Financial Policy Summary and Record of the Financial Policy Committee Meeting on 8 December 2020

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This is the record of the Financial Policy Committee meeting held on 8 December 2020.

It is also available on the Internet: https://www.bankofengland.co.uk/financial-policy-summary-and-record/2020/December -2020

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 18 March 2020 and the record of that meeting will be published on 29 March.

Financial Policy Summary

The Financial Policy Committee (FPC) aims 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 UK financial system is supporting the economy during the pandemic

UK households and businesses have needed support from the financial system to weather the economic disruption associated with Covid-19 (Covid). The financial system has so far provided that support, reflecting the resilience that has been built up since the global financial crisis, and the extraordinary policy responses of the UK authorities.

Businesses have raised substantial external financing since the start of the Covid pandemic from banks and financial markets, to help finance their cash-flow deficits. Households' debt-servicing burdens have fallen during that period, supported by payment deferrals from lenders. The extension of the Coronavirus Job Retention Scheme has supported household incomes.

Although there have been encouraging developments on vaccines, the FPC, consistent with its remit, is focused on the range of downside risks that remain. These include risks that could arise from the evolution of the pandemic and consequent measures to protect public health, as well as from the transition to new trading arrangements between the European Union and the United Kingdom.

The outlook for financial stability

Banking system resilience

The FPC judges that the UK banking system remains resilient to a wide range of possible economic outcomes. It has the capacity to continue to support businesses and households even if economic outcomes are considerably worse than currently expected. This reflects the build-up of substantial buffers of capital since the global financial crisis.

Over the course of 2020, major UK banks' and building societies' ('banks') aggregate Common Equity Tier 1 capital ratio has increased to 15.8% at end-September, which is over three times higher than at the start of the global financial crisis. Over this period, they have provisioned for £20 billion of credit losses, although the effect on the capital ratio is reduced by the transitional relief of IFRS 9.

Some headwinds to banks' capital ratios are therefore anticipated over coming quarters as unemployment rises, business insolvencies rise from current low levels, and risk weights on banks' exposures increase. Nevertheless, the major UK banks can absorb credit losses in the order of £200 billion, much more than would be implied if the economy followed a path consistent with the MPC's central forecast.

The FPC judges that the UK and global macroeconomic scenarios required to generate losses on this scale would need to be very severe with, for example, UK unemployment rising to more than 15%.

The FPC expects banks to use all elements of capital buffers as necessary, to continue to support the economy. Alongside the Prudential Regulation Authority (PRA), it is taking action to support the use of capital buffers.

The FPC is updating its guidance on the path for the UK countercyclical capital buffer (CCyB) rate. It now expects this rate to remain at 0% until at least 2021 Q4. Due to the usual 12-month implementation lag, any subsequent increase is not expected to take effect until 2022 Q4 at the earliest. The eventual pace of return to a standard 2% UK CCyB rate will depend on banks' ability to rebuild capital while continuing to support households and businesses.

The FPC welcomes the PRA's intention to return towards the standard framework for bank distributions. This reflects some reduction in the uncertainty related to Covid, and the ability of banks to withstand significant losses. The FPC recognises the importance of a stable and predictable capital framework which provides certainty to banks and facilitates the use of capital buffers where necessary.

Cutting support to the economy to avoid the use of capital buffers would be costly for the wider economy and consequently for banks themselves.

Stability in the provision of financial services at the end of the transition period with the EU

Financial sector preparations for the end of the transition period with the EU are now in their final stages. Most risks to UK financial stability that could arise from disruption to the provision of cross-border financial services at the end of the transition period have been mitigated. The mitigation of these risks reflects extensive preparations made by authorities and the private sector over a number of years.

However, financial stability is not the same as market stability or the avoidance of any disruption to users of financial services. Some market volatility and disruption to financial services, particularly to EU-based clients, could arise.

Market volatility could be reinforced in the event that some derivative users are not fully ready to trade with EU counterparties or on EU or EU-recognised trading venues. Financial institutions should continue taking measures to minimise disruption.

Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC remains committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

Developments in the UK mortgage market

Mortgage credit conditions remain tighter than at the start of the year, particularly for high loan to value mortgages. This reflects reduced risk appetite from lenders due to the economic outlook, as well as operational constraints in meeting the current high demand for mortgages.

The FPC's mortgage market Recommendations limit the proportion of new mortgages with high loan to income ratios, guarding against an increase in the number of highly indebted households.

The measures are structural and intended to remain in place through cycles in the mortgage market. The FPC's last review of its Recommendations in 2019 found no evidence that they were having a material impact on mortgage availability overall since they were introduced in 2014. That has remained the case since.

The FPC periodically reviews its measures, including their calibration. It judges that changes over time in the risks faced by households mean the measures warrant a further review. That is under way and the FPC will report its conclusions in 2021.

Ensuring the financial system is ready to serve the future economy

The supply of productive finance for companies

In order to help limit the degree of economic scarring caused by Covid, work to increase the supply of longer-term, equity-like financing is increasingly important. The Bank, with HM Treasury and the Financial Conduct Authority, has launched an industry working group to facilitate investment in productive finance.

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, along with many authorities internationally, is considering the potential effects on financial stability if stablecoins were to be adopted widely. A discussion paper on these issues will be published in due course by the Bank. That paper will also address issues that may arise in connection to the concept of a Central Bank Digital Currency — an electronic form of central bank money that could be used by households and businesses to make payments.

The FPC is also considering how the regulatory system should adapt to assure confidence in the value of stablecoins at all times, while supporting innovation, in an efficient way. Their users must be as sure of their ability to redeem their money in cash, at face value, at all times, as they are with private money — commercial bank deposits — that is in widespread circulation in the UK today.

Record of the Financial Policy Committee meeting held on 8 December 2020

1. The Financial Policy Committee (FPC) met on 8 December 2020 to agree its view on the outlook for financial stability and, on the basis of that, its intended policy action. It discussed the risks faced by the United Kingdom (UK) financial system and assessed the resilience of the system to those risks.

2. Its aim was to ensure the UK financial system was resilient to, and prepared for, 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.

Macro-economic and financial market back-drop

3. As it had done in September, the Committee noted the challenging backdrop to its discussion. As had been set out in the November 2020 Monetary Policy Report (*MPR*), a resurgence in Covid cases and the reintroduction of measures to contain the spread of the virus had weighed on near-term UK and global activity.

4. The outlook for the UK remained unusually uncertain. It would depend on the evolution of the pandemic and measures taken to protect public health around the world, as well as the nature of, and transition to, the new trading arrangements between the European Union (EU) and the UK. It would also depend on the responses of households, businesses and financial markets to these developments.

5. The FPC noted that there had been encouraging developments on Covid vaccines but that a number of downside risks to UK financial stability remained including: further Covid-related disruption; more structural shifts in the economy during and following the Covid shock that could result in higher unemployment and lower supply capacity due to some businesses closing or reducing their level of activity; and disruption arising at the end of the transition period with the EU. Consistent with its remit, the FPC was focussed on the range of downside risks that remained.

Financial markets

6. The FPC judged that core financial markets had continued to function well. Bid-offer spreads of government and corporate bonds remained similar to those seen at the start of the year before the market disruption associated with Covid, and repo rates were close to their reference rates. Global equity indices were up 10-13% since the previous *Financial Stability Report (FSR)*, and up 10-16% since the last FPC meeting in September.

7. The FPC judged that UK corporate bond spreads appeared compressed, given the uncertain outlook. Once adjusted for the deterioration in credit quality and increase in duration, sterling corporate bond spreads were within the 1st percentile of their historical distribution.

8. The FPC considered that some markets might therefore be vulnerable to a potential repricing if corporates' credit fundamentals were to deteriorate and risk appetite fell. Such moves could be magnified by the underlying vulnerabilities that were exposed during the March 'dash for cash'.

9. The FPC had previously highlighted near-term risks stemming from the sale of BBB bonds which had been downgraded, so called 'fallen angels'. Following a sharp increase in downgrades during March and April, the volume of 'fallen angels' had stabilised. The face value of 'BBB-' rated bonds across major currencies, with a 50% chance of being downgraded in the next 90 days, had more than halved since March.

10. But the risk remained higher than usual when looking at the expected performance of bonds at a slightly longer – one to two year – horizon, as the share of sterling 'BBB-' rated bonds on 'negative outlook' had increased almost fivefold since March. The FPC considered that this risk could materialise earlier if the outlook deteriorated further, for example due to further restrictions on economic activity or due to disruption of services around the end of the transition period with the EU in December.

11. The FPC noted that while active investment funds and insurers had sold only up to a third of the downgraded sterling fallen angel bonds they held during 2020 H1, there remained a risk that the capacity of the sterling high-yield market to absorb further sales could be tested were downgrade rates to increase materially. But delays in re-balancing portfolios (as had been seen in March) and pre-emptive selling by investors ahead of downgrades taking place, could help to cushion some of the pricing impact if this risk were to materialise.

12. The FPC welcomed the Financial Stability Board's (FSB) holistic review of the March market turmoil, which had been published in November. The FPC agreed to publish a full update of its market based finance agenda in 2021 H1. This would follow publication of the FPC's preliminary findings in the August 2020 *FSR*, and would also represent the FPC's response to HM Treasury's recommendation to publish a more detailed assessment of the oversight and mitigation of systemic risks from the non-bank financial sector by end-2020. Completing this review in 2021 H1 would enable the FPC to incorporate findings of the FSB's holistic review into its assessment and help the Bank to feed its findings into the international consideration of efforts to address any problems identified.

Global outlook

13. The FPC also considered risks to the global outlook that might affect UK financial stability. Disruption to global activity could increase the risks associated with UK banks' exposures in the affected countries and generate additional macroeconomic spillovers to the UK economy.

14. The outlook for global activity remained highly uncertain, and heavily dependent on the path of the Covid virus. Recent developments on vaccines could reduce uncertainty and support the path for activity if it led to an earlier reduction in health risks. The recovery, which had begun over May and June, had been stronger than expected in 2020 Q3. UK-weighted world GDP was estimated to have grown by just over 8% on the quarter, leaving it around 4% below its 2019 Q4 level. But Covid cases had accelerated in the autumn, particularly in advanced economies, and governments had re-imposed restrictions, most notably in Europe. Global growth looked likely, therefore, to slow in the fourth quarter.

15. The outlook for overseas credit conditions would depend on the health of the banking system as well as the macroeconomic environment. While capital ratios for banks in the United States (US) and euro area had increased in Q3, in part reflecting fewer new loan loss provisions, they were likely to face some headwinds in the near term. In its November Financial Stability Review, the European Central Bank (ECB) noted signs of optimistic provisioning by euro area banks, with provisioning remaining below levels observed in previous crises and those in other jurisdictions, notably the US.

16. Surveys had suggested that credit availability at banks had tightened in both the euro area and the US. Overall however, the volume of finance raised by companies in the euro area and the US had remained robust so far. Corporate bond issuance had been strong in the US, which in some cases had been used to repay bank borrowing. In the euro area, bank lending had continued to be an important source of finance for companies so far this year, with government guarantees playing a significant role in supporting bank lending in some countries.

17. In addition to the risks associated with the pandemic, there were also geopolitical risks that could spill over to the UK. Such risks remained elevated. Trade tensions between the US and China had continued, and the US had responded to the national security law that came into force in Hong Kong in June by publishing a list of individuals who would face sanctions.

The UK financial system supporting the economy during the Covid pandemic

18. The Committee reviewed how the UK financial system had supported households and corporates to help weather the economic disruption associated with Covid to date and how it was meeting the demand for finance.

19. The FPC judged, in aggregate, that the UK financial system had so far been able to provide the support needed, reflecting the resilience that had been built up since the global financial crisis (GFC), and the policy responses of the UK authorities.

Corporates

20. The FPC noted that Bank staff estimates of the total cash-flow deficit of businesses during the Covid disruption were little changed since August, at up to around £180bn. The effect of the second lockdown had been accompanied by the extension of fiscal support measures, such as the Coronavirus Job Retention Scheme (CJRS), which had supported household incomes and corporate cash flows.

21. The FPC observed that businesses had raised substantial external financing since the start of the Covid pandemic to help finance their cash-flow deficits. Since March, UK businesses had raised over £77 billion of net additional financing from banks — primarily through government-backed loan guarantee schemes — and through access to financial markets.

22. UK companies had raised, in aggregate, around as much external finance as the cash-flow deficit that would remain if they used up all their cash balances from before the shock. Intelligence from the Bank's Agents had suggested that there were no immediate credit availability concerns amongst large corporates but that lenders had reduced loan limits or tightened their underwriting standards for certain sectors.

23. Net bank lending to small and medium-sized enterprises (SMEs) up to October was over 40 times higher than the 2016-2019 average. The vast majority of this had been through government backed loan schemes. Nevertheless, smaller companies had raised less external finance than their estimated cash-flow deficits and would overall be more reliant on depletion of their cash buffers to finance cash-flow deficits.

24. The FPC noted that government support had reduced unemployment and insolvencies but that, even in the central case outlined by the *MPR*, unemployment was likely to rise and insolvencies would be likely to increase from their current very low levels and that these developments would be most likely in sectors which had been particularly affected either by the economic disruption related to Covid or by structural change in the economy which had been accelerated by Covid.

25. If downside risks to the outlook were to materialise, some companies, particularly those in sectors most affected by Covid, could require additional external finance to bridge further disruption. Given the recent extension of the eligibility period of government loan schemes, some of these companies would be able to borrow more if they needed to raise additional liquidity.

26. Prior to the Covid disruption, around 40% of SMEs had not borrowed before. On 10th November it had been announced that participating lenders in the scheme were able to offer smaller businesses across the UK a 'top-up' to their existing Bounce Back Loan if they originally borrowed less than the maximum amount available to them, which was the lower of 25% of turnover or £50k. The analysis presented to the FPC estimated that this could accommodate £5bn of additional lending in aggregate.

Households

27. Government support, which had limited any increase in unemployment and helped to maintain household incomes and payment deferrals had together avoided a sharp increase in households' debt servicing burdens as a share of income. The latest NMG survey had suggested the share of households with high debt-servicing ratios (DSRs) was around 1.3% in September. This had fallen from 2.2% in May (excluding the effect of payment deferrals) reflecting a recovery in earnings, driven by those returning to work from furlough and the self-employed. UK Finance data for October had suggested a total of 4.4 million payment deferrals had been agreed over the course of the Covid shock, and around 320,000 deferrals were still in place. Arrears and government support had also contained the level of defaults.

The resilience of the UK banking system and the UK Countercyclical Capital Buffer rate

28. The FPC reviewed developments since October and considered the outlook for bank resilience including the setting of the UK countercyclical capital buffer (CCyB) rate and the 2021 stress test.

29. Over the course of 2020, major UK banks' and building societies' ('banks') aggregate Common Equity Tier 1 (CET1) ratio had increased to 15.8% at end-September, which was over three times higher than at the start of the GFC and around 9 percentage points above minimum requirements. However, some headwinds to banks' capital positions were anticipated over coming quarters, principally from risk-weighted asset inflation and the reduction in International Financial Reporting Standard 9 (IFRS 9) transitional relief on the existing stock of provisions as unemployment and insolvencies increased and some assets moved into default.

30. The subdued market valuations of banks' equities reflected subdued expected earnings and uncertainties around the economic outlook. Investors were demanding higher returns to compensate for uncertainty so banks' cost of equity had risen. While bank equity prices had increased sharply in mid-November following positive news on potential vaccines, the average banks' price to book ratio, which measures the market value of shareholders' equity relative to the accounting value of that equity, remained at around 0.6.

31. The average banks' price to book ratio had been persistently below one for a number of years. It had fallen even more at the beginning of the year as the pandemic hit and profit expectations decreased materially. The recent weakness of bank valuations also reflected a material increase in the returns demanded by investors – the cost of equity. The biggest influence on the cost of equity had been uncertainty about the economic outlook. Consistent with this, banks' share prices increased sharply in mid-November, following the news regarding potential vaccines.

32. Developments over the course of 2020 supported the view that banks' low price to book ratios were consistent with market concerns over expected future profitability rather than concerns about the solvency of banks. For example, while Corporate Default Spreads, which capture investors' views on default risk, rose sharply at the onset of the Covid outbreak, they had now returned to pre-Covid levels. That was consistent with the high aggregate CET1 capital ratio for the major UK banks.

33. The FPC continued to judge that the UK banking system remained resilient to a wide range of possible economic outcomes and had the capacity to continue to support businesses and households even if economic outcomes are considerably worse than currently expected. The Monetary Policy Committee's (MPC) central forecast in November 2020 for the UK and global economies remained materially less severe than the scenarios generated by the August 'reverse stress test' exercise.

34. Banks would need to incur at least £120 billion of credit losses to deplete aggregate end-2019 capital buffers by 5.2 percentage points, the extent of the capital drawdown in the 2019 stress test in which banks demonstrated they could continue to lend. The FPC judged that to generate such losses would require a very severe global and UK economic scenario, much more severe than consistent with the MPC's central forecast, with, for example, UK unemployment peaking at around 15%.

35. In practice, banks were able to withstand scenarios even more severe than this. Capital buffers were higher than those set for regulatory purposes, so £120bn of credit losses would, in aggregate, deplete only around 60% of the buffers of capital which sit above banks' minimum requirements. In aggregate, banks would be left with the ability to absorb a further £80 billion of losses arising from further shocks before breaching regulatory minima.

36. Cutting support to the economy to avoid the use of capital buffers would be costly for the wider economy and consequently for banks themselves. In that regard, the FPC agreed that the UK banking system is a source of strength for the economy, helping to absorb rather than amplify the economic shock caused by Covid. It remained the FPC's judgement that it was in banks' collective interest to continue to support viable, productive businesses, rather than seek to defend capital ratios by cutting lending which could have an even greater negative effect on banks' capital ratios.

UK Countercyclical Capital Buffer Rate

37. The ability to draw on capital buffers allows banks to continue to support the economy while weathering losses. With that in mind, at its Policy Meeting on 9 March, the FPC had reduced the UK Countercyclical Capital Buffer (CCyB) rate to 0%. The FPC had also provided guidance that it did not expect to increase the rate until at least March 2021.

38. At its Policy meeting on 8 December, the FPC noted that this indicative period was due to end at the time of its next quarterly decision on the UK CCyB rate. It continued to judge that cutting lending to businesses and households to avoid the use of capital buffers would be costly for the wider economy and consequently for the banks themselves. It therefore remained important that there be clarity about the period of time the FPC expected the UK CCyB rate to remain at 0%. In light of these considerations, the FPC decided to update its guidance.

39. The FPC agreed that it was appropriate to maintain the UK CCyB rate at 0% in 2020 Q4 and that it expected to maintain a UK CCyB rate of 0% until at least December 2021. Due to the usual 12-month implementation lag, any subsequent increase would not be expected to take effect until 2022 Q4 at the earliest. The FPC considered that this action supported further the ability of banks to supply the credit needed, and reinforced the expectation that all elements of banks' substantial capital buffers could be drawn down as necessary to support the economy.

40. The eventual pace of return to a standard UK CCyB rate in the region of 2% would depend on banks' ability to rebuild capital while continuing to support the UK economy, households and businesses. The FPC judged that its updated guidance should help to give banks clarity that they could use capital buffers as necessary.

Systemic Risk Buffer Rates

41. The FPC welcomed the Prudential Regulatory Authority's (PRA) decision to freeze the systemic risk buffer (SRB) rates, which applied to ring-fenced banks and large building societies, for an additional year. The updated policy means that SRB rates would next be assessed in 2022, based on end-2021 balance sheets. Any updated SRB rates would come into force in January 2024. The FPC noted that this provided firms with an extended period of certainty around their future capital requirements, and so helped buffer usability and banks' ability to support the real economy.

42. The FPC was mindful that total assets, the metric used to calibrate SRB rates, had grown significantly during 2020 in part due to the material expansion of central bank reserves through the MPC's Asset Purchase Facility. A rise in total assets above pre-defined thresholds, which correspond to SRB rates, would have led to a higher buffer rate being applied to firms' total book of

assets thus further constraining banks' capital. Without the PRA's action, some banks may have faced incentives to constrain lending to the real economy, in order to avoid sharp increases in capital requirements. The PRA decision would support buffer usability. The FPC intended to revisit the appropriate framework in due course, alongside a broader review of lessons learnt from the crisis about how the framework of capital requirements and buffers had performed under stress in terms of supporting continued lending to the real economy.

Dividends policy

43. The FPC welcomed the PRA's intention to transition back towards the standard framework for bank distributions.

44. In March 2020, at the onset of the pandemic in the UK, the PRA had welcomed the decisions of the boards of the large UK banks to suspend dividends and buybacks on ordinary shares until the end of 2020. At the PRA's request, they had also cancelled payments of any outstanding 2019 dividends, even though these banks held capital well above regulatory levels, and above the levels at which prudential regulations would require restrictions on distribution.

45. The FPC supported the exceptional actions taken in March, which were appropriate given the unprecedented levels of economic uncertainty at that time. The FPC now welcomed – from the perspective of its own objectives to support the supply of credit to the economy during this stress – the PRA's intention to transition back towards the standard framework for bank distributions.

46. The FPC judged that banks were resilient to, and could continue to lend in, a wide range of economic scenarios. Recommencing some distributions would be consistent with this judgement. The PRA's framework of temporary guardrails would help to protect the resilience of the banking system in a wide range of possible outcomes. It is important to emphasise that when a dividend is postponed it is not necessarily lost if the contingency that triggered the deferral is not realised.

47. The FPC recognised the importance of a stable and predictable capital framework which provided certainty to banks and facilitates the use of capital buffers where necessary. The FPC was of the view that the high returns currently demanded by bank investors (banks' high cost of equity) primarily reflected the uncertain economic outlook. The transition back towards the standard framework for bank distributions through 2021 should, by reducing any additional uncertainty about the outlook for dividends, help to reduce their cost of equity.

2021 stress test

48. The FPC and PRA would conduct a stress test, involving the major UK banks and building societies, in 2021. The FPC discussed the role of stress testing during a stress that was unfolding.

49. The Committee noted that the Bank's approach to stress testing aimed to use periods in which the economy was growing to build up banks' buffers of capital, ready to be drawn on to support the economy in a stress. This was achieved by stressing banks against broad, severe and hypothetical stress scenarios.

50. However, the Committee also noted that, once the economy entered a stress, it would be counterproductive to subject banks to a stress test that layered a generic stress on top of a current stress event. The implication would be that capital buffers could not be depleted while in stress to support lending, or may even result in banks being required to build up capital buffers further. This would run counter to the Committee's goal of maintaining credit supply conditions during stress.

51. The Committee agreed that once the economy entered a stress, as it had, the focus of the stress tests should change, with stress tests used to assess if the buffers of capital banks had built up prior to the stress were big enough to deal with the stress that was unfolding. The FPC had undertaken such an exercise in May 2020 through its desktop stress test, which found that banks had the capital buffers to withstand even greater losses than those resulting from the MPC's plausible illustrative scenario as had been set out in the May *MPR*.

52. Given the uncertain economic outlook in an unfolding stress, it was also important to assess that banks' buffers of capital were sufficient to deal with the stress, even if it turned out to be more severe than central expectations. The August 2020 'reverse stress test' had then considered how severe a macroeconomic stress banks could withstand while continuing to lend. The results of the 'reverse stress test' exercise showed that the macroeconomic paths required to deplete banks' regulatory capital buffers would need to be very severe. The FPC judged the scenarios included in the 'reverse stress test' to reflect reasonable worst cases for the current economic outlook, implying banks therefore had sufficient capital buffers to allow them to lend in and remain resilient to a wide range of possible scenarios in the UK and globally.

53. The aim of the 2021 stress test exercise would be to update and refine the FPC's assessment. It would test banks' end-2020 balance sheets to a scenario similar to that generated in the 'reverse stress test' and would therefore be a cross-check on the FPC's judgement of how resilient banks were to a reasonable worst-case stress in the current environment and will support the PRA's objective of promoting the safety and soundness of PRA-regulated firms. There would be no mechanical link from the results to regulatory response, but the outcome of the test would be used to update the FPC's judgements about the most appropriate way in which the banking system could continue to support the economy through the stress.

Stability in the provision of financial services after the end of the transition period with the EU

54. Negotiations on a free trade agreement (FTA) covering the broad arrangements for trading goods and services between the UK and EU were continuing. The ability to provide cross-border financial services between the UK and the EU would largely be determined by regulatory decisions made autonomously by the UK and EU, distinct from the broader FTA negotiations.

55. Consistent with its remit, since 2016 the FPC had identified and monitored risks of disruption that could arise if no further arrangements were put in place for the provision of cross border financial services when the UK's trading arrangements with the EU change. The FPC updated its assessment of actions to avoid disruption to the provision of financial services at the end of the transition period with the EU, as set out in its checklist and table of other risks of disruption to financial services.

56. The FPC continued to judge that most risks to UK financial stability that could arise from disruption to the provision of cross-border financial services at the end of the transition period had been mitigated. The mitigation of these risks reflected extensive preparations made by authorities and the private sector over a number of years.

57. Financial sector preparations for the end of the transition period were now in their final stages. All material subsidiaries of UK firms had been authorised in the EU and were fully operational, and over two-thirds of clients of major UK-based banks had now completed the necessary documentation to enter into derivatives trades with EU entities. Many clients were also actively trading from the new EU entities. UK firms also continued to novate existing trades where necessary to ensure clients could manage risks related to 'lifecycle' events.

58. Financial stability was not the same as market stability or the avoidance of any disruption to users of financial services. Financial markets could be expected to react to the outcome of the negotiations on arrangements for trading goods and services between the UK and EU.

59. Some market volatility and disruption to financial services, particularly to EU-based clients and customers, could arise. Some participants may not be fully ready to trade with EU counterparties or on EU or EU-recognised venues when EU participants' ability to trade with UK entities or on UK venues becomes restricted, which could reinforce market volatility.

60. For example, on the basis of the approach that had been announced by the EU and in the absence of further authority action, EU firms in scope of the EU Derivatives Trading Obligation (DTO) would no longer be able to trade some classes of derivatives, such as certain interest rate swaps and credit default swaps, on UK trading venues, and UK firms in scope of the UK DTO would no longer be able to trade these derivatives on EU venues.

61. Based on transaction reporting data as of October 2020, it was estimated that around US$200 billion of interest rate swap trading that took place daily in the UK was currently captured by the DTO. Absent a further change in policy, the portion of this covered by the EU DTO after the end of the transition period would be required to be traded on EU trading venues, or trading venues elsewhere recognised by the EU. To put this into context, the 2019 BIS triennial survey of derivative activity, which included activity taking place on and off trading venues, suggested around US$1.2 trillion of interest rate swaps were traded in the UK daily.

62. UK-based branches of EU firms would be subject to the UK DTO as well as the EU regime. As a result, these branches would only be able to trade those derivatives captured by the obligation on trading venues in other jurisdictions deemed equivalent by both the UK and the EU.

63. Firms were preparing to comply with the relevant obligations after the end of the transition period, including by executing some trades currently taking place on UK trading venues in the EU or other jurisdictions if necessary. This would result in fragmentation, and could give rise to disruption if some counterparties were not ready to trade immediately after the end of the transition period.

64. Other examples of disruption would affect households and businesses. Some UK banks had notified EU-based customers that they would not continue to provide certain retail banking services in some jurisdictions.

65. Processing payments, including Single Euro Payments Area (SEPA) payments, between the UK and EU would require additional information to be included after the end of the transition period, such as payers' addresses. While banks would generally hold payers' information for credit transfers originating from their customers, they were less likely to hold it for direct debits, where payments are initiated by creditors. Banks had been putting the necessary information in place. Larger UK firms were generally well advanced in providing the information, but there was less clarity about the progress of EU firms. To the extent that gaps remained at the end of the transition period, they were likely to result in some disruption to both EU and UK customers and businesses seeking to make and receive such payments.

66. The Committee judged that financial institutions should continue to take measures to minimise disruption, including by engaging with clients and customers.

67. Irrespective of the particular form of the UK's future relationship with the EU, and consistent with its statutory responsibilities, the FPC would remain committed to the implementation of robust prudential standards in the UK. This would require maintaining a level of resilience that was at least as great as that currently planned, which itself exceeded that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks.

Developments in the UK mortgage market

68. The Committee discussed developments in the mortgage market and its Recommendations relating to the owner-occupier segment of that market.

69. The FPC had, since June 2014, recommended a limit of 15% on the proportion of new mortgages extended at or above 4.5 times a borrower's income (known as the loan to income (LTI) flow limit). Building on Financial Conduct Authority (FCA) rules, the FPC had also recommended that lenders assess whether borrowers could meet their mortgage payments if their mortgage interest rate switched to the contractual reversion rate and increased by 3 percentage points (known as the affordability test).

70. The Recommendations had been introduced to guard against risks to financial stability from an increase in the number of highly indebted households. Historically, a rapid build-up of mortgage debt had been an important source of risk to financial and economic stability. In the UK, mortgages were households' largest financial liability and lenders' largest loan exposure. A loosening in lenders' underwriting standards could therefore lead to a significant increase in the number of more highly indebted households. In an economic downturn, these households were more likely to face difficulties and could cut back sharply on spending to make their mortgage payments, posing risks to the wider economy and ultimately to lenders.

71. The FPC's most recent review of the Recommendations, conducted in 2019, had concluded that the benefits from the tools substantially outweighed any macroeconomic costs. The Committee had also judged that the measures had prevented a potential loosening of underwriting standards that would otherwise have led to an increase in the number of more highly indebted households.

72. The Committee considered recent developments in the mortgage market. Mortgage approvals for house purchases in October – around 97,500 – were higher than in any month since the GFC, partly reflecting catch-up from low levels earlier in the year. However, credit conditions had tightened, particularly at high loan-to-value ratios; lenders had withdrawn some products from the market; and spreads of quoted rates on new mortgages over the risk-free rate had widened. This was likely to reflect reduced risk appetite from lenders due to the economic outlook, as well as operational constraints interacting with the current high demand for mortgages partly driven by the stamp duty holiday. At the same time, there had been an increase in the proportion of mortgages extended at high LTI multiples and, in aggregate, there continued to be headroom for additional lending before reaching the FPC's LTI flow limit. The FPC noted that the last review of its Recommendations in 2019 had found no evidence that they were having a material impact on mortgage availability overall since they were introduced in 2014; and that this had remained the case since.

73. The Committee noted that although the Recommendations were intended to remain in place through cycles in the mortgage market, the FPC was committed to periodically reviewing the measures, including their calibration, in response to structural changes in the economic environment.

74. The Committee discussed the arguments for amending the calibration of the measures.

75. When introduced, in 2014, the affordability test was roughly in line with lenders' prevailing standards. At the time, market expectations were for interest rates to rise by 225 bps over 5 years; a stress rate of 3 percentage points was therefore judged to provide insurance against rate increases, as well as potential shocks to incomes and mortgage interest rates that would increase borrowers' DSRs in a downturn.

76. The affordability test effectively sets an implicit LTI cap for each borrower that depends on the term of the mortgage, the borrower's spending commitments and the reversion rate on the mortgage. For example, a borrower seeking a 25-year mortgage with a reversion rate of 4% (and hence a 'stress rate' in the test of 7%) would be able to borrow 4.7 times their income if they could afford to spend 40% of income on mortgage payments. The LTI flow limit Recommendation limits the number of mortgages extended at LTI ratios of 4.5 or higher to 15% of a lender's new mortgage lending. The LTI flow limit could therefore serve as a simple backstop to the affordability test, while ensuring that access to high LTI mortgages remained for those borrowers who could afford it even if they were to experience an adverse shock.

77. Since the introduction of the Recommendations, there had been a substantial fall in long-term bond yields and in the expected increase in short-term interest rates. At the same time, the trend equilibrium real interest rate had fallen to very low levels, as a result of longer-term structural factors. This suggested that households' capacity to service debt was more likely to be supported by a prolonged period of lower interest rates than had appeared to be the case in 2014.

78. Meanwhile the spread between reversion rates – usually the standard variable rate (SVR) – and a weighted average of quoted rates had nearly doubled since 2014, leading to an increase in the spread between quoted rates and stressed rates implied by the affordability test.

79. In isolation, these developments suggested that the current affordability test might provide greater insurance now against a plausible rise in rates than it had when the measure had been introduced. However, risks to household incomes and unemployment might have changed over time, and, while the calibration of the affordability test was expressed as a rate rise, it also sought to ensure that households in aggregate were better able to withstand fluctuations in income and employment through an economic cycle. The FPC therefore agreed that these developments

warranted a review of the Recommendations, including their calibration. The FPC would report its conclusions in 2021.

Ensuring the financial system is ready to serve the future economy

Systemic stablecoins and financial stability

80. In the Record of its December 2019 meeting, the FPC had set out its expectations for how stablecoins should be treated in the regulatory framework. It judged that:

a. Payment chains that used stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Firms in stablecoin-based systemic payment chains that were critical to their functioning should be regulated accordingly.

b. Where stablecoins were used in systemic payment chains as money-like instruments, they 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.

81. With respect to the first of the FPC's expectations, the FPC noted that payments chains could, and in some case had, become large, complex and segmented across a large number of firms. The recent case of the insolvency of payments processing firm Wirecard demonstrated the interconnectedness of payment chains and showed the potential for disruption if any part of the chain faced difficulties.

82. In that context, the FPC noted that the Bank, as the regulator of systemic payment systems, with the objective of maintaining financial stability, would need to have the necessary powers over systemic stablecoin payment firms. This would allow the Bank to apply payment system regulation irrespective of the technology used to make payments. The FPC also supported necessary powers for the FCA and Payment Systems Regulator (PSR) based on their objectives. To that end, the FPC supported HM Treasury's Payments Landscape Review, a review of payments networks in the UK, and its planned consultation on the UK regulatory approach to cryptoassets and stablecoins. The FPC considered that its previous analysis and expectations on payments and stablecoins, including on the need for regulation to reflect the financial stability risk, rather than the legal form of payments activity, and for end-to-end resilience across crucial payments chains, should usefully inform both HMT's response to its consultation on the regulatory approach to cryptoassets and stablecoins and its Payments Landscape Review. The FPC had a statutory duty to monitor and identify risks to the UK financial system. Consistent with its statutory responsibilities it would, where necessary, make Recommendations to HMT regarding gaps in the regulatory perimeter which might represent risks to

financial stability. Doing so would deliver on the FPC's primary objective to protect UK financial stability, while providing certainty for both regulators and innovators, and ensuring that innovation could take place in the UK with confidence.

83. The FPC noted that stablecoins could provide benefits to users. But, with respect to the second of the FPC's expectations, the FPC reiterated that stablecoins would only be adopted widely and become successful as a safe and trusted means of payment, if they met appropriate standards and confidence in their value was assured at all times. In particular, their users must be as sure of their ability to redeem their money in cash at face value, at all times, as they were with private money, in the form of commercial bank deposits, that is in widespread circulation in the UK. Other forms of private money, such as e-money, would also need to meet the FPC's expectation, were their issuers to become systemic.

84. The FPC considered how the regulatory system should adapt to ensure this, while supporting innovation, in an efficient way. The Committee discussed the extent to which equivalent standards to those that apply to commercial bank money should be met using the same mechanisms of prudential regulation, retail depositor protection, and access to central bank facilities. Systemic stablecoins that backed the money they issue with assets like those held by banks (such as loans) would require a similar regime and protections. However, for systemic stablecoins backed by a much narrower range of less risky assets, and in a legally ring-fenced manner, it might be possible to design an appropriate regime that would deliver the standards of protection currently required of commercial bank money without application of the full regime applied to commercial banks. For example, one possibility could be a regime in which systemic stablecoins were backed with high quality, highly liquid assets, such as government bonds, held in a legal structure only for the benefit of coinholders.

85. Another possibility would be to back systemic stablecoins with central bank money in one form or another. Such an approach exists in the UK for private issuers of physical cash in Scotland and Northern Ireland. If a stablecoin were backed only by central bank money, it would be economically similar to a Central Bank Digital Currency (CBDC). This is an electronic version of central bank money that could be used by households and businesses to make payments.

86. The FPC also considered the potential effects on the financial system more broadly if stablecoins were to be adopted widely.   The Committee noted that, if systemic stablecoins were to meet the necessary requirements and standards, they could emerge as a substitute for commercial bank deposits as a means of payment. And if a substantial amount of the private sector's money balances were held in the form of stablecoin rather than in commercial bank deposits, the financial system may need to adapt in order to maintain the supply of credit to the economy.

87. The FPC also discussed the risk that users could transfer large volumes of money between the banking system and systemic stablecoins in a volatile manner, for example in a stress. Further work is needed to explore the potential of this risk, its impact and severity and the relative effectiveness and viability of the available mitigants.

88. The FPC noted that a forthcoming Bank discussion paper would discuss some of these issues in more detail. In particular, it would cover the assets that could back stablecoins if they were not subjected to the existing prudential banking regulation, the potential financial stability implications of large or volatile stablecoin balances, and the effectiveness and viability of potential mitigants. The paper would also address issues that may arise in connection to the introduction of a Central Bank Digital Currency (CBDC), building on the Bank's March 2020 CBDC Discussion Paper.

The supply of productive finance for companies

89. The Committee reviewed its work plan on productive finance. Addressing issues related to productive finance was part of the FPC's secondary objective, but could also improve financial stability outcomes, in line with the FPC's primary objective. The Covid shock had brought the supply of productive finance into sharper focus, given the need for longer-term financing options to support the corporate sector.

90. Addressing possible distortions to the supply and intermediation of longer-term productive finance, as was set out in the August *FSR*, was one of many factors that could help pave the way for a higher level of investment.

91. The Committee noted that longer-term forms of financing would be important to limit the degree of economic scarring caused by Covid. In addition, investments into green technology and infrastructure would be an important part of the recovery from Covid, and the transition to an economy with net zero greenhouse gas emissions.

92. The Committee noted that there had been important developments in this work since August. These included a new industry working group[1] to be convened by the FCA, the Bank and HM Treasury to facilitate investment in productive finance. The FCA planned to consult early in 2021 on setting up a framework for a long-term asset fund.

Climate Biennial Exploratory Scenario

[1] https://www.bankofengland.co.uk/news/2020/november/hmt-boe-and-fca-convene-working-group-to-facilitate-investment-in-productive-finance

93. In May 2020, as part of the Bank's response to Covid, the FPC and PRA agreed to postpone the launch of the Climate Biennial Exploratory Scenario. The launch of the exercise had now been rescheduled, with a start date of June 2021 and results due to be published early in 2022. The FPC supported the decision that the largest UK banks and insurers would take part.[2] Given its role in protecting and enhancing the resilience of the financial sector to climate risk, the FPC welcomed the launch of this exercise.

Libor transition

94. The Committee received an update on the transition away from Libor. In November, the administrator of Libor, ICE Benchmark Administration, had issued a consultation on its intention for euro, sterling, Swiss franc, yen and some US dollar Libor panels to cease at end-2021, and for the remainder of US dollar panels to cease at end-June 2023. In parallel, US authorities issued supervisory guidance on limiting new use of US dollar Libor after end-2021, and the FCA noted it would coordinate with US and other authorities around limiting new use of US dollar Libor.

95. The Committee noted that an objective of planning for the end of Libor was to minimise disorderly outcomes and risks to financial stability, by removing reliance on Libor in new and existing business. To this end, the Committee noted recent progress by the International Swaps and Derivatives Association in publishing a protocol for legacy Libor-linked derivatives contracts. This would provide a readily available avenue to adopt fallbacks into most non-centrally cleared derivative contracts and replace Libor with risk-free rate alternatives, if the fallbacks had been triggered. Over 1500 entities worldwide had signed up to date, including the Bank in respect of its own market activity. The Committee also welcomed that the FCA had set out a potential approach to the use of proposed new powers under the Financial Services Bill to ensure an orderly wind-down of Libor. The Committee reiterated that to avoid disruption in financial markets, market participants must continue to accelerate their plans to eliminate reliance on Libor benchmarks before end-2021.

[2] For more information on the CBES see https://www.bankofengland.co.uk/news/2020/november/the-boe-is-restarting-the-climate-biennial-exploratory-scenario

The following members of the Committee were present:

Andrew Bailey, Governor

Colette Bowe

Alex Brazier

Ben Broadbent

Jon Cunliffe

Jon Hall

Anil Kashyap

Donald Kohn

Dave Ramsden

Nikhil Rathi

Elisabeth Stheeman

Sam Woods

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

Under the Bank of England Act 1998, a court observer is permitted to be present at the FPC meeting. At the meeting on 8th December, no court observer was present.

Table 3.A Checklist of actions to avoid disruption to end-users of financial services at the end of the transition period

This checklist reflects the risk of disruption to end-users including households and companies if no further arrangements are put in place for cross-border trade in financial services at the end of the transition period on 31 December 2020. The risk assessment takes account of progress made in mitigating any risks. It assesses risks of disruption to end-users of financial services in the UK and, because the impact could spill back, also to end-users in the EU.[a]

Risks of disruption are categorised as low (green), medium (amber) or high (red). Arrows reflect developments since the FPC's previously published checklist alongside the October 2020 Financial Policy Summary. Blue text is news since then.

The checklist is not a comprehensive assessment of risks to economic activity arising from the end of the transition period. It covers only the risks to activity that could stem from disruption to provision of cross-border financial services.

	Risk to UK	Risk to EU	
Ensure a UK legal and regulatory framework is in place			The passage of the EU (Withdrawal) Act 2018 and secondary legislation has ensured that an effective framework for the regulation of financial services will be in place, and that EU financial services companies can continue to serve UK customers. Following the completion of secondary legislation, remaining EU Exit instruments will be finalised by the regulators to ensure new EU legislation and provisions coming into force before the end of 2020 can operate effectively in the UK following the end of the transition period. The State Aid (Revocations and Amendments) statutory instrument has been made. This ensures the Bank of England can continue to provide certain types of emergency lending, should it be needed in future.
Insurance contracts			The UK Government has legislated to ensure that the 16 million insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced after the end of the transition period. UK insurance companies have restructured their business in order to service the vast majority of their £60 billion of EU liabilities. The European Insurance and Occupational Pensions Authority (EIOPA) has published recommendations to national authorities supporting recognition or facilitation of UK insurance companies' continued servicing of existing EU contracts at the end of the transition period.
Asset management			Co-operation agreements between the Financial Conduct Authority (FCA), the European Securities and Markets Authority (ESMA) and EU National Competent Authorities will apply from the end of the transition period. This enables EU asset managers to delegate the management of their assets to the UK. The UK Government has legislated for EU asset management firms to continue operating and marketing in the UK. And to operate in the EU, the largest UK asset managers have completed their establishment of EU authorised management companies
Banking services			The UK Government has legislated to ensure that UK households and businesses can continue to be serviced by EU-based banks after the end of the transition period. EU authorities have not taken similar action. As a result, major UK-based banks have been transferring their EU clients to subsidiaries in the EU so that they can continue providing services to them. All material subsidiaries are authorised, fully operational and trading. Firms are in the final stages of transferring clients to their EU entities. Over two thirds of clients of major UK-based banks have now completed the necessary documentation to enter into derivatives trades with EU entities. Many clients are also actively trading from the new EU entities. However, some operational risks remain, including if many of the remaining clients seek to switch trading to the EU entities in a short period of time. This could amplify market volatility. The EU has stated that in the short to medium term it will not assess the equivalence of the UK's regulatory and supervisory regime to its own for the purposes of MiFIR Article 47, which covers investment services.[b] This would have allowed for material cross-border access for investment services, further reducing the residual risk of disruption.

Over-the-counter (OTC) derivative contract continuity			Certain ‘lifecycle’ events may not be able to be performed on UK/EEA uncleared derivative contracts after the end of the transition period and on cleared derivatives contracts between UK clearing members and EEA clients.[c] In the absence of mitigating actions this could compromise the ability of derivatives users to manage risks. There are £16 trillion of uncleared derivative contracts between the EU and UK, of which £13 trillion is currently due to mature after 31 December 2020. The UK Government has legislated to ensure that EU banks can continue to perform lifecycle events on contracts they have with UK businesses. The European Commission has not reciprocated for UK-based banks’ contracts with EU businesses. Some EU member states have permanent or temporary national regimes which could enable lifecycle events on certain contracts to be performed. UK firms are prioritising the novation of at-risk contracts. The European Supervisory Agencies have proposed amendments to EU legislation that, if adopted, would enable certain trades novated from UK to EU entities before 2022 to continue to benefit from relief from clearing and margin requirements, creating further time for those trades to be novated without triggering additional requirements. The EU has stated that in the short to medium term it will not assess the equivalence of the UK’s regulatory and supervisory regime to its own for the purposes of MiFIR Article 47, which covers investment services. This would have mitigated risks of disruption to lifecycle events on the majority of contracts.
Central clearing of OTC derivative contracts			The UK Government has legislated to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses after the end of the transition period. There are currently £60 trillion of derivative contracts between UK CCPs and EU clearing members, £54 trillion of which is due to expire after December. The EU has adopted a decision to provide equivalence to the future UK legal and supervisory framework for central counterparties (CCPs) until end-June 2022, and UK CCPs have been recognised by ESMA. This will allow UK CCPs to continue servicing EU clearing members after the end of the transition period. The Bank and ESMA have put in place a new co-operation agreement to support this activity.
Personal data			The UK Government has legislated to allow the free flow of personal data from the UK to the EU after the transition period. The European Commission is undertaking an assessment of the adequacy of the UK’s data protection standards. If the EU does not deem the UK’s data regime adequate, both UK and EU households and businesses may be affected due to the two-way data transfers required to access certain financial services. Companies can add standard contractual clauses (SCCs) and binding corporate rules (BCRs) into contracts in order to comply with the EU’s cross-border personal data transfer rules in the absence of adequacy. UK firms are generally well advanced in implementing these mechanisms. Following recommendations from the European Data Protection Board and a statement from the Information Commissioner’s Office, firms are undertaking an assessment of whether SCCs and BCRs need to be updated to comply with EU requirements, and whether further appropriate measures need to be taken where personal data transfers from the EEA into the UK are necessary to ensure the continuity of services.

(a) In most cases, the impact on EU users of changes to the provision of services will apply to the wider European Economic Area (EEA).
(b) Markets in Financial Instruments Regulation.
(c) These lifecycle events include for example amendments to the contract, compressions, rolling of contracts or exercise of some options.

Table 3.B Other risks of disruption to financial services

These risks could cause disruption to economic activity at the end of the transition period if they are not mitigated and there are no further financial services arrangements in place at the end of the transition period. The FPC judges their disruptive effect to be somewhat less than that of those issues in its checklist.

Access to euro payment systems	The Single Euro Payments Area (SEPA) schemes are currently used by UK payment service providers (PSPs, including banks) to make lower-value euro payments such as bank transfers between businesses, mortgage and salary payments on behalf of their customers. The European Payments Council has confirmed that the UK will retain SEPA access after the end of the transition period subject to its continued compliance with the established participation criteria. Once the UK becomes a third country, processing payments, including SEPA payments, between the UK and EU will require additional information to be included for the payment instructions to meet regulatory requirements, such as payers' addresses. While banks will generally hold payers' information for credit transfers originating from their customers, they are less likely to hold it for direct debits, where payments are initiated by creditors. Banks have been putting the necessary information in place where possible. Larger UK firms are generally well advanced in providing the information, but there is less clarity about the progress of EU firms. To the extent that gaps remain at the end of the transition period, they are likely to result in some disruption to both EU and UK customers and businesses seeking to make and receive such payments until the necessary information is in place. UK firms will also need to maintain access to TARGET2 to use it to make high-value euro payments. UK banks intend to access TARGET2 through their EU branches or subsidiaries or correspondent relationships with other banks.
Ability of EEA firms to trade on UK trading venues	EU-listed or traded securities are traded heavily at UK trading venues which offer deep liquidity pools for a range of securities traded by UK and EU firms. The EU's Trading Obligations require EU investment firms to trade EU-listed or traded shares and some classes of OTC derivatives on EU trading venues or trading venues in jurisdictions deemed equivalent by the EU. The UK will also have analogous trading obligations when the transition period ends. ESMA has excluded from the EU Share Trading Obligation EU shares which are traded on UK trading venues in sterling. The FCA has acted to allow UK firms to continue trading all shares on EU trading venues and systemic internalisers providing they have a UK recognised status after the transition period. This largely mitigates the risk of disruption, though a portion of trades currently taking place on UK venues will be required to take place on EU venues in future which could result in market fragmentation. In the absence of further authority action in relation to derivatives trading, EU firms in scope of the EU Derivative Trading Obligation (DTO) would no longer be able to trade some classes of derivatives, such as certain interest rate swaps and credit default swaps, on UK trading venues, and UK firms in scope of the UK DTO would no longer be able to trade these derivatives on EU trading venues. Based on transaction reporting data as of October 2020, it is estimated that around US$200 billion of interest rate swap trading that takes place daily in the UK is currently captured by the DTO. Absent a further change in policy, the portion of this covered by the EU DTO after the end of the transition period would be required to be traded on EU trading venues, or trading venues elsewhere recognised by the EU. To put this into context, the 2019 BIS triennial survey of derivative activity, which would include activity taking place on and off trading venues, suggested around US$1.2 trillion of interest rate swaps were traded in the UK daily.[a] UK-based branches of EU firms would be subject to the UK DTO as well as the EU regime. As a result, these branches would only be able to trade those derivatives captured by the obligation on trading venues in other jurisdictions deemed equivalent by both the UK and the EU. ESMA has stated that it does not consider that a change of its approach to the EU DTO is warranted. The FCA has not adjusted its approach either. They continue to monitor market developments. Firms are preparing to comply with the relevant obligations after the end of the transition period, including by executing some trades currently taking place on UK trading venues in the EU or other jurisdictions if necessary. This would result in fragmentation and could

	give rise to disruption if some counterparties are not ready to trade immediately after the end of the transition period. The EU and UK could deem each other's regulatory frameworks as equivalent for the purposes of relevant regulations, thereby comprehensively mitigating risks of fragmentation and disruption.
Servicing banking and insurance customers	Major UK banks' and insurers' actions to prepare their EU subsidiaries will enable their provision of new services to many EU customers after the end of the transition period. The ability of UK banks and insurers to continue providing some services to customers — particularly retail customers — resident in the EU will be determined by national regimes. The scope and availability of national regimes is decided by individual EU member states. Depending on the national regime in place, the ability of UK banks and insurers to provide certain services to EU-based customers may be impaired. Some UK banks have been notifying EU-based customers that they will not continue to provide certain retail banking services in some jurisdictions. As referred to above, EIOPA has published recommendations to national authorities supporting recognition or facilitation of UK insurance companies' continued servicing of EU contracts at the end of the transition period.
Financial market infrastructure	After the end of the transition period, UK financial market infrastructures (FMIs) will no longer be protected under EU law against payments or transfers being revoked, or collateral being clawed back, in the event that an EEA member enters insolvency. EEA countries accounting for most of the EEA members of UK FMIs have implemented national legislation intended to provide settlement finality protection in the event of insolvency of local firms using UK-based financial market infrastructure. Some member states and UK FMIs are expected to complete the final steps required to maintain settlement finality protections by the end of the transition period. The UK Government has legislated transitional provisions to allow central securities depositories (CSDs) established outside the UK to continue to provide CSD services in the UK after the transition period. The EU has adopted a decision to provide equivalence to the UK legal and supervisory framework for CSDs, until end-June 2021. Depending on whether ESMA also recognises the UK CSD, the UK CSD could continue to provide CSD services to issuers in respect of securities issued under EU law after the end of the transition period.
Prudential requirements	The UK Government has legislated to allow regulators to delay the impact on UK-based firms of prudential requirements on EU exposures that would apply after the transition period. UK regulators intend to delay the application of some requirements for 15 months, to end-March 2022. EU regulations will subject EU banks' and insurance companies' UK exposures to stricter capital and liquidity requirements. Some restrictions might also be imposed for EU Money Market Funds and institutional investors on holdings of UK-managed or located exposures. If the EU were to deem the UK's regulatory and supervisory regimes as equivalent, this would avoid the application of some of these requirements.
Credit Rating Agencies (CRAs)	EU rules will prevent some banks and insurance companies in the EU from calculating prudential requirements using ratings issued by UK CRAs after the end of the transition period unless the ratings are endorsed by an EU CRA. In advance of the UK's withdrawal from the EU, the FCA and ESMA reached a co-operation agreement and undertook assessments to facilitate endorsements. These will apply from the end of the transition period. The largest UK CRAs have EU entities. The decision to endorse ratings ultimately lies with the CRA.

(a) The BIS triennial survey includes data from April 2019. Quoted figure from that survey is daily trading in interest rate swaps other than overnight indexed swaps.

ANNEX: FPC POLICY DECISIONS

Outstanding FPC Recommendations and Directions

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

Other FPC policy decisions which remain in place

The table below 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.

Topic	Calibration
Countercyclical capital buffer rate	The FPC agreed to maintain the UK CCyB rate at 0% in December 2020, unchanged from March. This rate is reviewed on a quarterly basis. The UK has also reciprocated a number of foreign CCyB decisions — for more details see the Bank of England website.[1] 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,[2] and the FCA has issued general guidance.[3]
Mortgage affordability	At its meeting in June 2017, the FPC replaced its June 2014 mortgage affordability 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 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.

[1] https://www.bankofengland.co.uk/financial-stability
[2] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps914.pdf
[3] https://www.fca.org.uk/publications/finalised-guidance/fg17-2-fpc-recommendation-loan-income-ratios-mortgage-lending