



Financial Stability Report Summary

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Sovereign and banking system concerns have re-emerged in parts of Europe. The IMF and European authorities proposed a substantial package of support for Ireland. But market concerns spilled over to several other European countries. At the time of writing, contagion to the largest European banking systems has been limited. In this environment, it is important that resilience among UK banks has improved over the past year, including progress on refinancing debt and on raising capital buffers. But the United Kingdom is only partially insulated given the interconnectedness of European financial systems and the importance of their stability to global capital markets.

More medium-term risks are posed by a redistribution of capital within the financial system. Capital has flowed into safe assets and, despite recent increases, bond yields remain low in many advanced economies. There are some signs of this intensifying a search for yield, including into emerging market assets. Low yields may also be masking latent distress among some overextended borrowers, including some households, corporates and sovereigns. Against that backdrop, it is in banks' collective interest to build resilience gradually through retention of earnings, which would be boosted if banks restrain distribution of profits to equity holders and staff.

On the policy front, the FSB/G20 reform programme includes improvements in the loss-absorbency of systemically important financial institutions and in the regimes through which they could be resolved; strengthening of central counterparties' (CCP) risk management; and improvements in the capital regime for banks' trading books. Reform in those areas will engender incentives for activity to migrate to unregulated parts of the financial system, so it is important that policymakers exercise vigilance about the regulatory perimeter.

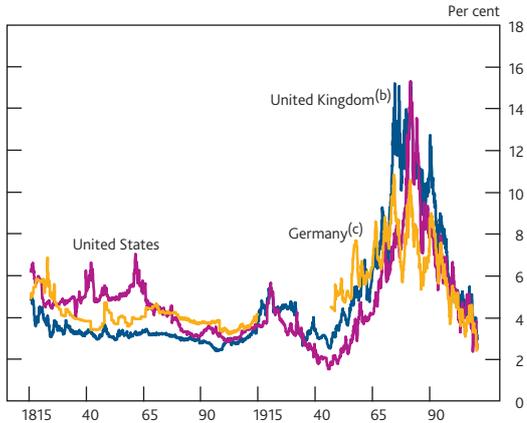
Key risks to the UK financial system:

- Contagion of sovereign concerns, interacting with and amplifying bank fragility in Europe (pages 27–28).
- A redistribution of capital globally, increasing the risk of overheating in some emerging market economies (pages 17–18).
- Low bond yields in advanced economies, which could reignite a search for yield but whose sudden reversal might lead to sharp falls in asset prices (pages 20–21).
- The exposure of latent distress among some borrowers internationally, including in the commercial property sector, if growth is weaker than expected or market interest rates rise by much more than anticipated (pages 32–33).
- Market disruption and contagion as a result of weaknesses in risk management, both in bilateral trades between market counterparties and at systemically important central counterparties (page 46).

Policy measures required:

- Guided by tighter Basel III standards, a gradual transition by banks to greater resilience by retaining earnings, avoiding rapid adjustment via tightening credit conditions (pages 48–50).
- Initiatives in securitisation markets to match better the investment requirements of long-term investors with banks' need to lengthen the maturity of funding (page 50).
- Measures to mitigate the risks associated with systemically important financial institutions, including capital surcharges and improved resolution arrangements in which losses are borne by existing liability holders (pages 51–53).
- Extension to central clearing and strengthened CCP risk management, fostered by user-ownership and 'not-for-profit' arrangements (pages 53, and 57–58).
- The BCBS review in 2011 of regulatory capital requirements for trading books to take account of liquidity risk and potential regulatory arbitrage (page 58).

Historical government bond yields(a)

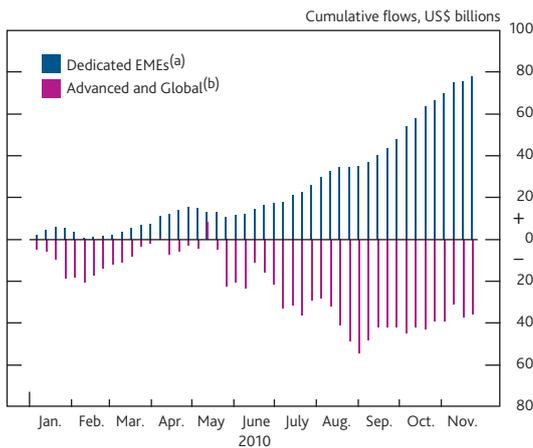


Source: Global Financial Data.
 (a) Ten-year yields.
 (b) Due to data limitations, the UK series prior to 1958 is compiled from yields on 2½% UK Consolidated Stock (Consols). As Consols are undated stock, the time-series comparison is only approximate.
 (c) Due to data limitations, no data are shown for Germany from 1915 to 1946.

Sovereign concerns have boosted demand for safe assets...

...keeping bond yields at historically low levels despite recent rises.

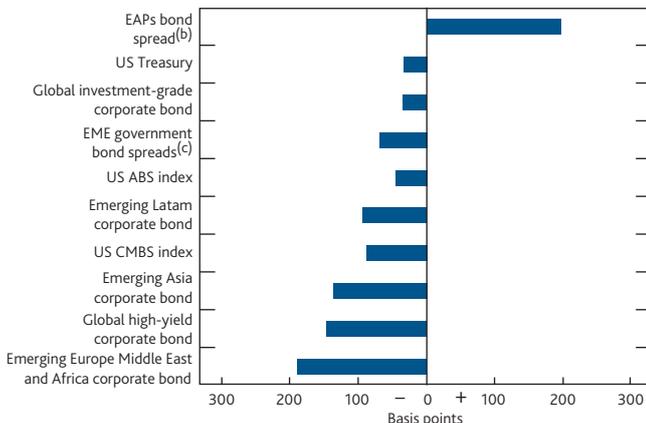
Investments in equity funds



Sources: Emerging Portfolio Fund Research and Bank calculations.
 (a) Includes newly industrialised economies.
 (b) 'Advanced and Global' includes the following equity funds: Global, Japan, Pacific, United States and Western Europe.

Capital has flowed out of some advanced-economy risky assets...

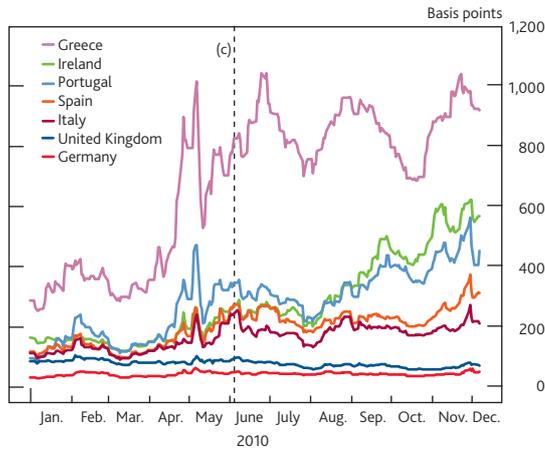
Changes in yields and spreads of selected assets(a)



Sources: Bank of America Merrill Lynch Global Research, Bloomberg, Thomson Reuters Datastream and Bank calculations.
 (a) Change in yields (unless otherwise specified) since June 2010 Report.
 (b) Ten-year government bond spreads to bunds. 'EAPs' (euro-area periphery countries) comprises Greece, Ireland, Italy, Portugal and Spain.
 (c) Emerging Market Bond Index Global Composite — yield to maturity over US Treasuries.

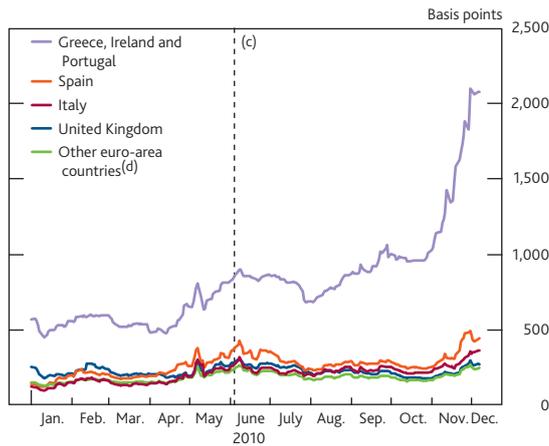
...while there are signs of a search for yield in some emerging markets, which could affect banks active in those markets.

Cost of default protection for European sovereign debt^{(a)(b)}



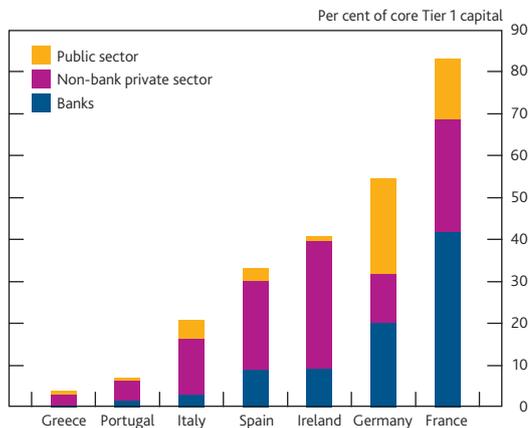
Source: Thomson Reuters Datastream.
 (a) Senior five-year sovereign credit default swap premia.
 (b) Data to close of business on 7 December 2010.
 (c) June 2010 Report.

Cost of default protection for European banks' subordinated debt^{(a)(b)}



Sources: Capital IQ, Markit Group Limited, Thomson Reuters Datastream and Bank calculations.
 (a) Asset-weighted five-year credit default swap premia.
 (b) Data to close of business on 7 December 2010.
 (c) June 2010 Report.
 (d) 'Other euro-area countries' consists of Austria, Belgium, France, Germany and the Netherlands.

Major UK banks' claims on selected European countries^{(a)(b)(c)}



Sources: Bank of England, published accounts and Bank calculations.
 (a) Barclays, HSBC, Lloyds Banking Group, Nationwide Building Society and Royal Bank of Scotland.
 (b) Claims data are to end-June 2010, adjusted for risk transfers. Excludes guarantees and derivatives.
 (c) Core Tier 1 capital data are to end-June 2010, except for Nationwide Building Society (end-April 2010).

Re-emerging sovereign and banking concerns in parts of Europe...

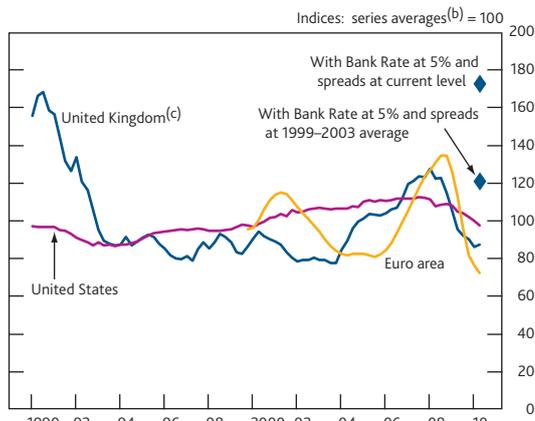
...could lead to further impairment of bank funding,...

...increased risk on UK banks' direct exposures to the most vulnerable economies...

...and on indirect exposures via UK banks' claims on more highly exposed European banking systems,...

...alongside wider disruption to capital markets internationally.

Household income gearing^(a)

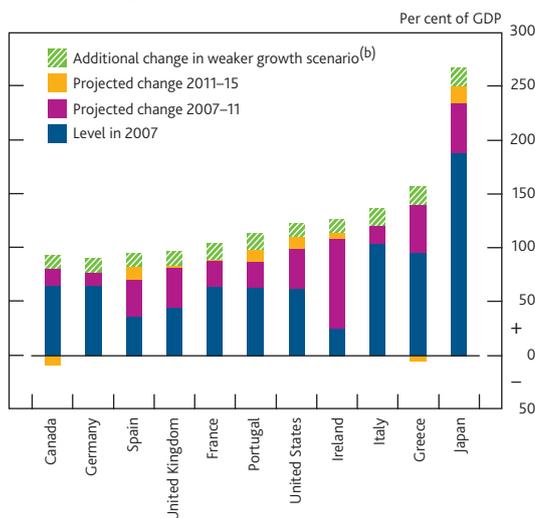


Sources: ECB, ONS, Thomson Reuters Datastream and Bank calculations.
 (a) For the United Kingdom and the euro area income gearing is measured as the ratio of household interest payments to post-tax income. For the United States it is measured as the ratio of total household debt repayments to post-tax income.
 (b) Series averages are calculated over the period shown on the chart.
 (c) Includes FISIM adjustment.

An extended period of low bond yields might accentuate the search for yield...

...or a snap back in yields might reveal latent distress in overextended balance sheets of some companies and households...

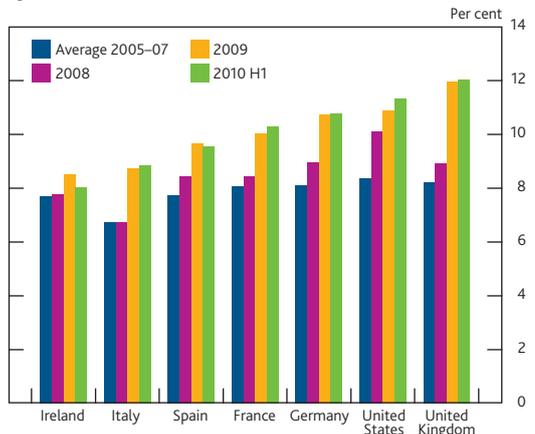
IMF sovereign debt projections^(a)



Sources: IMF Fiscal Monitor (November 2010), IMF Global Financial Stability Report (October 2010) and Bank calculations.
 (a) Gross general government debt.
 (b) Growth 1 percentage point weaker than the baseline IMF World Economic Outlook forecast.

...and some sovereigns where debt is projected to remain elevated.

Tier 1 capital ratios for selected international banking systems^{(a)(b)(c)(d)}

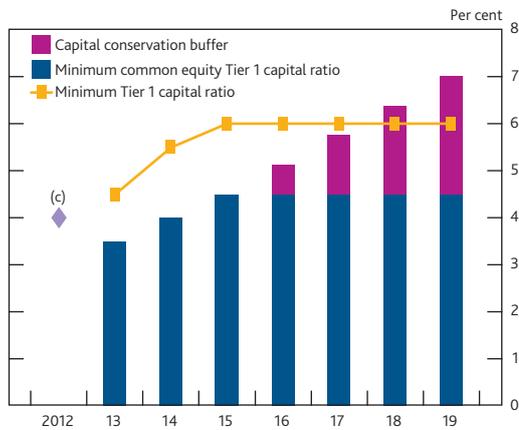


Sources: Capital IQ, Moody's Investors Service, SNL Financial, published accounts and Bank calculations.
 (a) Includes banks with total assets of more than \$100 billion at end-2009.
 (b) Aggregated from individual banks' (risk-weighted) capital ratios, weighted by total assets.
 (c) UK data exclude Northern Rock.
 (d) All figures are under local accounting conventions.

The increased resilience of large international banking systems provides some insurance against these risks...

...helping — at the time of writing — to limit wider contagion.

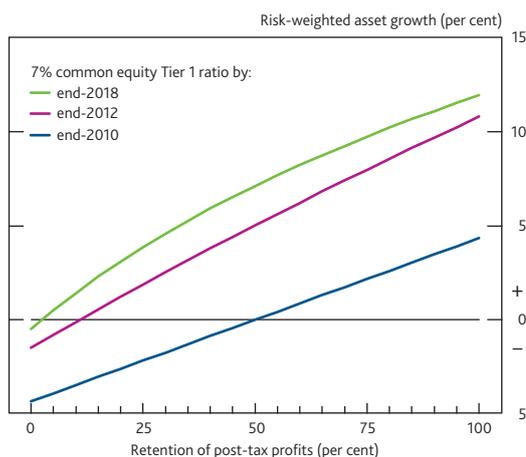
The extended transition to Basel III regulatory capital requirements^{(a)(b)}



Sources: BIS and Bank calculations.
 (a) Phase-in arrangements will be effective from 1 January each year.
 (b) The definition of common equity Tier 1 capital will be strengthened under Basel III.
 (c) Diamond represents current 4% FSA regulatory core Tier 1 capital requirement.

Banks have an extended period to meet new Basel III requirements...

Combinations of asset growth and profit retention during the transition to new Basel capital levels^(a)



Sources: Bloomberg, Citibank, Deutsche Bank, Thomson Reuters Datastream, UBS and Bank calculations.
 (a) See FSR Chart 5.6 for further details.

...which they can achieve by profit retention, avoiding tighter credit conditions which could dent economic recovery and undermine their own resilience.

On the policy front, reforms include ways to boost the loss absorbency of banks that are 'too important to fail' and new resolution regimes...

...and a strengthening of CCP management of counterparty default...

...which could be fostered by user-ownership and 'not-for-profit' governance arrangements.