BANK OF ENGLAND

Financial Stability Report Summary

April 2008 | Issue No. 23

Rising US sub-prime defaults were the trigger for a broad-based repricing of risk and deleveraging in credit markets. An adjustment was needed after the credit boom and will inevitably have costs, but it is proving even more prolonged and difficult than anticipated. Prices in some credit markets are likely to overstate the losses that will ultimately be felt by the financial system and the economy as a whole, as they appear to include large discounts for illiquidity and uncertainty. Conditions should improve as market participants recognise that some assets look cheap relative to credit fundamentals. With sentiment still weak, the Bank has announced a special scheme to improve the liquidity position of the banking system and to increase confidence in financial markets.

This *Report* sets out:

– The reasons for the repricing of credit risk and deleveraging being so protracted.
– Why market-based estimates of the costs of the crisis are likely to overstate ultimate losses.
– Prospects for financial stability.
– Measures to help contain the length and costs of the turmoil and to prevent its recurrence.

Key risks to financial stability include:

- Market participants overreact to market-based estimates of losses that likely overstate the ultimate costs of the turmoil (page 25).
- Inadequate information about key valuation assumptions and uncertainties around reported losses and exposures prolong concerns about counterparty credit risk and strains in money markets (page 45).
- In the near term, tight funding conditions mean banks are vulnerable to adverse news and rumours, as highlighted by the run on Bear Stearns in mid-March (page 39).
- Tight credit conditions can be expected to lead to a pickup in defaults among vulnerable borrowers, including a subset of households (page 21), parts of the commercial property sector (page 21), and some highly leveraged non-financial companies (page 22).
- Financing difficulties could emerge in some emerging markets, including countries in Central and Eastern Europe with large current account deficits (page 16).

Key actions that need to be taken include:

To rebuild confidence in financial institutions:

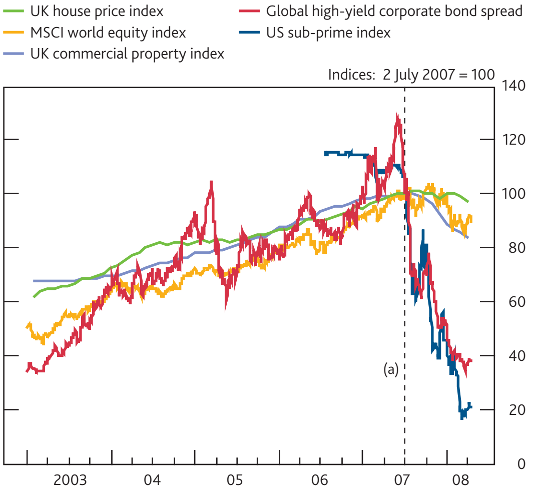
- The Bank has announced a new scheme aimed at improving the liquidity position of the banking system (Box A, page 10).
- Banks raising capital as a signal of strength in volatile markets (page 56).
- Consistent, frequent and co-ordinated disclosure by banks of positions and losses, including key assumptions and uncertainties (page 55).
- Enhanced information on complex instruments (page 56).
- Authoritative guidance on the application of mark-to-market accounting rules in stressed markets (page 55).

To improve ongoing financial stability:

- Better governance of risk management within banks (page 57).
- Improved liquidity risk management (page 60) and strengthened regulatory standards for liquidity (page 61).
- Differentiated ratings for structured products and more information on the drivers and uncertainties around ratings (page 57).
- Sharper regulatory incentives for banks to control risks through the cycle (page 64).
- Strengthened UK and cross-border crisis management arrangements (pages 67–69).

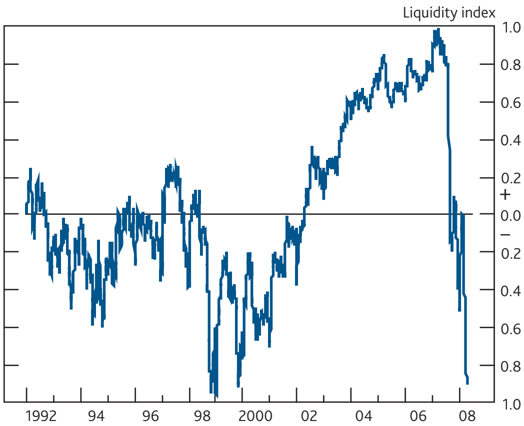
This document provides a short, visual guide to the analysis within the *Report*. It is also available on the Bank's website at **www.bankofengland.co.uk/publications/fsr/2008/fsrsum0804.pdf**.

Asset prices during the recent market turbulence



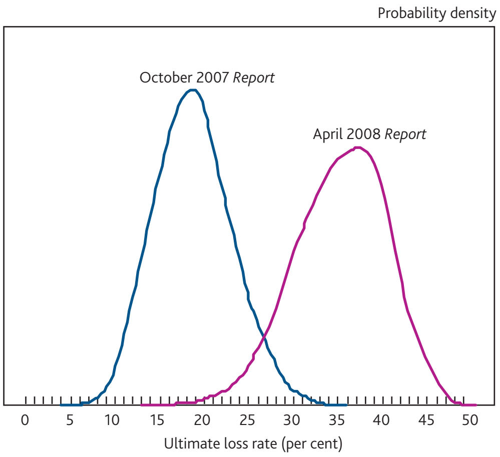
Sources: Halifax, IPD, JPMorgan Chase & Co., Merrill Lynch, Thomson Datastream and Bank calculations.
Price indices for selected assets.
(a) October 2007 *Report*. See *FSR* Chart 3.1 for details.

Financial market liquidity



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thomson Datastream and Bank calculations.
Index of financial market liquidity. See *FSR* Chart 3.2 for details.

Market-implied expectations of ultimate loss rates on US sub-prime mortgages



Source: Bank calculations using data from JPMorgan Chase & Co.
Markets' modal expectation of loss rates on sub-prime assets is 38%, which would be consistent with a probability of default of 76% and a loss given default rate of 50%, both of which would be unprecedented.
See *FSR* Chart 1.8 for details.

Rising defaults in the US sub-prime mortgage market have set in train a broad-based repricing of credit risk (page 20)…

…and deleveraging (a reduction in risk-taking) by some market participants (page 34).

But this process is proving to be even more prolonged and difficult than anticipated.

Markets are struggling to establish prices that can clear an overhang of financial assets created during the credit market boom…

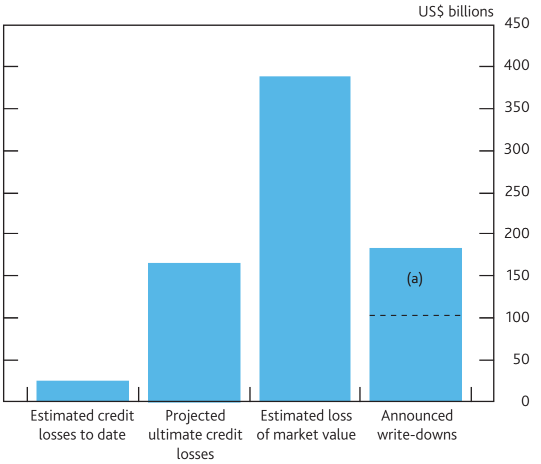
…with liquidity in markets impaired (page 24)...

…and, in particular, many asset-backed securities markets effectively closed (page 20).

Current pricing in ABX markets implies unprecedented losses on US sub-prime mortgages…

…or, more plausibly, embody large discounts for illiquidity and uncertainty (page 17).

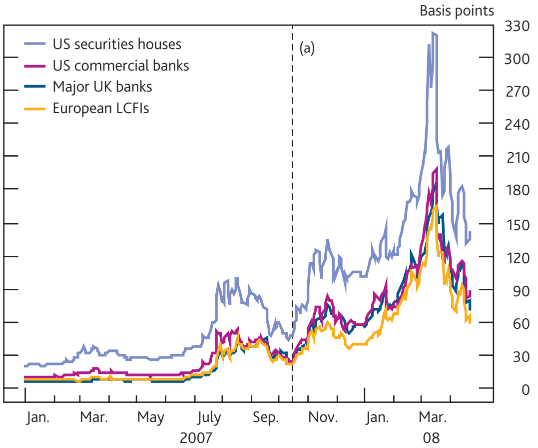
Losses on sub-prime asset-backed securities



Sources: Banks' financial statements, Bank of America, BlackRock, Dealogic, JPMorgan Chase & Co., Moody's Investors Service, Standard and Poor's and Bank calculations.
Market value falls look large compared with estimated credit losses and announced write-downs at major UK banks and LCFIs to date.
(a) Area below dotted line shows net write-downs by major UK banks and LCFIs since the start of 2007 to 22 April 2008, while total height of bar shows an S&P estimate (published on 13 March 2008) of write-downs by all investors. See *FSR* Chart 3.3 for details.

As a result, estimates of losses based on market values (Box 1, page 18) are likely to overstate ultimate losses.

Major UK banks' and LCFIs' credit default swap premia



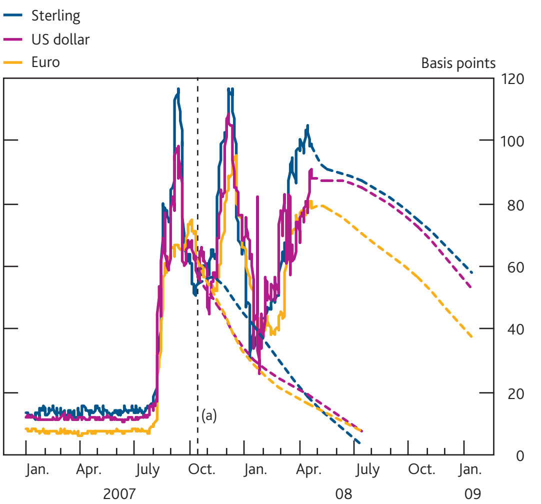
Sources: Markit Group Limited, Thomson Datastream, published accounts and Bank calculations.
UK banks' and LCFIs' credit default swap premia (asset-weighted average five-year premia).
(a) October 2007 *Report*. See *FSR* Chart 2.18 for details.

But falls in asset prices have undermined confidence in banks (page 35) and monoline insurers (Box 3, page 36)…

…culminating in the collapse of Bear Stearns (pages 25, 39)…

…though CDS premia have fallen significantly in recent weeks.

Three-month interbank rates relative to expected policy rates

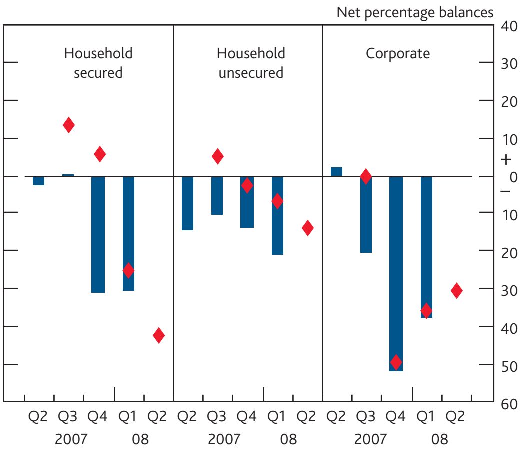


Sources: Bloomberg and Bank calculations.
Risk premium on three-month interbank lending. Dashed lines show three-month forward spreads.
(a) October 2007 *Report*. See *FSR* Chart 1.1 for details.

Looking forward, money market conditions should improve as confidence returns…

…and market participants recognise that some assets look cheap on a fundamentals basis (page 48).

Credit availability in the United Kingdom

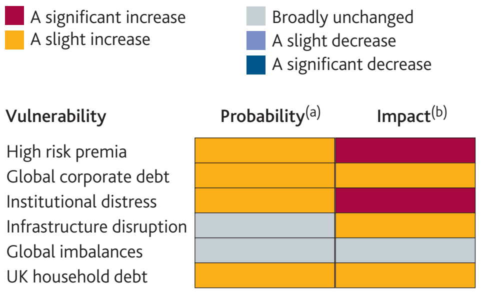


Source: Bank of England *Credit Conditions Survey*, 2008 Q1.
Actual (bars) and expected (diamonds) credit availability. See *FSR* Chart 3.6 for details.

But tighter credit conditions mean some rise in financial distress among vulnerable borrowers can be expected, including:

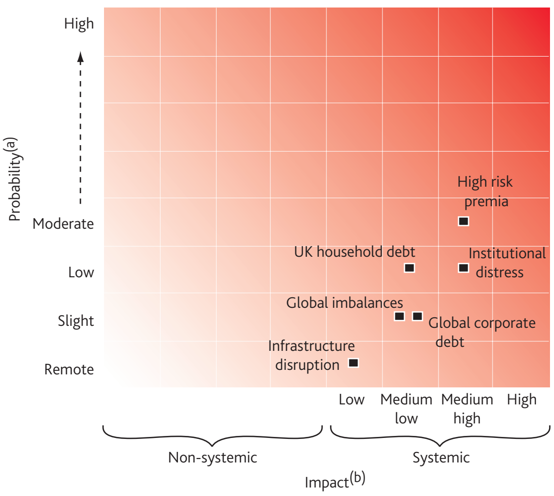
– parts of the commercial real estate sector (page 21 and Box 2, page 31);
– some leveraged non-financial companies (page 22); and
– some high-risk households (page 21).

Sources of tail risk in the period ahead: change in assessment since October 2007



Source: Bank assessment.
(a) Assessed change in the probability of a severe crystallisation of a vulnerability at some point over the next three years.
(b) Assessed change in the expected impact on financial stability if a vulnerability is triggered in a severe scenario.
See *FSR* Table 3.A for details.

Judgement on levels of likelihood and impact of key sources of tail risk



Source: Bank assessment.
(a) Probability of a severe crystallisation of a vulnerability at some point over the next three years.
(b) Expected impact on financial stability if a vulnerability is triggered in a severe scenario.
See *FSR* Chart 3.15 for details.

Conditions are likely to improve as confidence and risk appetite recover...

...but some tail risks remain (page 49)...

...the most significant of which is that current elevated risk premia persist and prompt further deleveraging and tightening in credit conditions (page 52).

This highlights the need to reduce uncertainty about banks' liquidity positions and to rebuild confidence in the resilience of banks (pages 55–56)...

...and for medium-term measures to address revealed weaknesses in risk management (page 57), to strengthen regulation (pages 62–64) and to improve crisis handling (pages 66–69).