Bank of England

Financial Policy Summary and Record of the Financial Policy Committee meeting on 11 June 2024

27 June 2024

This is the record of the Financial Policy Committee meeting held on 11 June 2024.

It is also available on the Financial Policy Summary and Record page of our website:
https://www.bankofengland.co.uk/financial-policy-summary-and-record/2024/june-2024

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 His 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 19 September 2024 and the record of that meeting will be published on 2 October 2024.

Financial Policy Summary, 2024 Q2

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 is able to absorb rather than amplify shocks and serve UK households and businesses.

The overall risk environment

The overall risk environment remains broadly unchanged from Q1. Markets continue to price mostly for a benign central case outlook, and some risk premia have tightened even further, despite the global risk environment facing several challenges. Some of these challenges have become more concerning and proximate.

In aggregate, UK household and corporate borrowers have been resilient, although many remain under pressure. UK banks are in a strong position to support households and businesses, even if economic and financial conditions were substantially worse than expected.

The adjustment to the higher interest rate environment is continuing globally, including as businesses and households refinance their debt. Risks are crystalising in the US commercial real estate market and important vulnerabilities in market-based finance are yet to be addressed globally.

Developments in financial markets

The Monetary Policy Committee's (MPC's) central projection for UK GDP growth, unemployment and inflation has improved slightly further since Q1, and global growth is projected to rise in the medium term, although several risks to that outlook remain. Economic data news has pushed out market expectations on the timing of reductions in policy rates in the US and UK, although rate cuts have now begun in some jurisdictions. Markets responded to the announcement that French parliamentary elections would be held on 30 June and 7 July. For example, the spread between French and German 10-year government bond yields rose to its highest level since 2017.

Risk premia on US equities have been compressed for some time but have also fallen across a range of other markets this year and are now very low by historic standards, including for more leveraged borrowers. While there is some evidence of investors demanding higher risk premia on small pockets of the riskiest bonds, the widespread overall compression of risk premia, in an uncertain risk environment, suggests that investors are continuing to put less weight on risks to the macroeconomic outlook. Valuations and risk premia are therefore vulnerable to a shift in risk appetite that could be triggered by factors

including a weakening of growth prospects, more persistent inflation, or a further deterioration in geopolitical conditions.

Although financial market asset valuations have so far been robust to large increases in interest rates and recent geopolitical events, the adjustment to the higher interest rate environment is not yet complete and market prices remain vulnerable to a sharp correction. This could adversely affect the cost and availability of finance to the real economy via two main channels. First, a sharp market correction would make it more costly and difficult for corporates to refinance maturing debt, including by reducing the value of collateral. This is particularly relevant given the large proportion of leveraged lending and high-yield market-based corporate debt that is due to mature by the end of 2025. Second, it could interact with vulnerabilities in market-based finance, which may amplify the correction. For example, it may cause large losses for leveraged market participants, which could further reduce risk appetite, or it may lead to a spike in liquidity demand and a deterioration in the functioning of core markets.

Global vulnerabilities

Global vulnerabilities remain material. US commercial real estate (CRE) borrowers have significant short-term refinancing needs and a number of overseas banks with large exposures to CRE, in the US and other jurisdictions, experienced significant falls in their equity prices earlier in the year. Stresses in global CRE markets could affect UK financial stability through several channels, including a reduction in overseas finance for the UK CRE sector.

Policy uncertainty associated with upcoming elections globally has increased. This could make the global economic outlook less certain and lead to financial market volatility. It could also increase existing sovereign debt pressures, geopolitical risks, and risks associated with global fragmentation, all of which are relevant to UK financial stability.

UK household and corporate debt vulnerabilities

In the context of strong nominal household income growth and continued low unemployment, the aggregate UK household debt to income ratio has continued to fall. That said, many UK households, including renters, remain under pressure from higher living costs and higher interest rates. The share of households spending a high proportion of their available income servicing their mortgages is expected to increase slightly over the next two years, but it is likely to remain well below pre-global financial crisis (GFC) levels. Mortgage arrears remain low by historical standards and are expected to remain well below their previous peaks.

Aggregate measures of UK corporate debt vulnerability have fallen further and corporates are likely to remain broadly resilient to the current economic outlook,

including high interest rates. But there remain pockets of vulnerability among highly leveraged corporates. Despite strong issuance so far in 2024, a significant portion of market-based corporate debt is due to mature in the coming years, so risks associated with the need to refinance at higher interest rates remain. The most highly leveraged and lowest rated corporates, including those backed by private equity, are likely to be more exposed to this risk.

Private equity

The private equity (PE) sector grew rapidly during the period of low interest rates and plays a significant role in financing UK businesses. The long-term nature of capital investments into PE allows and incentivises fund managers to act less cyclically, which can reduce the volatility of financing flows in macroeconomic downturns. **However, the widespread use of leverage within PE firms and their portfolio companies makes them particularly exposed to tighter financing conditions.**

Although the sector has been resilient so far, it is facing challenges in the higher rate environment. These manifest in refinancing risk as debt matures, and an increased drag on performance from higher financing costs. Vulnerabilities from high leverage, opacity around valuations, and strong interconnections with riskier credit markets mean the sector has the potential to generate losses for banks and institutional investors, and cause market spillovers to highly correlated and interconnected markets such as leveraged loans and private credit – all of which could reduce investor confidence, further tightening financing conditions for businesses. Disruptions in international PE markets could also spill over to the UK, particularly from US markets given their size and importance, and because the majority of PE funds backing UK corporates are based in the US.

Improved transparency over valuation practices and overall levels of leverage would help to reduce the vulnerabilities in the sector. Risk management practices in some parts of the sector also need to improve, including among lenders to the sector such as banks. The FPC will consider the outcome of regulatory work by the Financial Conduct Authority and Prudential Regulation Authority to address some of these issues. Because of the interconnections between PE markets in different jurisdictions, international co-ordination will be important.

UK banking sector resilience

The UK banking system has the capacity to support households and businesses, even if economic and financial conditions were to be substantially worse than expected. The UK banking system is well capitalised and UK banks maintain strong liquidity positions. The return on equity of major UK banks in aggregate has risen to around their cost of equity, and asset quality remains strong.

The FPC judges that changes in credit conditions overall reflect changes to the macroeconomic outlook. Mortgage approvals have risen, in part in response to a fall in quoted mortgage rates since last summer. Overall credit conditions for corporates have remained broadly unchanged since the start of the year.

A number of system-wide factors are likely to affect bank funding and liquidity in the coming years, including as central banks normalise their balance sheets as the extraordinary measures put in place following the GFC and the Covid pandemic are unwound. The Bank of England is unwinding its holdings in its Asset Purchase Facility, as determined by the MPC, and the Term Funding Scheme with additional incentives for SMEs is coming to an end. **It is important that banks factor these system-wide trends into their liquidity management and forward planning over the coming years.** Banks have a number of ways in which they can manage their funding and liquidity, including use of the Bank of England's facilities, such as the Short-Term Repo and Indexed Long-Term Repo facilities.

The UK countercyclical capital buffer rate decision

The FPC is maintaining the UK countercyclical capital buffer (CcyB) rate at its neutral setting of 2%. The FPC will continue to monitor developments closely and stands ready to vary the UK CcyB rate, in either direction, in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment. The Bank's 2024 desk-based stress test will further inform the FPC's assessment of the resilience of the UK banking system to downside risks.

The resilience of market-based finance

There remain important vulnerabilities in market-based finance that the FPC has previously identified. In particular, leveraged positions, which have been a driver of a number of recent stress events, appear to be increasing among hedge funds. The work of international and domestic regulators to develop appropriate policy responses to address the risks of excessive leverage is therefore important. **The FPC supports the Financial Stability Board's international work programme on leverage in non-bank financial institutions, and encourages authorities globally to take action to reduce the vulnerabilities through internationally co-ordinated policy reforms.**

Given the significant progress made on liability-driven investment (LDI) fund resilience across domestic and international authorities over the past 18 months, the FPC has closed its November 2022 and March 2023 Recommendations on LDI resilience. Its March 2023 Recommendation that The Pensions Regulator should have the remit to take into account financial stability considerations in its work on a continuing basis remains in place.

The FPC welcomes the launch of the second round of the Bank's system-wide exploratory scenario (SWES) exercise. In the first round, the hypothetical SWES scenario led most participating non-bank financial institutions to report significant liquidity needs from margin calls. Many participants started the scenario with greater resilience than they had at the onset of recent market shocks. For example, the current level of resilience of money market funds is well above existing minimum requirements. This is also in part the result of recent regulatory actions, such as the LDI resilience standard recommended by the FPC. Participants therefore expected those liquidity needs could be mostly met by pledging assets. However, participants' responses also implied that terms in the sterling repo market would tighten, and that there would be selling pressure in the sterling corporate bond market.

In the second round, the Bank is exploring the assumptions underpinning participants' actions and how different assumptions might alter actions taken and lead to different outcomes in markets. **The analysis has already provided important insights which demonstrate the value of system-wide exercises. The overall results of the exercise will be published in 2024 Q4.**

Record of the Financial Policy Committee meeting on 11 June 2024

1. The Committee met on 11 June 2024 to agree its view on the outlook for UK financial stability and other matters that would be included in the June 2024 Financial Stability Report (FSR). The FPC discussed the risks faced by the UK financial system, assessed the resilience of the system to those risks and, on that basis, agreed its intended policy action. The FSR and this document together record the judgements of the FPC and the Committee's associated deliberations.

2. The 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 is able to absorb rather than amplify shocks and serve UK households and businesses.

Developments in financial markets

3. The FPC noted that economic data news had pushed out market expectations on the timing of reductions in policy rates in the US and UK, although rate cuts had now begun in some jurisdictions. Markets had responded to the announcement that French parliamentary elections would be held on 30 June and 7 July. For example, the spread between French and German 10-year government bond yields had risen to its highest level since 2017.

4. Valuations across a range of asset classes remained stretched. Measures of risk premia had compressed further since the FPC's March 2024 policy meeting and were materially more compressed than at the time of the December 2023 FSR. Equity markets had continued to rally.

5. Credit spreads remained historically tight, especially in the US and in markets for high-yield (HY) bonds, suggesting investor perception of credit risk remained low. In part this reflected the fact that market participants were now expecting stronger economic growth than they had earlier in the year, particularly in the US. The FPC also noted that investors were differentiating between credits of different quality within HY markets. Spreads of lower-rated HY bonds were more elevated relative to their historical distributions, whereas the general compression in spreads was driven by higher-rated HY bonds.

6. Nevertheless, the FPC judged that it remained concerning that risk premia across a range of markets had compressed further and several measures were close to their historical lows, despite the fact that global and geopolitical risks were still heightened and the adjustment to the higher interest rate environment was not yet complete. The widespread overall compression of risk premia in an uncertain risk environment suggested that investors globally

were continuing to put less weight on downside risks to growth, or potential credit risks associated with higher rates as inflation was brought back to target sustainably.

7. The FPC judged that valuations and risk premia therefore remained particularly vulnerable to a shift in risk appetite. An adjustment could be triggered by factors including a weakening of growth prospects, more persistent inflation, or a further deterioration in geopolitical conditions.

8. Should these downside risks materialise, a change in sentiment could lead to a sharp correction in market prices, adversely affecting financing to the real economy via two main channels. First, it would make it more costly and difficult for corporates to refinance maturing debt, including by reducing the value of collateral. This was particularly relevant given the large proportion of leveraged lending and high-yield market-based corporate debt that was due to mature by the end of 2025. Second, it could interact with vulnerabilities in market-based finance, which may amplify any correction. For example, it may cause large losses for leveraged market participants, which could further reduce risk appetite, or it may lead to a spike in liquidity demand and a deterioration in the functioning of core markets.

9. Further detail on the analysis underpinning these judgements would be set out in the 'Developments in financial markets' chapter of the June 2024 FSR.

Global vulnerabilities

10. The FPC judged that global financial stability vulnerabilities remained material. Risks had been crystallising in the US commercial real estate (CRE) and Chinese property markets, while geopolitical developments and policy uncertainty associated with upcoming elections continued to contribute to uncertainty around the global outlook.

11. CRE prices had continued to fall in many advanced economies, with more pronounced moves in specific segments of that market. The equity prices of more exposed banks in the US and other countries had stabilised but had not recovered from the falls seen earlier in the year, and CRE debt in the US faced significant short-term refinancing needs. Stresses in exposed overseas banks and non-banks could affect UK financial stability through several channels, including macroeconomic and financial market spillovers, contagion to funding conditions for UK banks, and a reduction in overseas finance for the UK CRE sector, leading to further downward pressure on UK valuations.

12. As in Q1, financial stability spillovers from the adjustment in the mainland China property market had been limited, but significant downside risks remained. The Chinese authorities had provided further support to address property developers' inventory overhang and to support demand, but the adjustment in the property sector, alongside broader structural trends, was likely to weigh on growth in China for some time. More widespread crystallisation of risks in China could lead to spillovers to the UK and other countries. The 2022/23 ACS

results had indicated that major UK banks would be resilient to a severe downturn and very significant declines in property prices in mainland China and Hong Kong.

13. Growing interest rate differentials between the US and a number of other countries had generated moves in exchange rates and, in some places, increased financial pressures. Non-China emerging market economies had generally continued to be resilient but the shift towards ‘high for longer’ interest rates in the US had increased financial pressure on them and the risk remained of a sudden repricing of non-China emerging market assets if global financial conditions were to tighten sharply. In Japan, growing interest rate differentials had led the yen to depreciate to historic lows against the US dollar, prompting intervention in the foreign exchange market by the Japanese authorities. Nonetheless, domestic yields had risen in Japan, and further rises could generate unrealised losses due to interest rate risk on debt security holdings across some Japanese banks.

14. The FPC judged that policy uncertainty associated with upcoming elections globally had increased. This could make the global economic outlook less certain and lead to financial market volatility. Government policy uncertainty could increase existing sovereign debt pressures, geopolitical risks, and risks associated with global fragmentation. A deterioration in market perceptions of the path for public debt globally could lead to market volatility and interact with vulnerabilities in market-based finance, potentially tightening credit conditions for households and businesses.

15. Geopolitical developments, including frictions in international cooperation and continuing conflicts in the Middle East and Russia's war in Ukraine, increased the uncertainty around the economic outlook and could also lead to financial market volatility. In a fragile environment, geopolitical risks could interact with each other and increase the likelihood of other vulnerabilities crystallising, amplifying the impact on global and UK financial stability.

16. Further detail on the analysis underpinning these judgements would be set out in the ‘Global vulnerabilities’ chapter of the June 2024 FSR.

UK debt vulnerabilities

UK household resilience

17. The FPC noted that the Monetary Policy Committee’s (MPC) central projection for UK GDP growth, unemployment and inflation had improved slightly further since Q1. Household income growth remained robust over the past year, and the aggregate household saving ratio had increased to 10.5% in 2023 Q4.

18. Reflecting these developments, the aggregate UK household debt to income ratio was now at its lowest level since 2002, reducing the risk that households would materially amplify a shock. However, many UK households, including renters, remained under pressure from

higher living costs and higher interest rates. Higher mortgage rates continued to pass through to mortgagors as their fixed-rate mortgages expired and they refinanced. Over the next four years, the vast majority of fixed-rate mortgagors were expected to refinance, most at rates higher than they currently paid. A smaller group, predominantly those on variable-rate mortgages, could see a reduction in their monthly payments.

19. The FPC continued to expect the aggregate mortgage debt service ratio to increase slightly to above 8% over the next two years, similar to the peak projected in 2024 Q1 and the December 2023 FSR, but well below pre-global financial crisis (GFC) levels.

20. The share of owner-occupier mortgages in arrears of 2.5% or more of the outstanding balance was broadly unchanged at 1.1% in 2024 Q1 and remained low in historical terms, as the robust nominal wage growth over recent quarters combined with low unemployment had helped to contain the rise. More than half of the mortgages in arrears were originated prior to 2008. Owner-occupied mortgage arrears were expected to increase further but were likely to remain well below their early 1990s and post-GFC peaks of 4.0% and 2.4%, respectively. The resilience of the UK household sector reflected, at least in part, the FPC's mortgage market interventions and the Financial Conduct Authority's (FCA) responsible lending requirements, which limit the build-up of household indebtedness to unsustainable levels.

21. The FPC noted that consumer credit remained low as a share of aggregate household debt, and direct financial stability risks were limited. Arrears on consumer credit lending increased a little since the December 2023 FSR but remained low by historical standards. Although consumer credit lending made up a relatively small share of bank exposures, compared to mortgages, impairment rates were expected to be higher on consumer credit lending, and would be more sensitive to rises in unemployment, compared to other exposures. As such, a greater impact of any increase in arrears would be felt by those lenders whose exposures were concentrated in consumer credit or to higher risk borrowers.

22. The FPC noted that consumer credit remained an important determinant of household debt financing burdens, reflecting that consumer credit loans tend to have significantly shorter terms and higher interest rates than mortgages. Compared to mortgages, consumer credit debt was also more likely to be held by low-income households. Overall, the FPC judged that low-income household budgets remained under significant pressure, but that those pressures were not likely to pose direct financial stability risks.

UK corporate resilience

23. The FPC noted that the aggregate UK corporate debt to earnings ratio had continued to trend down to around 280% (from its pandemic peak of 343% in 2020 Q4). This had reduced the risk that corporates would materially amplify a shock, but vulnerable corporates remained under pressure, and the full impact of higher rates had yet to be fully felt.

24. The FPC judged that, in aggregate, the UK corporate sector was expected to remain broadly resilient to the current economic outlook, including high interest rates. But pockets of risk remained, particularly in highly-leveraged businesses, including private equity backed businesses (see *Recent developments in private equity markets* section), and in SMEs.

25. Despite strong issuance so far in 2024, a significant portion of market-based corporate debt is due to mature in the coming years, so risks associated with the need to refinance at higher interest rates remained. The most highly-leveraged and lowest-rated corporates, including those backed by private equity, were likely to be more exposed to this risk.

26. The FPC noted that pressures on SMEs were relatively greater than for larger corporates as the majority of SME debt was floating rate. The diversity of funding sources for SMEs was also more limited, a fact corroborated by the publication of the results of the productive finance survey commissioned by the Bank and the Department for Business and Trade. The FPC welcomed the publication of the results of this survey in the 2024 Q1 Quarterly Bulletin, and the insights it provided on challenges facing SMEs.

27. The FPC noted that corporate insolvencies rose in 2024 Q1, as expected. They remained above their pre-Covid levels and were mostly concentrated among smaller firms.

28. The FPC recognised that there were a number of headwinds continuing to face some parts of the UK CRE market, including cyclical pressures and the climate transition, that were weighing on prices and making refinancing challenging. Office and retail also faced structural challenges including the post-pandemic shift to more remote working and the ongoing shift from physical to online shopping. UK CRE prices had fallen over 20% from their 2022 peaks, although the pace of decline had slowed in recent quarters. The FPC noted that the results of the 2022/23 ACS showed that the major UK banks would be resilient to a much larger fall in CRE prices than already observed.

29. Further detail on the analysis underpinning these judgements would be set out in the 'UK household and corporate vulnerabilities' chapter of the June 2024 FSR.

Recent developments in private equity markets

30. The FPC noted that, having grown rapidly in the period of low interest rates, private equity (PE) played a significant role in financing UK businesses. The long-term nature of capital investments into PE allowed and incentivised fund managers to act less cyclically, which could reduce the volatility of financing flows in macroeconomic downturns. However, the widespread use of leverage within PE firms and their portfolio companies made them particularly exposed to tighter financing conditions.

31. Although the sector had been resilient so far, the sector was facing challenges in the higher rate environment, in part because PE has multiple layers of leverage (some of which

was provided by banks). That introduced vulnerabilities relating to refinance risk as debt matures, and an increased drag on performance from higher financing costs. And the lack of transparency to those outside the PE market made it challenging to assess the full aggregate extent of leverage across the PE ecosystem.

32. PE markets had strong interconnections with riskier credit markets, where underwriting practices weakened through the lower rate period. Private credit and leveraged lending were typically conducted on a floating-rate basis and, unless they had entered into an interest rate hedge, corporates funded that way were facing a higher cost of debt. This would lead to lower performance of these indebted companies compared to the lower rate period.

33. Further vulnerabilities identified by the Committee included variable and opaque valuation and risk management practices.

34. The FPC judged that a shock to highly indebted corporates or investor confidence could be amplified by the underlying vulnerabilities within the PE ecosystem through a number of channels.

35. For example, some PE-backed firms may find it difficult to access external financing in the absence of further PE support. PE-backed companies represented a sizeable portion of highly indebted companies, with high leverage making them more vulnerable to refinancing risk. Some of these businesses may need to reduce their indebtedness, potentially through new equity, in response to the higher interest rate environment.

36. Furthermore, the global banking system had significant exposures to private equity activity. The potential impact of losses on these exposures could in part reflect weaknesses in banks' risk management practices. For non-banks, the potential for risks to arise through UK pension funds and insurers was limited given their small exposures, but global institutional investors, particularly those in the US, were more exposed in aggregate.

37. Finally, shocks to indebted PE-backed corporates could spillover to interconnected and highly correlated markets such as leveraged loans, private credit, and high yield bonds. A large portion of borrowers in these markets were PE-backed firms. The lack of transparency could limit the ability of lenders to PE-backed companies to assess the credit risk to which they were exposed, given that they might not be themselves actively involved in PE markets.

38. More broadly, disruptions in international PE markets could also spillover to the UK, particularly from US markets given their size and importance, and because the majority of the PE investor base for UK companies was headquartered abroad, primarily in the US.

39. The FPC reiterated that the extent of transparency around asset valuations, overall levels of leverage, and the complexity and interconnectedness of the sector made assessing the financial stability risks challenging. It was therefore important for both those in the PE sector and their counterparties to manage their risks carefully. Improved transparency over

valuation practices and overall levels of leverage would help to reduce the vulnerabilities in the sector.

40. The FPC welcomed ongoing regulatory work to address some of the key vulnerabilities associated with the PE sector:

- Given the lower transparency of valuation practices in the sector, the FCA was currently reviewing private asset valuation practices, focussing on the personal accountabilities for valuation practices in firms, the governance of valuation committees, the information reported to boards about valuations and the oversight by relevant boards of those practices.
- To improve risk management practices among banks lending to the sector, the PRA had undertaken a thematic review of private-equity-related financing activities. This resulted in a **Dear CRO letter** identifying gaps to be addressed in banks' risk management frameworks relating to their private equity exposures.

41. The FPC would consider the outcome of this regulatory work. It also noted that, because of the interconnections between PE markets in different jurisdictions, international co-ordination would be important.

42. Further detail on the analysis underpinning these judgements would be set out in the 'Vulnerabilities in private equity' chapter of the June 2024 FSR.

UK banking sector resilience

43. The FPC judged that the UK banking system had the capacity to support households and businesses, even if economic and financial conditions were to be substantially worse than expected. In 2024 Q1, major UK banks remained well capitalised, with a CET1 ratio of 14.7%, and they maintained strong liquidity positions with an aggregate 3-month moving average liquidity coverage ratio (LCR) of 150% in April.

44. In aggregate, small and medium-sized UK banks and building societies were also well capitalised and maintained strong liquidity positions. In 2024 Q1, they had an aggregate CET1 ratio of 17.7%, and an LCR of 260% in April.

45. The FPC noted that there was a wide range of business models among small and medium-sized UK banks. Some were specialised in particular activities or served particular sectors. This variety of business models meant individual banks would be presented with different challenges or opportunities as the environment evolved.

46. Some forms of lending – as well as lenders that were more concentrated in those assets – were more exposed to credit losses as borrowing costs rise or should economic conditions turn out worse than expected. This included consumer credit, buy-to-let lending, and lending to finance commercial real estate investments, highly leveraged corporates and associated private equity activity.

47. Asset quality remained strong. There was a continued increase in arrears across some UK banks' loan portfolios in Q1, but this was broadly as banks had expected. Major UK banks' forward-looking indicators of asset quality had improved.

48. Current levels of default on the leveraged loan portfolios of UK banks and the decline in property prices in mainland China and Hong Kong property markets remained significantly less severe than those to which major UK banks were tested as part of the 2022/23 ACS stress test.

49. The 2022/23 ACS had indicated that the major UK banks were resilient to a severe stress scenario. The Bank's 2024 desk-based stress-test exercise would further inform the FPC's monitoring and assessment of the resilience of the UK banking system to downside risks.

50. The FPC judged that changes in credit conditions overall reflected changes to the macroeconomic outlook. Households had seen some easing in mortgage credit conditions. Mortgage approvals had risen, in part in response to a fall in quoted mortgage rates since last summer. Overall credit conditions for corporates had remained broadly unchanged since the start of the year, including for SMEs.

51. The FPC noted that the return on equity of major UK banks had risen to a level around that of its cost of equity. Net interest margins were a little below their 2023 Q2 peaks but were expected to remain higher than when Bank Rate had been close to the effective lower bound, and just below its long run average.

52. Price to tangible book ratios (PtTB) were an indicator of the market value of banks' expected future profitability. As such, the FPC monitored PtTB ratios as one indicator of investor confidence in the ability of the banking sector to generate earnings that would allow it to support households and businesses, and as an indicator of risk to the viability of different business models. Low PtTB ratios could affect banks' willingness or ability to support the real economy by making it more difficult for them to raise capital. PtTB ratios could also affect decisions made by individual firms regarding their business models, the amount of profit they retained as capital, and longer-term investment decisions.

53. The FPC judged that PtTB ratios reflected a number of underlying drivers, including: factors which affected the equity market as a whole, such as the perception of the macroeconomic outlook and market depth; factors specific to the banking sector, such as the regulatory and policy landscape and outlook, including with respect to the degree of competition; and factors relating to individual banks, such as the central outlook for earnings and investors' confidence in that outlook.

54. UK banks' PtTBs had risen in recent months, reflecting higher return on equity and increasing investor confidence in its sustainability. The aggregate PtTB for the major UK

banks remained below that of the major US banks, and similar to that of major EU banks. The difference between the price to earnings ratio of major UK banks and US banks was similar to the difference between the price to earnings ratio of other sectors of the UK economy and their US counterparts. The range of PtTB ratios across UK banks was broadly consistent with their relative returns on tangible equity.

55. The FPC would continue to monitor developments in UK banks' market valuations, including in comparison to international peers.

56. A number of system-wide factors were likely to affect bank funding and liquidity in the coming years, including as central banks normalised their balance sheets following the GFC and the Covid pandemic. The Bank of England was unwinding its holdings in its Asset Purchase Facility in line with the approach decided by the MPC, and the Term Funding Scheme with additional incentives for SMEs (TFSME) was coming to an end. Banks have a number of ways in which they can manage their funding and liquidity, including use of the Bank of England's facilities which supply central bank reserves in exchange for a wide range of liquid and less liquid collateral. These facilities include Short-Term Repo (the STR) and Indexed Long-Term Repo (the ILTR).

57. The impact of these system-wide trends on individual banks would vary depending on their funding structure and business models. It was important that banks factor these system-wide trends into their liquidity management and planning over the coming years. The FPC would continue to monitor the implications of these trends for financial stability.

58. The FPC discussed the role of central bank reserves in the financial system as central banks normalised their balance sheets. The level of reserves supplied by the Bank to support UK financial stability would have to balance the rise in liquidity needs relative to the pre-GFC period, when the level of reserves was inadequate, against a desire not to over-supply reserves and impede the incentives for robust private sector liquidity management. The FPC noted the importance of the broader design of the Bank's steady state balance sheet framework for financial stability.

59. Further detail on the analysis underpinning these judgements would be set out in the 'UK banking sector resilience' chapter of the July 2024 FSR.

The UK countercyclical capital buffer rate decision

60. The FPC discussed its setting of the UK countercyclical capital buffer (CCyB) rate. The Committee reiterated that its principal aim in setting the CCyB rate was to help ensure that the UK banking system was better able to absorb shocks without an unwarranted restriction in essential services, such as the supply of credit, to the UK real economy. The UK CCyB rate enables the capital requirements of the UK banking system to be adjusted to the changing scale of risk of losses on UK exposures over the course of the financial cycle. The

approach therefore includes an assessment of financial vulnerabilities and banks' capacity to absorb losses on their UK exposures, including their sensitivity to shocks.

61. In considering the appropriate setting of the UK CCyB rate this quarter, the FPC discussed its judgements around underlying vulnerabilities that could amplify economic shocks. There was little news in key indicators since the previous quarter. Indicators of terms and conditions in financial markets remained stretched. In contrast, several indicators relevant to banks' UK exposures, including household debt-to-income, corporate gross debt to earnings and domestic credit growth, remained around or below long-term averages.

62. Aggregate debt levels had ticked down slightly, the aggregate saving ratio had increased, and the share of households with high mortgage DSRs was expected to remain well below pre-GFC levels. But higher rates were still stretching vulnerable households and highly leveraged corporates would have to refinance the majority of their fixed-rate debt over the coming years at higher interest rates.

63. The FPC observed that UK banks' resilience was being supported by increases in banks' return on equity, relatively strong asset quality and strong capital positions. And the results of the 2022/23 ACS had indicated that the major UK banks were resilient to a severe stress scenario. Households had seen some easing in mortgage conditions, but overall credit conditions for corporates had remained broadly unchanged since the start of the year. The FPC judged that changes in credit conditions overall reflected changes to the macroeconomic outlook.

64. In view of these considerations, the FPC decided to maintain the UK CCyB rate at 2%. Maintaining a neutral setting of the UK CCyB rate in the region of 2% would help to ensure that banks continued to have capacity to absorb unexpected future shocks without restricting lending in a counterproductive way.

65. The FPC recognised the continued uncertain environment and reiterated that it would continue to monitor the situation closely and stood ready to vary the UK CCyB rate in either direction - in line with the evolution of economic and financial conditions, underlying vulnerabilities, and the overall risk environment. The Bank's desk-based stress test exercise this year would further inform the FPC's monitoring and assessment of the resilience of the UK banking system to downside risks.

66. Consistent with the FPC's CCyB Policy Statement, if vulnerabilities that could amplify future economic shocks increased to an elevated level, so as to pose greater risks to banks' resilience, the FPC would be prepared to raise the UK CCyB rate above its neutral rate of 2%. This would ensure that banks had an additional cushion of capital with which to absorb potential losses, enhancing their resilience and helping to ensure the stable provision of financial services. In contrast, if conditions deteriorated by significantly more than currently expected, in a manner that might otherwise lead banks to restrict lending primarily to defend

their capital ratios, the FPC would be prepared to cut the CCyB rate as necessary. This would enable banks to use the released buffer to absorb losses and so be able to support lending.

Stress testing the UK banking system: the 2024 desk-based stress test

67. To support the FPC's and PRC's monitoring and assessment of the resilience of the UK banking system to downside risks, the Bank would carry out a desk-based stress test in 2024. The exercise would not involve firm submissions of stressed projections. It would use the Bank's own estimates of the impact of the stress scenarios on the resilience of the UK banking system.

68. A desk-based exercise would allow for that resilience to be tested to more than one adverse macroeconomic scenario. The exercise would test the resilience of the banking system, as represented by the major UK banks and building societies that account for around 75% of the sector's lending to the UK real economy, to two hypothetical scenarios. The scenarios included severe but plausible combinations of adverse shocks to the UK and global economies.

69. The scenarios were countercyclical and linked to the FPC's assessment of the underlying level of risks and vulnerabilities in the UK and global economies and financial markets.

70. The scenarios applied in the desk-based stress test were not a forecast of macroeconomic and financial conditions in the UK or abroad. Rather, as per the scenarios used in previous exercises, they represented coherent 'tail-risk' scenarios designed to be severe and broad enough to assess the resilience of the UK banking system to a range of adverse shocks. Monetary policy responses in the scenarios did not represent a forecast of how policy would respond in such a scenario.

71. Committee members agreed to the scenarios ahead of the publication of *'Stress testing the UK banking system: scenarios for the 2024 desk-based stress test'* on 27 June 2024. The Bank would publish findings from the desk-based exercise at an aggregate level by the end of 2024. It would not publish results at the level of individual banks.

The resilience of market-based finance

72. The FPC judged that vulnerabilities from market-based finance remained elevated. Stretched valuations and compressed risk premia remained vulnerable to a sudden shift in risk appetite. Vulnerabilities in leveraged market-based finance could amplify a sharp repricing in financial markets.

73. The FPC noted that on some measures aggregate leverage for hedge funds had increased. This had been driven by a number of trends including the growth in hedge funds' use of fixed income strategies, which generally employed higher leverage.

74. Hedge funds remained active in the US Treasury bond cash-futures basis trade. The aggregate size of their interest had increased materially relative to the December 2023 FSR. Interest in the basis trade remained driven by structural demand from asset managers for exposure to the US Treasuries and an increasing preference to source this exposure via the futures market.

Vulnerabilities in NBFI leverage

75. The FPC had previously identified non-bank leverage as a vulnerability in market-based finance, contributing to the Archegos default in 2021, the March 2020 dash for cash, the commodities market shock in 2022, and the LDI episode in 2022.

76. Leverage vulnerabilities could cause financial stability risks through two transmission channels: (i) to systemic markets, where deleveraging flows or liquidity demands to meet collateral or margin calls could lead to fire sales which amplify shocks; and (ii) to systemic institutions, where stress or default of a leveraged entity could propagate stress to its counterparties. As set out in the **Financial Stability in Focus: The FPC's approach to assessing risks in market-based finance**), the FPC judged that financial stability risks could arise from the nexus between leverage, concentrations, interconnectedness and jumps to illiquidity. This nexus was also challenging for authorities to monitor, due to the cross-border nature of risks and a lack of data.

77. The FPC discussed the vulnerabilities associated with concentrated leveraged positions and associated margining practices in OTC markets, particularly in core markets. Appropriate margining was one important way to help to mitigate leverage risks. But to do so effectively it would be important that:

- Core markets, such as government bond repo markets, had appropriate margining and haircuts. For example, the PRA previously identified shortcomings in UK banks' risk management processes and margining arrangements including in relation to collateral haircut requirements following a review of UK bank's fixed income financing;

- Margins appropriately reflected risks for concentrations and correlation in non-centrally cleared OTC markets; and

- Appropriate disclosures were made by NBFIs to counterparties to ensure they were better able to assess concentrated risk exposures.

78. The FPC stressed that the high degree of interconnectedness and cross-border activity associated with concentrated leveraged positions in core markets meant that those risks were most effectively addressed through internationally co-ordinated reforms.

79. The FPC noted that the Financial Stability Board (FSB) had published a report in September 2023 on the financial stability implications of leverage in non-bank financial intermediation and that the FSB was working on policies to enhance the monitoring of, and to address financial stability risks stemming from, leverage in NBFI. This included a planned FSB consultation report on NBFI leverage policy recommendations or policy options in December 2024.

80. The FPC welcomed the work of international and domestic regulators to develop appropriate policy responses to address the systemic risks from leverage in NBFI and stressed the need for appropriate policy recommendations or policy options upon which FSB members should act to address systemic risks from leverage.

Resilience in liability-driven investment funds

81. In November 2022, the FPC had recommended that regulatory action be taken, as an interim measure, by The Pensions Regulator (TPR), in co-ordination with the FCA and overseas regulators, to ensure liability-driven investment (LDI) funds remained resilient to the level of interest rates they could withstand at that point (300-400 basis points). In turn, in March 2023, the FPC had set out a steady-state resilience standard for LDI funds to be resilient to a yield shock of around 250 basis points, at a minimum, in addition to the resilience required to manage other risks and day-to-day movements in yields. It had recommended that TPR implement this standard as the supervisory and regulatory body for workplace pension schemes. The FPC also recommended that TPR should have mechanisms for monitoring LDI resilience and have the remit to take into account financial stability considerations in its work on a continuing basis.

82. In its March 2024 Record, the FPC had welcomed progress made against its November 2022 and March 2023 Recommendations. The Committee had noted continued progress in the implementation of the resilience standard the FPC recommended for LDI funds, and that its resilience standard was continuing to function well.

83. The FPC observed there had been further progress against the Committee's Recommendations to increase LDI resilience since March 2024. The FPC welcomed publication of the rules on sterling LDI funds from the Central Bank of Ireland (CBI) and Luxembourg's Commission de Surveillance du Secteur Financier (CSSF) on 29 April 2024, with the rules due to take effect from 29 July 2024. These rules represented the final step in the implementation of a comprehensive, cross-authority resilience framework for LDI funds covering both defined benefit pension schemes and the LDI funds in which they invest.

84. The FPC observed that its resilience standard was continuing to function as intended. The median leveraged pooled LDI fund had maintained resilience of 368 basis points since the start of the year, well above the FPC's 250bps minimum and the requirements set out in the CBI and CSSF's rules. In addition, funds were continuing to recapitalise at far higher levels than previously, and continued progress had been made on the areas for improvement in operational processes the FPC had previously identified.

85. Given the progress made on LDI fund resilience across domestic and international authorities, the FPC decided to close its November 2022 and March 2023 Recommendations relating to LDI resilience (see Annex for more details). The FPC decided its March 2023 Recommendation, that TPR should have the remit to take into account financial stability considerations in its work on a continuing basis, would remain in place.

86. The FPC noted the importance of continued oversight of LDI resilience by TPR, the FCA, and international authorities. For example, while substantial progress had been made on operational processes in the LDI sector, it was important that these processes were maintained and tested on a regular basis. The Bank was contributing to that work through its system-wide exploratory scenario (SWES) exercise, which included pension schemes and LDI funds.

System-wide exploratory scenario exercise

87. In November 2023, the Bank had launched the first round of the scenario phase of the SWES exercise. The SWES was the first exercise of its kind. It was being carried out to improve understanding of the behaviours of non-bank financial institutions (NBFIs) and banks in stressed financial market conditions, and how those behaviours might interact to amplify shocks to UK financial markets that are core to UK financial stability.

88. During the first round, participating banks and NBFIs had submitted responses indicating how they would expect to act following a set of hypothetical market shocks. The Bank had analysed responses to understand system-level and financial stability implications and had briefed the FPC on the findings.

89. The analysis had provided important initial insights which already demonstrated the value of system-wide exercises. NBFIs had reported that they would expect to face varied but significant impacts from the hypothetical market shocks. The FPC discussed the actions NBFIs and other participants had reported that they would have taken in response and the dynamics that those actions implied in markets of focus. Whilst impacts and responses varied by sector, the SWES scenario led most participating NBFIs to report significant liquidity needs. About 80% of these came from variation margin calls, just over 10% from initial margin calls and just under 10% from redemptions.

90. Many participants started the scenario with greater resilience than they had at the onset of recent market shocks. For example, the current level of resilience of money market funds was well above existing minimum requirements. That was also in part the result of recent regulatory actions, such as the LDI resilience standard recommended by the FPC. Participants therefore expected that liquidity needs could be mostly met by pledging assets. They would then use money market fund investments, existing cash balances, asset sales, and repo to meet the rest. NBFIs also reported actions for other reasons including in response to leverage or risk constraints, or for investment reasons. These resulted in some firms de-risking or requiring recapitalisation. Banks reported that they expected to continue making markets, and to roll clients' existing repo, albeit on tougher terms, implying a tightening in repo market conditions. First round submissions implied significant selling pressure in the sterling corporate bond market.

91. In June 2024 the Bank had launched the second round of the scenario phase. The Bank had shared its observations from first round submissions with participating banks and NBFIs. Participants had been asked to indicate how they would expect to act in light of these first round observations and some accompanying updated assumptions. The Bank would analyse responses to understand the financial stability implications of interactions between participants' actions.

92. Further detail on the analysis underpinning these judgements would be set out in the 'Resilience of market-based finance' chapter of the June 2024 FSR.

The following members of the Committee were present at the 11 June 2024 Policy meeting:

Andrew Bailey, Governor
Nathanaël Benjamin
Colette Bowe
Sarah Breeden
Ben Broadbent
Jon Hall
Randall Kroszner
Liz Oakes
Dave Ramsden
Nikhil Rathi
Carolyn Wilkins
Sam Woods

Gwyneth Nurse attended as the Treasury member in a non-voting capacity.

Given this was Ben Broadbent's final Policy meeting ahead of his term ending on 30 June 2024, the Chair, on behalf of the Committee, recorded his thanks for Ben's service to the Financial Policy Committee since becoming a member in 2014.

Annex: Financial Policy Committee policy decisions

FPC Recommendations implemented since the 13 March 2024 Policy meeting

On 23 March 2023, the FPC made the recommendation (23/Q1/1) that:

- The severe but plausible stresses to which LDI funds should be resilient should account for historic volatility in gilt yields, and the potential for forced sales to amplify market stress and disrupt gilt market functioning. If LDI funds were not resilient to such a shock, their defensive actions could cause financial instability, tightening credit conditions for UK households and businesses. The FPC judged that that these factors meant that the size of the yield shock to which LDI funds should be resilient should be, at a minimum, around 250 basis points.
- Liquid assets held to ensure resilience in the event of such a shock should be unencumbered and immediately available. Fund managers should have scope to consider additional assets, which investors had authorised them to use to meet collateral demands. Managers should apply appropriate prudence in doing this, for example by applying suitable haircuts.
- This minimum level of resilience should be maintained in normal times but could be drawn down on in stress. Minimum resilience around this level would ensure that funds could absorb a severe but plausible historical stress and still have a remaining level of headroom necessary to operate during a period of recapitalisation. This approach was consistent with the regulatory approaches in place for some systemically important financial institutions, where their standards were designed to allow institutions to continue operating after withstanding a severe stress.
- Funds should take into account the nature of their exposures, including duration, leverage, and concentration of holdings, and the liquidity, duration, and convexity of collateral, in modelling their resilience to yield moves.
- Pension schemes using leveraged LDI should be expected to be able to deliver collateral to their LDI vehicles within five days. Funds and schemes unable to implement these operational standards should be required to be resilient to a larger shock, calibrated to their own operational timelines.
- LDI funds should maintain additional resilience over and above the minimum to manage day to day volatility in yields and account for other risks they might face, including operational risks, in order to be able to maintain the minimum level of resilience in normal times. The amount of additional liquidity held should be calibrated by funds according to their own assessments of their exposures and operational

capabilities and other regulatory requirements, as well as interest rate trends and levels of market volatility. While this additional liquidity was expected to vary between funds, when combined with the minimum resilience to yield shocks, overall resilience levels should be broadly consistent with those currently prevailing in current market conditions (i.e. 300-400 basis points). Liquid asset holdings might be safely reduced over time if fund managers were able to demonstrate increased resilience through operational improvements.

On 23 March 2023, the FPC made the recommendation (23/Q1/2) that:

- TPR takes action as soon as possible to mitigate financial stability risks by specifying the minimum levels of resilience for the LDI funds and LDI mandates in which pension scheme trustees may invest. To ensure that they were able in practice to do this, it was important that trustees had a simple mechanism for monitoring, and LDI funds disclosing, levels of resilience in dynamic markets.
- TPR should have the ability to employ effective monitoring tools, and to enforce as appropriate in cases of non-compliance with this resilience level. The FPC asked TPR to report back on how it intended to implement the recommendation.

On 28 November 2022, the FPC recommended (22/Q4/1) that regulatory action be taken by TPR, in coordination with the FCA and overseas regulators, to ensure LDI funds remain resilient to the higher level of interest rates that they can now withstand and defined benefit pension scheme trustees and advisers ensure these levels were met in their LDI arrangements.

Outstanding FPC Recommendations and Directions (as at the date of the FPC's meeting on 11 June 2024)

On 23 March 2023, the FPC made the recommendation (23/Q1/2) that:

- TPR should have the remit to take into account financial stability considerations on a continuing basis. This might be achieved, for example, by including a requirement to have regard to financial stability in its objectives, which should be given equal weight alongside other factors to which TPR is required to have regard. The FPC noted that in order to achieve this, TPR would need appropriate capacity and capability.

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 2% on 11 June 2024, unchanged from its 13 March 2024 Policy meeting. 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. 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, and the FCA has issued **general guidance**.

Leverage Ratio

In September 2021, the FPC finalised its review of the UK leverage ratio framework, and issued a Direction and Recommendation to implement the outcome of the review as set out in its **October 2021 Record**.

In line with its statutory obligations, the FPC completed its annual review of its Direction to PRA. The FPC revoked its existing Direction to the PRA in relation to the leverage ratio regime, and issued a new Direction on the same terms as in September 2021 with the addition of discretion for the PRA to set additional conditions to the central bank claims exclusion.

The full text of the FPC's new Direction to the PRA on the leverage ratio is set out in the Annex of the **October 2022 Record**, together with the original Recommendation (now implemented).

The PRA has **published its approach** to implementing this direction and recommendation.