under discussion in various jurisdictions, the Committee agreed that it remained against the public interest to publish its previous discussion of legislative solutions in the Record of its meeting. This is because doing so could precipitate the financial stability risks authorities were seeking to mitigate. Market participants could put undue reliance on the possibility of further legislative solutions being devised and this could reduce their incentives to transition to new reference rates in time, ahead of 2021.

72. The Committee decided to continue to defer publication, under Section 9U of the Bank of England Act 1998. It agreed that it would review again in 2022 Q1, once the key transition milestones at the end of 2021 had passed, or sooner if there are further material developments in proposed legislative solutions for the stock of legacy contracts.

August 2020 deferred text

In October 2019, the Committee agreed to continue to defer publication of Record text discussing Libor transition risks from legacy contracts. It agreed that it would review this decision again in 2021 Q4, or earlier if proposals for a legislative solution for the legacy stock of contracts were made public.

In June 2020, the UK Government announced its intention to ensure that the FCA had the appropriate regulatory powers to manage and direct any wind-down period prior to eventual Libor cessation. In addition, in July 2020, the European Commission published a proposal to amend the Benchmarks Regulation to provide for the designation of replacement benchmarks for certain benchmarks in cessation. Following these announcements, at its August meeting, the Committee again reviewed whether to publish or continue to defer publication of its previous discussion of legislative solutions from the Q2 and Q3 2019 Records.

The Committee concluded that, given other jurisdictions had not yet made public how they intended to approach the cessation of Libor under their domestic legal regimes, it remained against the public interest to publish its previous discussion of legislative solutions in the Record of its meeting. This is because doing so could precipitate the financial stability risks authorities were seeking to mitigate. Market participants could put undue reliance on the possibility of further legislative solutions being

[12] **https://www.consilium.europa.eu/en/press/press-releases/2021/02/02/financial-benchmarks-council-adopts-new-rules-addressing-libor-cessation/**

devised and this could reduce their incentives to transition to new reference rates in time, ahead of 2021.

The Committee decided to continue to defer publication, under Section 9U of the Bank of England Act 1998. It agreed that it would review again in 2021 Q4, or earlier if there are material developments in proposed legislative solutions for the legacy stock of contracts.

October 2019 deferred text

96. In July 2019, the Committee had discussed the risks to financial stability posed by the continued use of Libor beyond end-2021. Part of the discussion was around the role authorities would take in the transition to mitigate risks from a stock of remaining legacy contracts after end-2021.

97. At that stage, the FPC had considered that it was against the public interest to publish its discussion, because it could precipitate the financial stability risks authorities were seeking to mitigate. If market participants put undue reliance on the possibility of a legislative solution being devised, this could reduce their incentives to transition to new reference rates in time, ahead of 2021. This would continue to remain the case until the point at which Libor had ceased or firm proposals regarding a legislative solution were otherwise made public.

98. At its October meeting the Committee therefore agreed that it remained against the public interest to publish its discussion of legislative solutions in the Record of its meeting, and decided to continue to defer publication, under Section 9U of the Bank of England Act 1998. It would review again in 2021 Q4, or earlier if proposals for a legislative solution for the legacy stock of contracts were made public.

June/July 2019 deferred text

83. The Committee noted the fact that, even with sufficient levels of effort by market participants to accelerate the transition, there might be a stock of legacy contracts remaining after 2021.

84. In order to manage and mitigate any risks associated with this, it was important for authorities to consider a broad range of solutions, including the possibility of addressing the financial stability risks that these outstanding contracts could pose when Libor was discontinued by way of legislative options.

85. It was not clear to the Committee at this point if such a comprehensive legislative solution could be devised across all the necessary jurisdictions globally.

86. If market participants put undue reliance on the possibility of such a legislative solution being devised, this could reduce their incentives to transition to new reference rates in time, ahead of 2021, and could precipitate the financial stability risks that authorities were seeking to mitigate. The Committee therefore agreed that it was against the public interest to publish its discussion of any

possibility of addressing the financial stability risks associated with outstanding legacy contracts remaining after 2021 by way of a legislative option in the Record of its meeting, and decided to defer publication, under Section 9U of the Bank of England Act 1998. It was not possible to agree now the date at which this text would be published, but the Committee would keep this under review.