**FINANCIAL STABILITY REPORT PRESS CONFERENCE**

**Tuesday 13 December 2022**

**Opening remarks by Andrew Bailey, Governor of the Bank of England**

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

Before answering questions, I would like to highlight some key themes from the Report and the FPC's Q4 Policy Meeting.

In particular, I would like to draw out:

- The backdrop to the latest report and what that means for households, businesses and banks;
- The FPC's decision on the countercyclical capital buffer;
- The recent financial stability risks we faced in the gilt market from liability-driven investment funds; and
- Our broader work on tackling the risks posed by non-bank financial institutions.

**Backdrop to the latest report**

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

As you would expect, given the focus of today's press conference, I will not be discussing monetary policy. I will simply note that, like central banks across the world, the MPC has tightened monetary policy in response to the outlook for inflation.

Increases in the cost of living are stretching finances and making it harder for households and businesses to service their debts. Higher interest rates, and the expectation that they will rise further, are adding to that.

- Monthly payments on around 4 million owner occupied mortgages are expected to increase over the next year. However, overall, households are more resilient now than they had been in the run up to both the 2008 financial crisis and the 1990s recession. The proportion of disposable incomes spent on mortgage payments is expected to remain lower than the peaks during both of those stresses.
- A combination of higher costs, lower demand, rising rates, and continued supply chain disruption is putting pressure on businesses. However, in aggregate firms are less indebted than in previous periods of stress.

The UK banking sector is resilient to an economic downturn much worse than the one currently expected. As result, banks are able to support creditworthy households and businesses through this downturn.

The strength of the banking sector reflects the large capital and liquidity buffers banks have built up because of the policies put in place after the 2008 financial crisis.

**The UK Countercyclical Capital Buffer (CCyB) rate decision**

In July, the FPC increased the CCyB rate to 2%, with this rate being due to come into effect in July next year. Today, the FPC is maintaining this rate at 2%.

The global and UK economic outlooks have deteriorated and financial conditions have tightened in response. Consistent with our July judgement, vulnerabilities that could amplify future economic shocks remain.

Maintaining a neutral CCyB at 2% helps to ensure banks continue to have capacity to absorb any future unexpected shocks without restricting lending in a counterproductive way.

The FPC will continue to monitor the situation closely, and we stand ready to vary the UK CCyB rate depending on how risks develop.

**The resilience of liability-driven investment funds**

Today's FSR also highlights some of the recent financial stability risks which the UK faced in September and October this year.

These risks arose when rapid and large movements in market interest rates on UK government debt exposed weaknesses in liability-driven investment – LDI – funds. These funds act as investments for many defined benefit pension schemes.

The interest rate moves led to a spiral of margin and collateral calls and forced government debt sales that risked leading to further market dysfunction. This was particularly concentrated among so-called 'pooled' funds.

Given the material risk to UK financial stability, the Bank of England intervened with a temporary and targeted programme of UK government bonds purchases.

Our action was successful in restoring market functioning and giving LDI funds time to build their resilience in the near-term to future volatility in the gilt market.

Today's FSR sets out the importance of improving longer-term resilience in the LDI sector in a number of ways. Some very welcome steps have already been taken, however further work will need to be done next year.

We have made a recommendation to relevant regulators to preserve increased resilience and then set out appropriate steady state resilience including in relation to operational and governance processes.

**The resilience of market-based finance**

The recent episode involving LDI funds also underscores a broader set of financial stability risks from non-bank financial institutions.

Today more business lending and other financial services come from institutions other than banks. The sector includes many different types of firms, operating from many different countries.

Over the past three years, we've seen risks crystallise in a number of areas across this sector.

- The 'dash for cash' in March 2020 showed how sudden spikes in liquidity needs during a stress can be amplified by vulnerabilities in non-bank finance.

- High levels of hidden leverage through equity derivatives was a key factor in the default of Archegos in March 2021, which led to sizeable losses for banks.
- Significant volatility in commodity markets earlier this year highlighted vulnerabilities in these markets with unexpected and sharp increases in margin requirements.
- The most recent episode involving LDI funds also demonstrated how market moves can be amplified by vulnerabilities in non-bank finance.

All of these episodes demonstrate the urgency of developing and adopting policy reforms to increase resilience across the sector.

The global Financial Stability Board has a comprehensive international work programme in train to do this which the UK fully supports and is contributing to. The work programme focuses on a number of specific areas, including:

- Increasing the resilience of money market funds and open-ended funds
- Improving margin practices
- Understanding and addressing the risks posed by decentralised finance and crypto asset markets, and
- Understanding drivers of illiquidity in core funding markets, including leverage in the non-bank sector

Alongside this international work, the Bank of England will continue to tackle vulnerabilities with specific domestically designed actions where it is effective and practical.

We will develop our stress-testing approaches to gain a better understanding of the resilience of the sector to shocks and its links to banks and financial markets.

Given this, today we are setting out that the Bank of England will run an exploratory scenario exercise focused on non-bank financial institution risks.

**Summary**

The economic environment is challenging. Inflation is high, demand is slowing, and interest rates have been rising. Household and corporate finances are under greater strain. Overall, however, both households and businesses are more financially resilient than they were in previous periods of stress. And – thanks to the policies put in place after the 2008 financial crisis – banks are more resilient. They are now in a position to support customers and lessen the economic stress, rather than amplify it as they did in the past. Non-banks have become an increasingly important part of the financial landscape, however. And recent events remind us that regulatory reform to improve the resilience of non-banks is both necessary and urgent.

I want to leave two key messages.

First, a robust and well-capitalised financial sector is better protected against financial instability, and thus more able to support customers through difficult times. And these two elements – financial stability and customer support – beneficially interact.

Second, Brexit provides an opportunity to re-set regulations to fit the UK as a single country, and we will do that. It is not a matter of universal deregulation – but rather getting regulations that suit our case. The post financial crisis regulations have served an important purpose –

the system is more robust. However, the mere passage of time does not mean those regulations are no longer needed – far from it. They should be kept relevant and amended as such, but we should eschew “This Time is Different” type arguments.

Thank you.