Should financial markets be worried?

My reflections on the Bank of England assessment

of the UK financial stability

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Executive summary

The Bank of England’s July 2025 Financial Stability Report underscores that the UK financial system is resilient but operating under sustained stress from high rates, liquidity fragility, and interconnected risks. This is what it means concretely for the key market participants.

- The **gilt markets, alongside the repo and derivatives markets can be subject to liquidity and margin call crisis**
- **CCPs** must manage margin and collateral liquidity, potentially increasing initial deposit buffer
- **Banks** need to guard against rising credit and market risks; while being prepared for increasing liquidity challenges and increased margin calls (on repos and interest rate derivatives)
- **NBFIs** remain the largest structural vulnerability due to leverage, liquidity mismatches, and cross-market contagion channels. Regulators are starting to increase their focus significantly on them. Their systemic importance is now recognised by the regulators.
- **Be prepared for a comprehensive review of the regulatory framework governing liquidity management** across the financial system

Heightened uncertainty

The Bank of England's July 2025 Financial Stability Report paints a picture of a financial system that remains fundamentally sound yet increasingly strained under the weight of persistent economic pressures.

While the UK's financial infrastructure has proven its resilience, the report makes clear that the ***landscape has shifted***, with institutions now operating in an environment characterized by ***sustained high interest rates, tightening liquidity conditions, and complex interconnections*** that threaten to amplify shocks across the system.

At the heart of the Bank's concerns lies a simple but powerful reality: ***interest rates have remained elevated far longer than many had anticipated***. This higher-for-longer scenario has created a cascade of pressures throughout the financial ecosystem.

Funding and liquidity risks at the top of the agenda

Funding costs remain stubbornly high, liquidity buffers have grown thinner, and both corporate borrowers and households face the prospect of refinancing existing debt at significantly higher rates than when those obligations were first undertaken. What might once have been manageable refinancing events now carry the potential to trigger meaningful credit losses across the banking sector.

The ***fragility of market liquidity emerges as a particularly acute concern*** in the report. The ***gilt market, alongside critical repo and derivatives markets, continues to operate with notably less depth*** than it possessed before the liability-driven investment crisis of 2022. This thinness means that during periods of stress, price movements can be more volatile and transmission of shocks more rapid. The memory of that autumn crisis clearly haunts the corridors of Threadneedle Street, serving as a stark reminder that seemingly stable markets can deteriorate with alarming speed when liquidity evaporates.

Global interconnectedness continues to amplify these risks

Global interconnectedness adds another layer of complexity to this already challenging environment. The financial system has evolved into an intricate web of relationships where distress in one corner can rapidly spread to seemingly unrelated areas. A crisis in US commercial real estate or troubles within the leveraged finance markets could find their way to UK shores through funding channels and derivatives exposures, creating vulnerabilities that transcend geographic boundaries and market segments.

Getting ready for more margin calls

For central counterparties, these conditions present a particularly demanding operating environment. The increased volatility in interest rates has led to larger and more frequent margin calls, both initial and variation margin, placing significant liquidity demands on clearing members. The availability of high-quality collateral, always a precious commodity in times of stress, has become even more constrained under the prolonged period of elevated rates.

The Bank expects these crucial market infrastructures to respond by strengthening their stress-testing frameworks, enhancing their liquidity arrangements, and refining their recovery plans to ensure they can withstand simultaneous shocks emanating from non-bank financial institutions or cross-border events.

Operational resilience has also moved to the forefront, with regulators intensifying their focus on cyber security and the dependencies that CCPs have developed on third-party technology providers. The message is clear: these institutions must enhance their margin models, improve their access to liquidity, and coordinate more effectively with clearing members to prevent procyclical dynamics from amplifying market stress.

Mounting pressures on banks’ capital and risk/volatility management

Banks find themselves in a curious position, simultaneously strong and vulnerable. Their capital and liquidity positions remain robust by historical standards, yet profitability pressures are mounting and credit risks are beginning to materialize.

As corporate borrowers and mortgage holders refinance their obligations at today's higher rates, arrears are expected to rise. For banks active in repo markets, derivatives trading, and leveraged finance, the volatility of mark-to-market valuations and counterparty risk has intensified. Perhaps most concerning are the connections banks maintain with non-bank financial institutions.

Lending relationships with hedge funds and investment funds create exposure channels through which margin stress and liquidity strains in those sectors could rapidly transmit to bank balance sheets.

The Prudential Regulation Authority has responded by emphasizing the importance of robust internal stress testing, maintaining adequate liquidity coverage in this higher rate environment, and preparing for potential cyber disruptions that could compound financial stress.

NBFIs are the greatest concern in the short-term, and regulatory environment is tightening

Yet it is the non-bank financial sector (Non-Bank Financial Institutions also known as NBFIs) that emerges as the report's greatest source of concern. These institutions, ranging from open-ended investment funds to hedge funds and private credit vehicles, exhibit the structural vulnerabilities that keep financial stability authorities awake at night.

The combination of leverage and liquidity mismatches creates a volatile cocktail, particularly dangerous in stressed market conditions. As interest rates remain elevated and margin requirements increase, funding costs for these institutions have climbed substantially. Their reliance on short-term repo financing and derivatives leverage means that a sudden deterioration in market conditions could trigger fire-sale dynamics, as institutions scramble to meet margin calls and redemption requests by selling assets into already fragile markets.

The systemic importance of this sector is now fully recognized, with the Financial Stability Report highlighting ongoing collaboration between the Bank of England, the Financial Conduct Authority, and international regulatory bodies to address these structural vulnerabilities through enhanced data collection and the development of macroprudential tools. The regulatory environment for non-bank financial institutions is clearly tightening, with enhanced reporting requirements, liquidity stress testing, and the potential introduction of new margin or leverage limits on the horizon.

Tech risks and operational resilience continue to be a priority

Cyber security and operational resilience thread through the entire report as critical priorities that transcend individual institutions or sectors. The Bank and fellow regulators continue to conduct system-wide exercises testing the financial sector's ability to withstand and recover from major operational disruptions. The introduction of the Critical Third Parties regime reflects growing awareness that the financial system's dependence on a small number of technology and service providers creates concentration risks that must be actively managed.

Conclusion: no need to panic yet, but being more vigilant than ever

The overarching narrative of the July 2025 Financial Stability Report is one of vigilance rather than alarm. The UK financial system has weathered previous storms and possesses the fundamental strength to navigate current challenges. However, the combination of sustained high interest rates, compressed market liquidity, rising debt refinancing burdens, and the complex interconnections between banks, central counterparties, and non-bank financial institutions creates an environment where shocks could propagate more rapidly and with greater force than in calmer times. The regulatory response is appropriately focused on ensuring that institutions across all sectors strengthen their resilience, enhance their risk management frameworks, and prepare for scenarios that test their ability to maintain stability under stress. In this uncertain landscape, the watchword is preparedness, with financial stability authorities working to ensure that the system can bend without breaking when the next test inevitably arrives.