BANK OF ENGLAND

Financial Stability Report Summary

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The financial system has been significantly more stable over the past six months, underpinned by the authorities' sustained support for the banking system and monetary policy measures. Low risk-free interest rates and reduced uncertainty among investors have led to a rebound in a range of asset prices. Activity in many capital markets has resumed, reducing financing risks for some borrowers. The market rally has boosted bank profits and lowered concerns about potential future losses, and banks have raised further external capital. As solvency concerns have eased, banks have been able to issue unguaranteed term debt, helping them to reduce their reliance on short-term funding.

But overstretched balance sheets will take time to adjust fully. Around the world, a number of borrowers, including in the commercial property sector, have large refinancing needs in the coming years. And while funding costs remain low, there is a risk of market participants building excessively risky positions, which could unwind abruptly when yield curves eventually rise. Banks need to reduce leverage further, extend the maturity of their funding and refinance substantial sums as official sector support is withdrawn. While their profitability is relatively buoyant and market conditions are broadly favourable, banks should take the opportunity to do so. That will reduce the risk of disruption to the flow of credit in the future.

In the medium term, the root causes of this and previous systemic crises must be tackled — excessive risk-taking in the upswing of the credit cycle and insufficient resilience in the subsequent downturn. An expectation that 'too important to fail' firms will receive public assistance, and that unsecured wholesale creditors will not share losses, has exacerbated both the boom and the bust. That calls for a robust, multi-faceted policy response. Regulatory policies should give greater emphasis to systemic risks over the cycle and across institutions, as set out in a recent Bank discussion paper. They should be complemented by structural measures to contain the spread of risk across the system. And because failures of financial institutions cannot and should not be prevented, the resolution framework will need to be improved to limit the impact on the wider economy.

Key risks in the financial system:

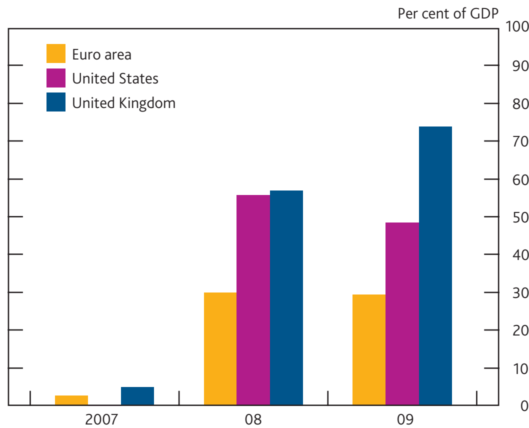
- Banks repair their balance sheets too slowly.
- The exit from policy support could lead to abrupt portfolio adjustments and unwinding of positions funded in low-yielding currencies (pages 26–27).
- A less robust than expected economic recovery could heighten strains on borrowers with stretched balance sheets, including some companies and households internationally (pages 19–26).
- Increased concerns about national balance sheets of some countries (page 26).
- A lack of clarity about sovereign support for quasi-government entities, as seen in Dubai and, earlier in the crisis, at US mortgage finance agencies (page 26).
- A setback in the asset price rally could cause sharp reversals in portfolio flows among some investors who have recently been less discerning about risk (pages 27–28).

Measures:

- Banks should strengthen their balance sheets opportunistically while profits are buoyant, including by limiting distributions. They should develop plans for repaying public support (pages 35–42).
- In the medium term reform must remove the expectation that 'too important to fail' firms will receive public support and that unsecured wholesale creditors will not share losses. Changes required include:
  - Strengthened microprudential regulation, raising the quality and quantity of capital and liquidity buffers (pages 45–51).
  - Regulatory policies should give greater emphasis to systemic risks over the credit cycle and across firms (pages 51–52).
  - Consideration of structural changes to the financial system to contain the spread of risk across the network, including extension of central clearing, and to insulate core financial services (pages 52–58).
  - Improvement of crisis resolution frameworks to limit the impact of systemic failures on the economy (pages 58–63).

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/2009/fsrsum0912.pdf**.

Public sector support during the financial crisis[a]

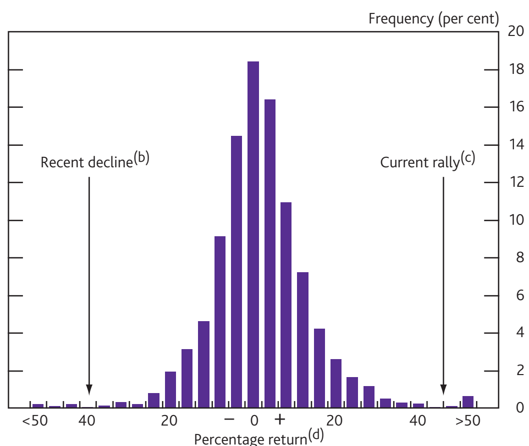


Sources: Bank of England, BIS, Board of Governors of the Federal Reserve System, ECB, FDIC, HM Treasury, IMF *World Economic Outlook* (October 2009), US Treasury and Bank calculations.
(a) End-year. 2009 figures are for November. See also footnotes to **Chart 1.1**.

The financial system is more stable than six months ago…

…underpinned by sustained government support for banks and monetary policy measures.

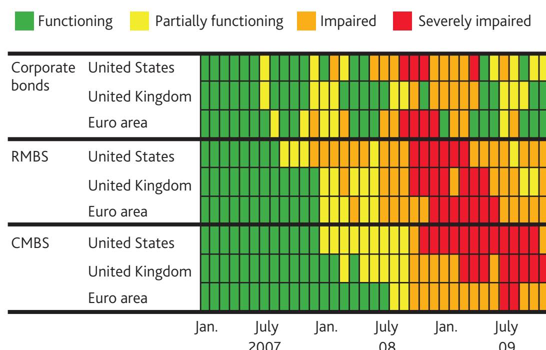
Declines and rallies in equity prices since 1693[a]



Sources: Bloomberg, Global Financial Data Inc. and Bank calculations.
(a) The chart shows returns on the FTSE All-Share index in the rally in the nine months to 4 December and in the decline over the preceding nine months, compared with the relative frequency of returns over other nine-month periods since 1693 (partly estimated).
(b) 4 June 2008 to 4 March 2009.
(c) 4 March 2009 to 4 December 2009.
(d) Axis labels reference the mid-point of categories that are 4 percentage points wide.

A sharp market rally internationally…

Primary market functioning[a]

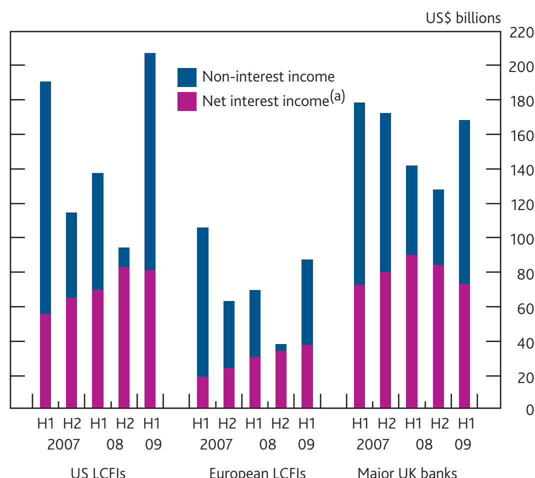


Sources: Bank of America Merrill Lynch, Dealogic, JPMorgan Chase & Co. and Bank calculations.
(a) Shading is based on a score that reflects primary issuance (relative to GDP) and spreads at issue, both expressed as a number of standard deviations from average, using available data from January 1998.

…and an improvement in the functioning of some capital markets…

…have eased access to finance for some corporate borrowers…

Financial institutions' income



Sources: Published accounts and Bank calculations.
(a) Net interest income pre-provisions.

...boosted bank profits...

Mark-to-market losses on selected financial assets[a]

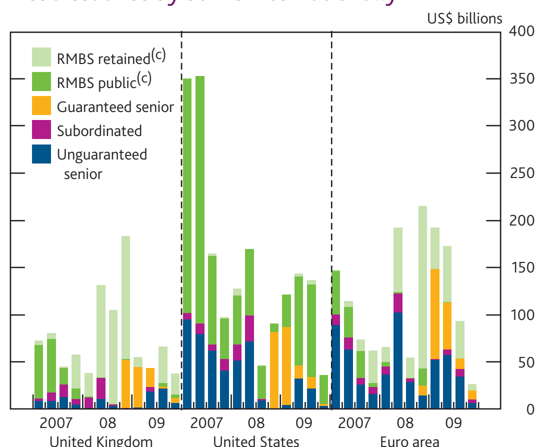
US$ trillions

	Outstanding amounts[b]	Mid-March 2009[c]	June 2009 *Report*[c]	Dec. 2009 *Report*
Equities	37.1	20.2	12.3	5.9
Corporate bonds	16.4	2.0	0.7	-0.7
RMBS[d]	3.4	1.4	1.1	0.7
CDOs[e] and CLOs	0.8	0.5	0.4	0.3
CMBS	0.8	0.3	0.2	0.2
Memo: debt securities	21.4	4.1	2.4	0.4
Total losses	–	**24.3**	**14.7**	**6.3**

Source: Bank calculations.
(a) Estimated loss of market value since January 2007, except for US CLOs, which are losses since May 2007. Assets cover the United Kingdom, United States and euro area, except for equities, which are global.
(b) Outstanding face values, except for equities, which are market values.
(c) Updated to reflect new estimates of outstanding amounts in mid-March and June 2009.
(d) Includes prime, non-conforming and buy-to-let mortgages for the United Kingdom; residential mortgages for the euro area; prime, Alt-A and sub-prime mortgages for the United States.
(e) US high-grade and mezzanine home equity loan ABS CDOs.

...and halved expected future losses on financial instruments.

Debt issuance by banks internationally[a][b]

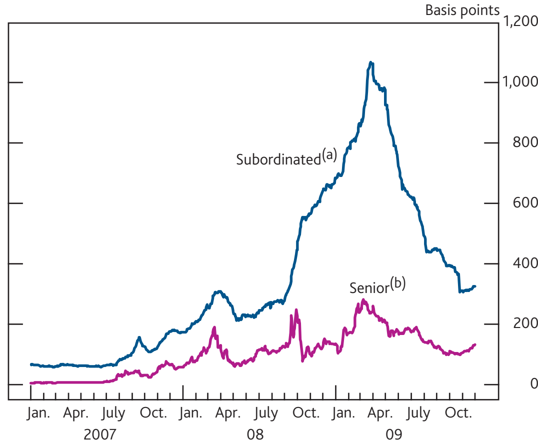


Source: Dealogic.
(a) Issuance with a value greater than US$500 million equivalent and original maturity greater than one year.
(b) Data for 2009 Q4 include October issuance only.
(c) Classified as RMBS where more than 50% of the underlying assets are residential mortgages. 'Retained' issues are not sold to the market by the originator, issuer or bookrunner.

This has supported further increases in banks' capital buffers, taking the total raised by banks internationally since the start of the crisis to nearly US$1.5 trillion...

...and raised appetite for unguaranteed long-term bank debt, lowering the maturity mismatch between banks' assets and liabilities...

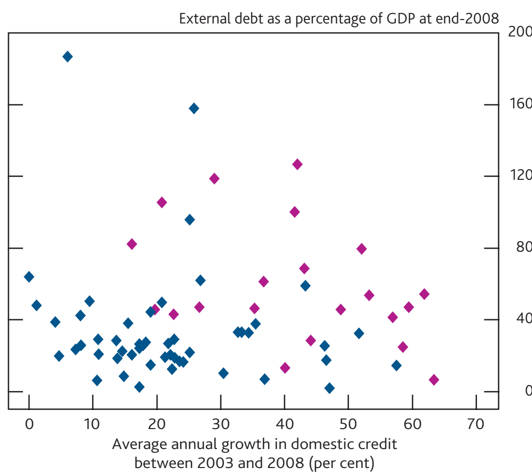
Market indicators of bank risk



Sources: Thomson Datastream and UBS Delta.
(a) iBoxx index of sterling financial subordinated debt spreads.
(b) Asset-weighted average of major UK banks' five-year senior CDS premia.

…improving perceptions about banking sector resilience.

Credit growth[(a)] and external debt in selected emerging market economies[(b)]

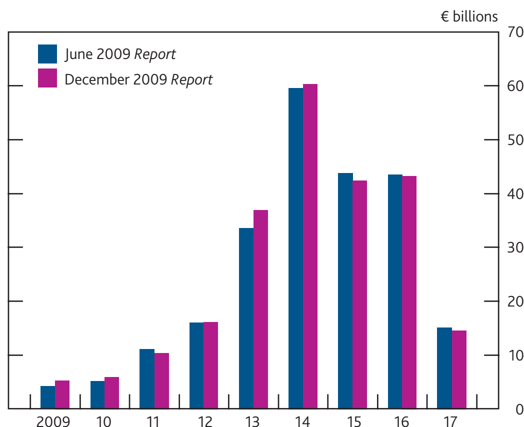


Sources: IMF *International Financial Statistics* and *World Economic Outlook*.
(a) Excludes credit to the government, public non-financial corporations and other financial institutions, except where countries do not report using the standardised IFS template.
(b) Emerging Europe and Commonwealth of Independent States shown as magenta diamonds.

But after the boom years, some balance sheets inevitably remain stretched…

…including for some emerging economies in Central and Eastern Europe…

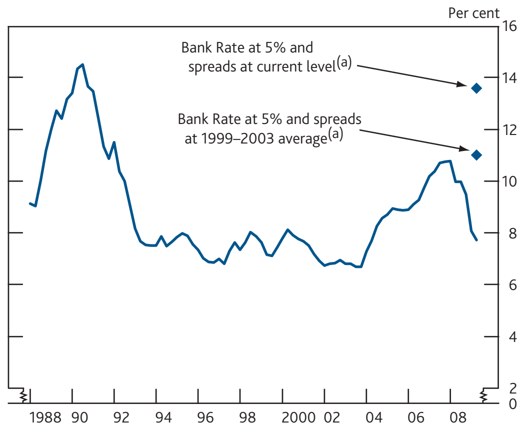
Refinancing schedule for European leveraged loans



Source: Fitch Ratings Ltd.
See FSR Chart 1.14 for details.

…for some companies which face significant refinancing risks, including commercial property companies…

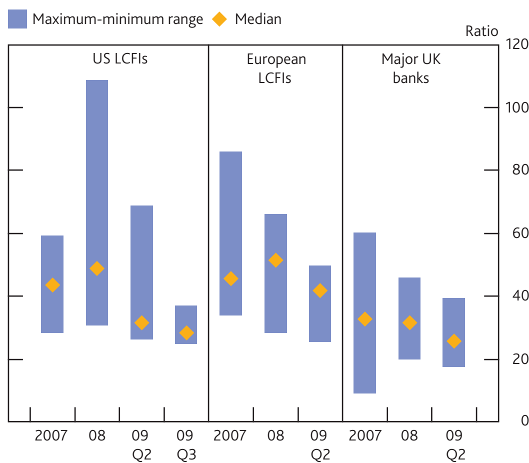
UK households: interest payments relative to income



Sources: Bank of England and Bank calculations.
(a) Bank Rate was most recently 5% on 7 October 2008.

...and some households where debt-servicing costs remain low at present, but would be sensitive to a rise in interest rates.

Bank leverage ratios internationally



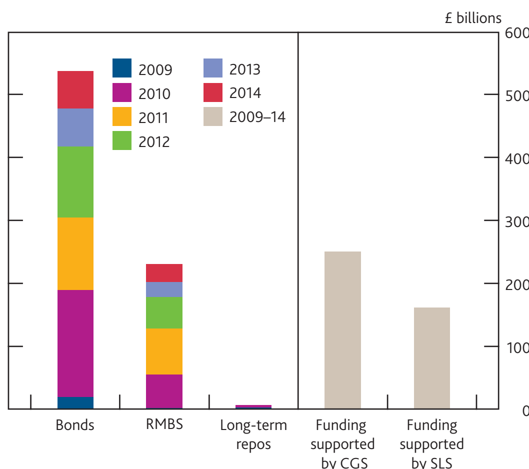
Sources: Published accounts and Bank calculations.
See FSR Chart 2.2 for details.

Many banks in the United Kingdom and internationally need to strengthen their balance sheets further...

...by reducing leverage...

...by planning to extend the maturity of their funding...

Major UK banks' maturing funding



Sources: Bank of England, Bloomberg, Deutsche Bank and Bank calculations.
See FSR Chart 2.19 for details.

...and by repaying public sector support.

While conditions remain favourable and profits are buoyant banks should take the opportunity to strengthen balance sheets, including by limiting distributions.

The root causes of this and previous crises need to be tackled including…

…excessive risk-taking in the upswing of the credit cycle…

…and insufficient resilience in the subsequent downturn…

…generating an expectation that ‘too important to fail’ firms will receive public support and that unsecured wholesale creditors will not share losses.

Regulation could be strengthened through:

- Higher minimum capital requirements, comprising instruments that can absorb losses such as equity, or contingent capital that converts to equity automatically in a pre-defined way.
- Appropriately defined mandatory maximum leverage ratios to complement risk-weighted capital requirements.
- Requiring banks to hold large buffers of reliably liquid assets, and complementary measures to reduce banks’ dependence on short-term wholesale borrowing to fund illiquid assets.
- Reducing overreliance on external credit ratings, potentially through regulatory incentives.
- Better disclosure, for example with regard to liquidity positions and exposures between financial institutions.
- The use of macroprudential tools to combat the build-up of risk over the credit cycle and across firms, as outlined in a recent Bank Discussion Paper.

That calls for a robust multi-faceted policy response including…

…regulatory policies that give greater emphasis to systemic risks over the credit cycle and across institutions (pages 45–52)…

Structural changes to support stability could include:

- Extension of central counterparty (CCP) clearing for financial contracts, backed up by robust CCP risk management.
- Development of capital markets to reduce economic dependency on credit intermediated by the banking system.
- Insulation of core financial services — such as payments and credit provision — from disruption stemming from other activities, and removal of the expectation of government support for wholesale creditors.

…structural measures to contain the spread of risk across the system (pages 52–58)…

Better crisis resolution arrangements should include:

- Pre-funded and risk-based deposit insurance to limit subsidies to riskier banks.
- The use of recovery and resolution plans (RRPs) to identify and reduce barriers to orderly resolution of financial institutions and to ensure losses can fall on unsecured wholesale creditors.
- Consideration of stronger arrangements to cater for the resolution of non-deposit taking institutions whose failure could undermine financial stability in some circumstances.
- Clear principles for public provision of capital support that ensure banks’ shareholders and unsecured wholesale creditors bear losses.

…and an improved crisis resolution framework (pages 58–63) to limit the impact of bank failures on the financial system and economy.