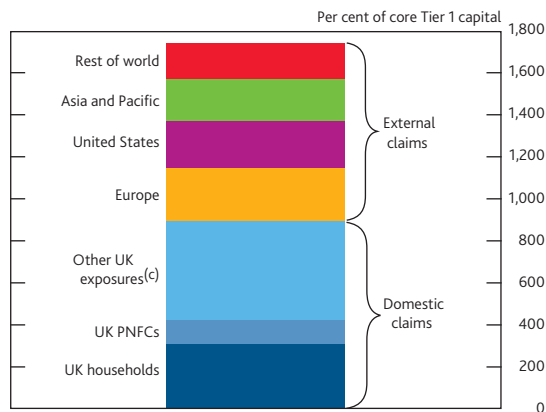


2 Credit risks to the banking system

The recovery in global activity has continued but downside risks have increased, in particular from weak fiscal positions in some euro-area economies. While UK banks' direct exposures to the most vulnerable sovereigns and their banks are limited, they are exposed to the private sectors in those economies and indirectly through their links to other banking systems.

The creditworthiness of larger companies in most advanced economies has improved, but commercial real estate remains a concern, including in Asia where signs of overheating have emerged. Loan forbearance may be masking underlying risks from continued high levels of indebtedness in parts of the corporate and household sectors in the United Kingdom and overseas.

Chart 2.1 Stock of UK banks' lending^{(a)(b)}



Sources: Bank of England, FSA regulatory returns and Bank calculations.

- (a) End-December 2010 adjusted for risk transfers. Excludes guarantees and derivatives. Core Tier 1 capital data are to end-December 2010.
- (b) Includes UK-owned banks and Santander UK's domestic lending. Santander UK's lending overseas is not available on a comparable basis to UK-owned bank lending overseas but is small. This is an approximation of the split between domestic and overseas lending as the two data sets are not directly comparable. In particular, domestic lending includes intragroup lending to other UK banks and financial institutions, whereas lending overseas excludes intragroup lending.
- (c) Includes lending to banks, other financial corporations and the public sector.

This section focuses on credit risks facing UK and key international banks. In aggregate, UK banks' exposures are approximately evenly split between the United Kingdom and abroad (**Chart 2.1**). So credit risks depend as much on the path of the global economic recovery as on prospects within the United Kingdom. In the Bank of England's May 2011 *Systemic Risk Survey*, the most frequently cited key risk to the UK financial system remained an economic downturn in the United Kingdom or globally (**Table 1.A**).

The global recovery has continued but downside risks have increased.

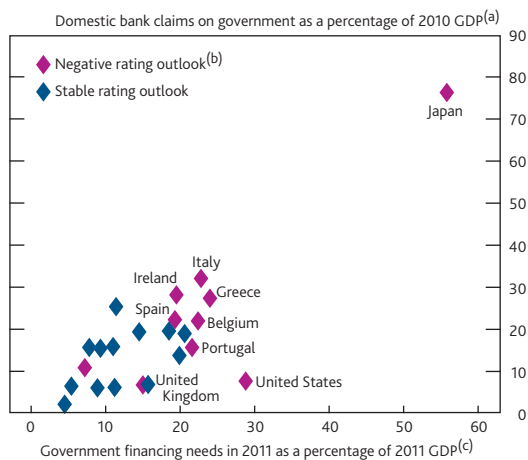
The recovery in global activity has continued since the December 2010 *Report*. In the IMF's June *World Economic Outlook* update, world output was projected to grow by more than 4% in 2011 and 2012, above the average in the decade prior to the financial crisis. But the IMF judged that downside risks to the world economy had increased, in particular from recent greater-than-anticipated weakness in US activity and renewed financial volatility from concerns about fiscal imbalances in parts of the euro area. Concerns were also expressed about medium-term fiscal sustainability in the United States and Japan. Overheating pressures in some key emerging economies were judged to have intensified and downside risks remained from higher commodity prices and increased political unrest in Middle Eastern and North African countries.

2.1 Sovereign and banking sector risks

Fiscal positions are fragile...

In the May 2011 *Systemic Risk Survey*, the proportion of respondents citing sovereign risk as a key concern rose sharply, to levels last seen a year ago when Greece turned to the EU

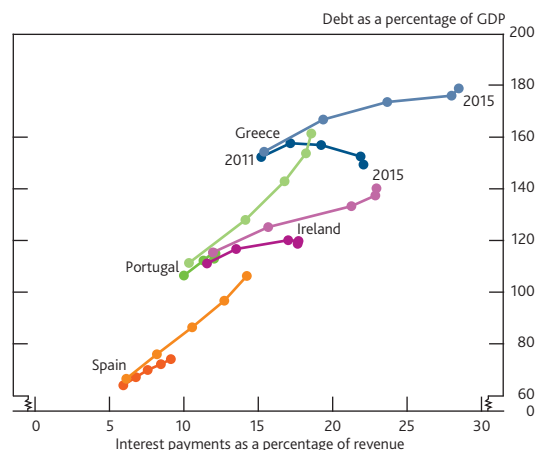
Chart 2.2 Government financing needs and domestic bank claims on government



Source: IMF *Global Financial Stability Report* (April 2011).

- (a) Includes all claims of domestic depository institutions (excluding the central bank) on their own general government.
 (b) Outlook is based on the most negative of the three major agencies' ratings.
 (c) Using IMF 2011 GDP projections.

Chart 2.3 An illustration of sovereign debt dynamics(a)(b)



Sources: Bloomberg, European Banking Authority (EBA), IMF, OECD and Bank calculations.

- (a) Dark lines represent IMF baseline. Light lines represent EBA adverse scenario.
 (b) For Greece and Spain the baseline scenario is consistent with the IMF April 2011 *World Economic Outlook*; for Portugal and Ireland the baseline scenario is consistent with the most recent review under their three-year arrangements under the IMF's Extended Fund Facility. For all countries the adverse scenario is consistent with that being used by the EBA in their stress testing of European banks. Relative to the baseline it incorporates on average around a 5¼ percentage point decline in nominal GDP growth and a 2¼ percentage point increase in sovereign debt yields over 2011 and 2012. Fiscal deficits are assumed to respond to GDP in line with elasticities estimated by the OECD following Girouard, N and André, C (2005), 'Measuring cyclically-adjusted budget balances for OECD countries', *Economics Department Working Paper no. 434*. After 2012 the shocks to GDP growth and interest rates are assumed to unwind gradually by the end of the period.

and IMF for financial support (Table 1.A). Sovereign debt positions in advanced economies have deteriorated dramatically since 2007, as a result of the depth of the recession and financial sector support operations. Most advanced economies plan to tighten fiscal policy in 2011. But deficits in many cases remain well above levels that would stabilise debt to GDP ratios. This year the IMF expects the average debt to GDP ratio for advanced economies to breach 100% for the first time since World War II. The United States, Japan and some euro-area sovereigns have negative credit rating outlooks (Section 1), in part reflecting their large refinancing needs over the next two years (Chart 2.2).

... especially where there are market concerns about debt sustainability...

Against that backdrop, concerns about the ability of some euro-area sovereigns to meet their debt obligations have risen since the December 2010 Report. Greece, Ireland and Portugal have each negotiated financial support packages from EU authorities and the IMF. But markets remain concerned about the sustainability of their fiscal positions. In these and some other euro-area economies, a persistent loss of competitiveness over the past decade has contributed to a sequence of current account deficits and the accumulation of large net external debt positions. It is also constraining the recovery in net trade necessary to generate growth and repay debt.

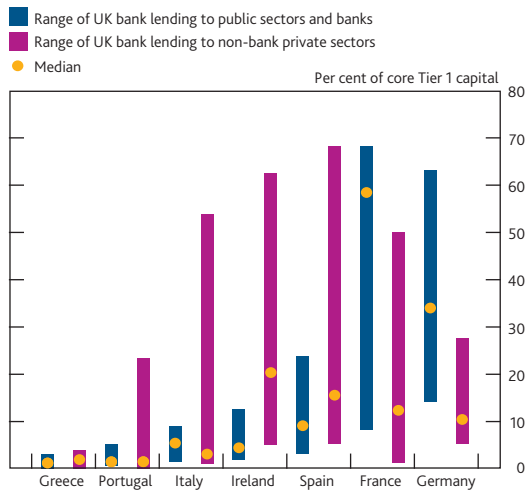
As sovereign debt ratios rise, their future path becomes more sensitive to possible shocks to GDP growth and funding costs. That sensitivity is illustrated for some euro-area sovereigns in Chart 2.3, which shows mechanical projections for debt ratios and debt-servicing costs under IMF baseline forecasts and an adverse scenario of weaker growth and higher interest rates. Under the illustrative adverse scenario, Greece and Ireland potentially face an interest bill in excess of 20% of revenue. Ratios above 20% have been observed in only about one tenth of cases for advanced economies since 1980.

In the light of these risks, market prices suggest that the likelihood of a sovereign debt restructuring in Greece is perceived to be high. Those concerns have been amplified by uncertainty about the extent to which the private sector might be required to participate in any restructuring.

... which are closely intertwined with banking sector risk.

Perceptions of greater sovereign risk have spilled over to the banking sector. That may have reflected some erosion in the expected ability or willingness of some sovereigns to support their respective domestic banking sectors. Banks are also directly exposed to sovereign risk through their holdings of government debt. These are high in several banking systems and have been increasing in a few cases (Chart 2.2). So higher sovereign risk premia have tended to raise the cost of credit for

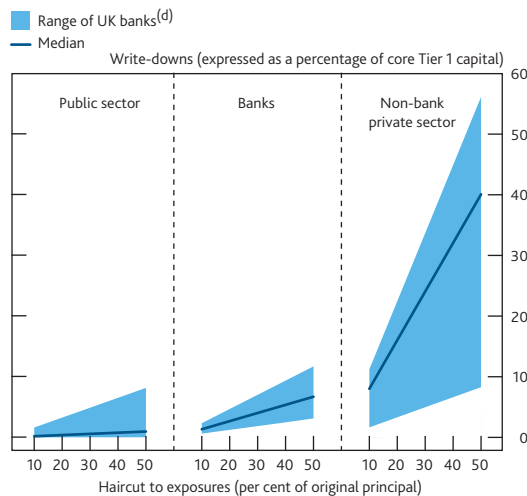
Chart 2.4 UK banks' lending to selected euro-area countries^{(a)(b)(c)}



Sources: Bank of England, published accounts and Bank calculations.

- (a) Shows the range of UK bank lending to sectors of selected euro-area economies. The sample of banks comprises Barclays, HSBC, Lloyds Banking Group, Nationwide and Royal Bank of Scotland.
 (b) Claims data are to end-December 2010, adjusted for risk transfers. Excludes guarantees and derivatives.
 (c) Core Tier 1 capital data are to end-December 2010, except for Nationwide which are to 4 April 2011.

Chart 2.5 Hypothetical pre-provision write-downs on UK banks' direct exposures to Greece, Ireland, Portugal and Spain^{(a)(b)(c)}



Sources: Bank of England, published accounts and Bank calculations.

- (a) Chart shows a range of hypothetical pre-provision write-downs across a sample of UK banks, calculated mechanically by applying a range of haircuts to their exposures to each sector.
 (b) Claims data are to end-December 2010, adjusted for risk transfers. Excludes guarantees and derivatives.
 (c) Core Tier 1 capital data are to end-December 2010 except for Nationwide Building Society which are to 4 April 2011.
 (d) Barclays, HSBC, Lloyds Banking Group, Nationwide and Royal Bank of Scotland.

banks, companies and households. That dampens economic recovery and adversely affects debt sustainability.

UK banks have direct and indirect exposures.

UK banks have modest direct exposures to sovereign and bank debt in Greece, Ireland and Portugal (**Chart 2.4**). More significant are their claims on the non-bank private sectors, which in Ireland and Spain together represent around 50% of the major UK banks' core Tier 1 capital. As a mechanical illustration, **Chart 2.5** shows a range of hypothetical pre-provision write-downs that could be faced by individual UK banks on their holdings of Greek, Irish, Portuguese and Spanish debt across different sectors.

UK banks are also exposed indirectly to economies under the greatest stress through their links with other major banking systems. For example, French and German banks have large exposures to vulnerable European economies. There is a risk that a sharp deterioration in economic conditions in vulnerable economies may have adverse implications for credit conditions in larger European economies. In conditions of severe stress in the euro area, this could increase the risk of losses to UK banks. The major UK banks' combined claims on France and Germany represent around 130% of their core Tier 1 capital, with close to one half accounted for by claims on banks. A more immediate risk to banks in the United Kingdom and overseas could arise from disruptions to bank funding markets triggered by concerns about counterparties' exposures to vulnerable euro-area countries.

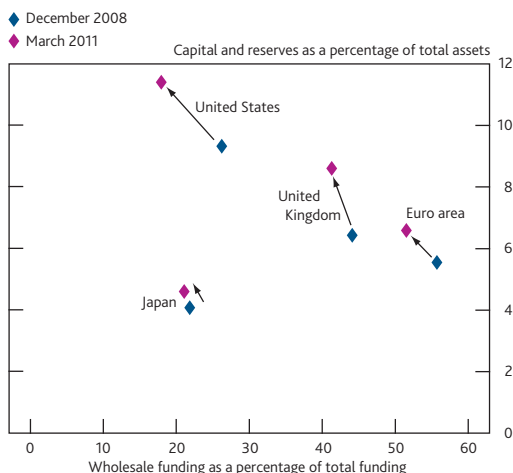
Spillovers to major banking systems have so far been limited...

Banks internationally have built up their resilience over the past two years by reducing their reliance on wholesale funding and raising their capital ratios (**Chart 2.6**). This has been helped by improved profitability. And although considerable uncertainty remains about the level of provisioning against banks' exposures to country risks, particularly when they are held in the banking book, UK banks with the largest potential credit losses from vulnerable euro-area countries have already reported significant loan loss provisions on these exposures (Section 3). That may help explain why the spillover of sovereign concerns onto UK banks has so far been limited (**Chart 2.7**).

...but euro-area banks remain vulnerable.

Overall, banks in the euro area remain heavily reliant on wholesale funding (**Chart 2.6**). In a number of euro-area countries, around 30% of bank debt is due to be rolled over by end-2012. Total euro-area bank term issuance has been buoyant in 2011 and above that required to repay maturing debt (**Chart 2.8**). Covered bonds, which are secured by bank assets, have formed an increasing part of the funding mix. Greater encumbrance of banks' assets means that in a stressed situation unsecured investors may be more uncertain about

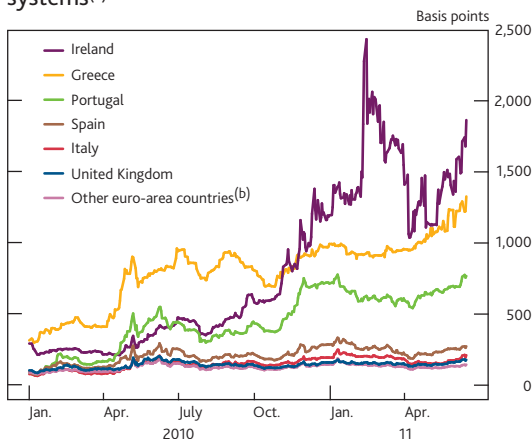
Chart 2.6 Banking system capital and reliance on wholesale funding^(a)



Sources: Bank of Japan, ECB, FDIC and Bank calculations.

(a) The chart gives an approximate indication of the direction in which different banking systems have moved as balance sheet definitions are not directly comparable.

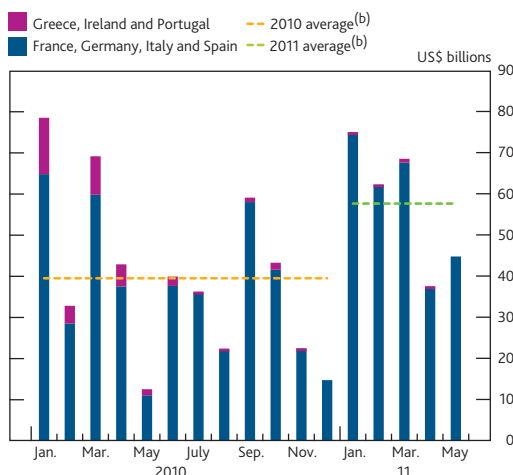
Chart 2.7 Cost of default protection for banking systems^(a)



Sources: Capital IQ, Markit Group Limited, Thomson Reuters Datastream and Bank calculations.

(a) Asset-weighted five-year CDS premia for a selection of banks in each country.
 (b) Consists of Austria, Belgium, France, Germany and the Netherlands.

Chart 2.8 Senior term debt issuance by selected euro-area banking systems^(a)



Sources: Dealogic and Bank calculations.

(a) Only covered bonds, medium-term notes, subordinated debt, senior debt, commercial mortgages, public RMBS and government-guaranteed debt are included.
 (b) Average of all countries.

being repaid, potentially leading them to withdraw their funds pre-emptively. Several euro-area banks are reliant on US money market funds for their short-term US dollar funding (Section 3).

In general, the tiering between banking systems in the euro area has intensified. According to Standard & Poor's, ratings for Europe's largest 100 banks show the widest range in creditworthiness in 30 years. Among these, Greek, Irish and Portuguese banks remain heavily reliant on ECB funding.

The impact of any sovereign debt restructuring on these banks would be significant given their large holdings of domestic public sector debt. If held in the banking book on a hold-to-maturity basis, sovereign exposures are not marked to market. And under the European implementation of Basel II, banks using the standardised approach are not required to hold capital against the risk of default of local-currency EU sovereign exposures. So there is a risk that banks have not set aside sufficient capital to absorb any losses. The European Banking Authority is planning to publish the results of stress tests in July.

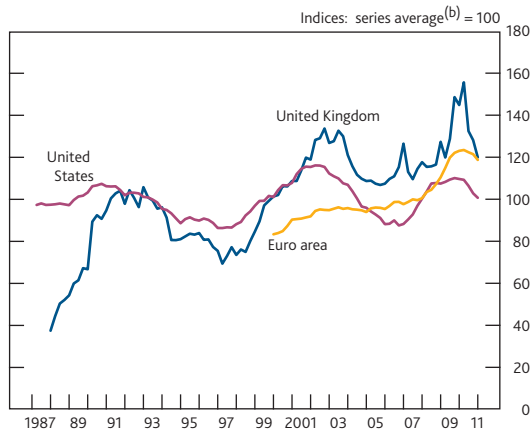
2.2 Corporate sector risks

Companies' financial positions have improved...

The creditworthiness of larger companies in most advanced economies has improved as profitability has increased. Credit conditions surveys in the United Kingdom and the United States suggest a further easing in bank lending standards in 2011 Q1, as perceptions of corporate sector credit risk have declined. In aggregate, measures of corporate sector leverage have fallen (Chart 2.9), driven by a simultaneous reduction in debt, higher profits and an increase in the market value of assets. Sentiment among UK chief financial officers (CFOs) in the 2011 Q1 *Deloitte CFO Survey* — which canvasses large companies — shifted towards raising leverage for the first time since 2008. And risk appetite has risen to the highest level since the survey started in 2007 Q3 (Chart 2.10). Globally there has been an increase in debt-financed mergers and acquisitions activity.

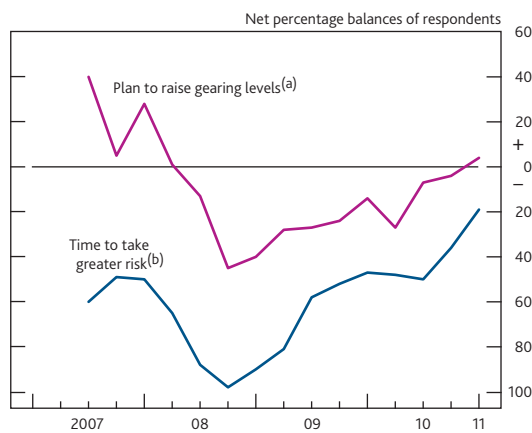
...but default rates have continued to rise for smaller companies.

Distress is more apparent among smaller companies in the United Kingdom. Data from companies' accounts indicate that small companies are more likely to have insufficient trading profits to cover their interest payments (Chart 2.11). The 2011 Q1 *Credit Conditions Survey* suggested that, in contrast to large and medium-sized companies, the default rate and loss given default to lenders have continued to rise among small companies (Chart 2.12). That pattern was expected to continue in 2011 Q2.

Chart 2.9 Corporate debt relative to profits^(a)

Sources: ECB, ONS, Thomson Reuters Datastream and Bank calculations.

- (a) Defined as debt net of an estimate of liquid assets, relative to a four-quarter moving sum of gross operating surplus.
 (b) Series averages are calculated over the period shown in the chart.

Chart 2.10 Attitudes of UK CFOs to risk and gearing

Source: *The Deloitte CFO Survey* (April 2011).

- (a) CFOs were asked if their aim for the next twelve months was to raise gearing, keep it unchanged, or reduce it.
 (b) CFOs were asked whether it was a good time to be taking greater risk onto their balance sheets.

Commercial real estate remains a concern internationally...

For the major UK banks, lending to the commercial real estate (CRE) sector accounts for around a third of lending to non-financial companies worldwide, with large overseas exposures to Hong Kong, Ireland, Spain and the United States. Market estimates suggest that global investment in CRE has picked up by around 40% over the past year, albeit from a very low base. Prime property values across the major markets have shown significant increases. In the United States, that has been aided by an easing in financing conditions — banks have relaxed lending conditions and the commercial mortgage-backed securities (CMBS) market has re-emerged. But European banks are still working through the legacy of excessive pre-crisis CRE lending, particularly in Ireland and Spain where property values continue to decline.

In the United Kingdom, the *Credit Conditions Survey* indicated that banks reduced the availability of credit to the CRE sector in 2011 Q1 and expected to reduce it in Q2. The *De Montfort Survey* recorded only around £20 billion of new lending in 2010, but pointed to significant refinancing needs with more than half (around £115 billion) of CRE debt maturing over the next three years. That gives an indication of the potential funding gap. Non-bank sources of funding, for example from CMBS, have been slow to return.⁽¹⁾

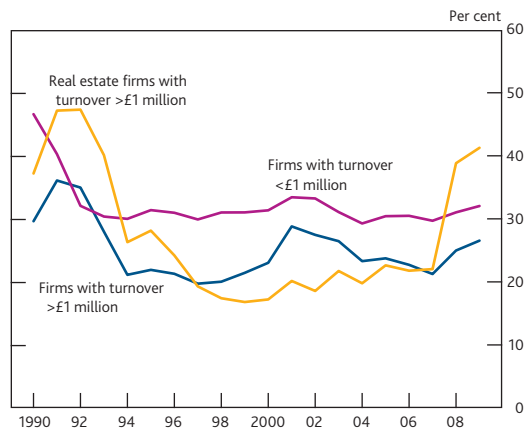
The refinancing challenge is particularly acute for non-prime CRE lending, where capital values remain depressed. The *De Montfort Survey* indicates that around 60% of outstanding UK CRE debt is secured by non-prime property. In part reflecting their relative exposures to prime and non-prime properties, CRE arrears rates across banks have been highly divergent (**Chart 2.13**).

...with underlying risks potentially masked by forbearance...

These differences may also in part reflect the effects of forbearance — the renegotiation or relaxation of the terms of a loan in response to an actual or prospective breach of its original terms. As discussed in Box 2, market contacts suggest that the extent of forbearance in the CRE sector could be significant, though it has been used in varying degrees by different banks. Forbearance may help explain why the overall rate of corporate insolvencies has been so low in the United Kingdom. In 2011 Q1, the corporate liquidations rate was around 0.7%, compared with a peak of 2.6% in the early 1990s, and write-offs have also been relatively low (**Chart 2.14**). Market contacts remain concerned that a deterioration in income streams, or increases in interest rates, could reduce borrowers' ability to service their debts, reducing banks' willingness and ability to continue to show forbearance.

(1) See pages 96–97 of the 'Markets and operations' section of the *Bank of England Quarterly Bulletin*, 2011 Q2, available at www.bankofengland.co.uk/publications/quarterlybulletin/qb1102.pdf.

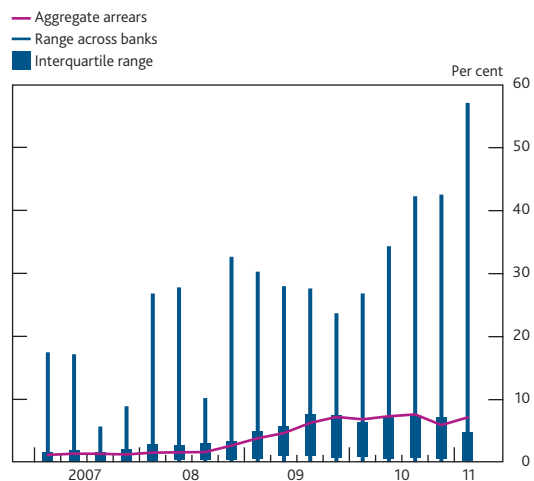
Chart 2.11 Percentage of firms with interest payments greater than profits^{(a)(b)}



Sources: Bureau van Dijk Fame database and Bank calculations.

- (a) Percentage of companies in each category with interest payments greater than their profits before interest.
- (b) Data include firms reporting turnover, profit and interest paid. These firms may not be representative of the population. Total sample size varies over time, ranging from around 14,000 in 1990 to over 90,000 in 2000. Changes in the composition of the data set may reduce comparability over time. Subsidiaries, as identified from company structures, are excluded. Company accounts are assigned to calendar years according to the statement date. The real estate sector is identified using SIC (2003) and SIC (1992) codes (the sample ranges from around 450 to 1,600 firms).

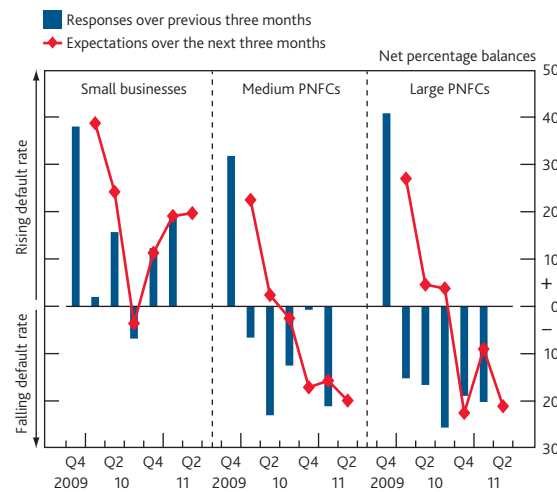
Chart 2.13 Arrears on UK commercial real estate loans^(a)



Source: FSA.

- (a) Arrears as a percentage of outstanding loans. Proxied by data on 'other secured' lending, which covers all non-residential lending secured on land and buildings in the United Kingdom. Data are for the 40 largest lenders.

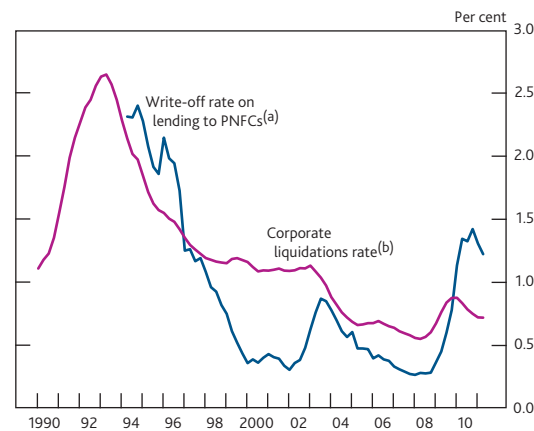
Chart 2.12 Default rate on loans by firm size^(a)



Source: Bank of England *Credit Conditions Survey*.

- (a) Net percentage balances are calculated by weighting together the responses of those lenders who answered the question. Expectations balances have been moved forward one quarter so that they can be compared with the actual outcomes in the following quarter.

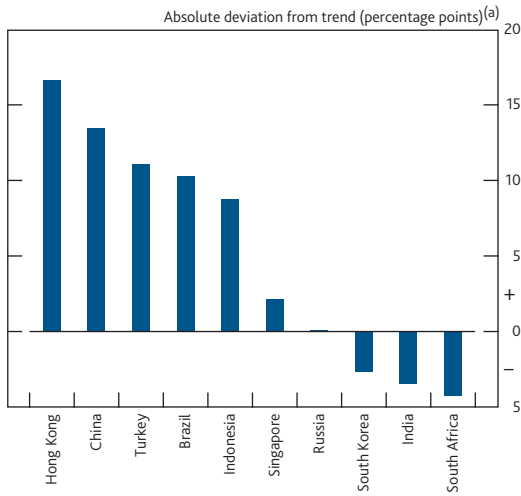
Chart 2.14 Corporate write-off and liquidation rates



Sources: Bank of England, The Insolvency Service and Bank calculations.

- (a) Write-off rate on lending by UK monetary financial institutions to private non-financial corporations (PNFCs). The series has been calculated as annualised quarterly write-offs divided by the corresponding loans outstanding at the end of the previous quarter, and is expressed as a four-quarter moving average. Lending is in both sterling and foreign currency, expressed in sterling terms. Non seasonally adjusted.
- (b) Calculated as the total number of corporate liquidations in the previous four quarters divided by the average number of active registered companies over that period. Since the Enterprise Act in 2002, a number of administrations have subsequently converted to creditors' voluntary liquidations. These are not included in the data. Data relate to England and Wales.

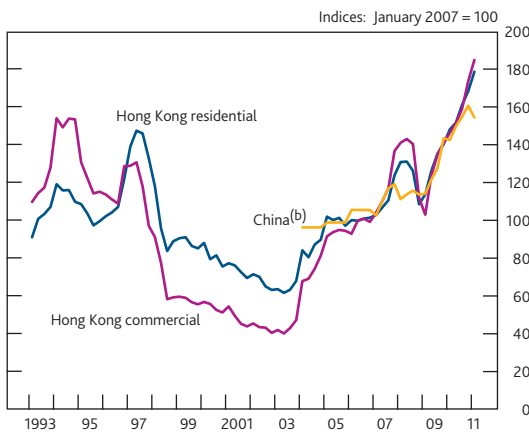
Chart 2.15 Domestic credit to GDP ratios in selected emerging economies



Sources: IMF *International Financial Statistics*, Thomson Reuters Datastream, national sources and Bank calculations.

(a) The deviation of the credit to GDP ratio from its long-term trend at 2010 Q4 using a Hodrick- Prescott filter. Based on the methodology in 'Countercyclical capital buffer proposal', July 2010, by the Basel Committee on Banking Supervision.

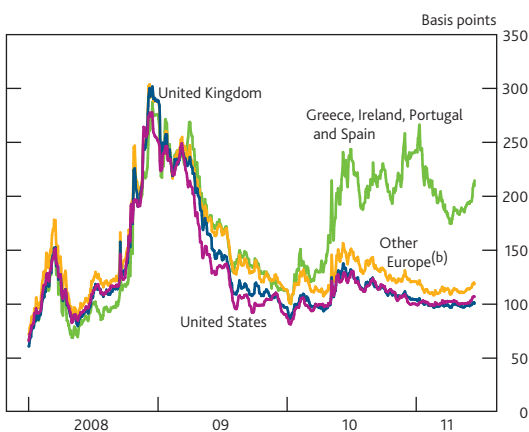
Chart 2.16 Hong Kong and Chinese real property prices^(a)



Sources: CEIC, IMF *World Economic Outlook* (April 2011) and Bank calculations.

(a) Nominal property prices are deflated by the GDP deflator.
(b) The series for China is a composite of residential and commercial property prices.

Chart 2.17 Cost of default protection for corporates^(a)



Sources: Thomson Reuters Datastream and Bank calculations.

(a) Calculated using the geometric mean of five-year CDS premia of non-financial corporates.
(b) Consists of Austria, Belgium, Finland, France, Germany, Italy and the Netherlands.

Companies' accounts point to a sharp increase in the proportion of real estate companies making insufficient trading profits to cover their interest payments, even at very low levels of interest rates (Chart 2.11). Defaults in the CRE sector would crystallise losses where the value of collateral has fallen below the amount of debt outstanding. Attempts to sell portfolios of distressed CRE assets could further weaken property values, raising losses given default. The Irish National Asset Management Agency and some UK banks, in particular Lloyds Banking Group and Royal Bank of Scotland, have begun to sell portions of their CRE portfolios.

...and rapid credit growth in Asia poses risks to property exposures.

In its April 2011 *Global Financial Stability Report*, the IMF warned about the build-up of financial imbalances and overheating asset markets in a number of emerging economies. Corporate leverage has increased above historical averages in the largest emerging economies, as companies have taken advantage of the resurgence of capital flows. Historical episodes of high capital flows have been associated with rapid domestic credit growth and increases in asset prices, which have often then corrected suddenly.

Some UK banks have large exposures to Asia and, in particular, to Hong Kong and China, which have increased rapidly over the past year. Buoyant credit growth in Hong Kong and China (Chart 2.15) has manifested itself in rapid increases in property prices (Chart 2.16). In Hong Kong, real property prices are almost double those prevailing in 2007, ahead of the financial crisis. In June 2011, the Hong Kong Monetary Authority introduced countercyclical supervisory measures to dampen the property market, the fourth time such measures have been introduced since October 2009. Credit growth and property prices have also been buoyant in Brazil, where Banco Santander (parent of Santander UK) has significant exposures.

Sovereign and banking sector risks have spilled over to the corporate sector in some euro-area economies.

There are some indications that sovereign and banking sector risks in the euro area are affecting the non-financial corporate sector. According to the April 2011 euro-area *Bank Lending Survey*, perceptions about the risks to banks from lending, and constraints on their ability to supply credit, contributed to a tightening in bank lending standards for non-financial companies in 2011 Q1. Banks expected to tighten credit standards further in 2011 Q2. Consistent with this, the cost of default protection has increased for companies in some countries where sovereign and banking risks have risen since early 2010 and where growth prospects are weak (Chart 2.17).

Box 2 Forbearance

In periods of stress, forbearance can help banks reduce losses and their customers avoid default. But it may also increase uncertainty about the resilience of the banking sector and constrain the supply of credit to the real economy. This box discusses forbearance and the risks that it poses to UK banks.

What is forbearance and why do banks forbear?

Forbearance refers to the renegotiation or relaxation of the terms of a loan in response to an actual or prospective breach of its original terms; it is an alternative to foreclosure or insolvency procedures (Figure 1). Forbearance can take many forms. These include loan restructuring and debt write-downs, banks not taking action against borrowers in breach of loan to value (LTV) covenants and allowing distressed borrowers to take a payment holiday or switch to an interest-only product.

Banks may decide to forbear for a number of reasons. One motivation is to reduce expected losses by providing greater flexibility to borrowers in the face of (what are perceived to be) temporary difficulties. By relaxing loan terms, lenders can reduce the probability of borrower default. And, by avoiding selling collateral when asset prices are depressed, banks can reduce any losses in the event that borrowers do default. In theory, banks may also forbear to delay making write-downs or provisions against non-performing loans until they have built up a stronger capital position.

Recent low interest rates are likely to have increased banks' incentives to forbear. Some forbearance methods, such as switching a borrower to an interest-only loan, are more effective at reducing the short-term burden of repayment

when interest rates are low. And cheaper funding reduces the cost to a bank of holding an asset on which they are receiving little or no income. Contacts have also noted that the large peak-to-trough falls in property values experienced during the crisis (20% for UK residential property and around 45% for UK commercial property) have created an incentive to forbear, particularly in cases where LTV covenants have been breached but lenders expect prices to recover at some stage.

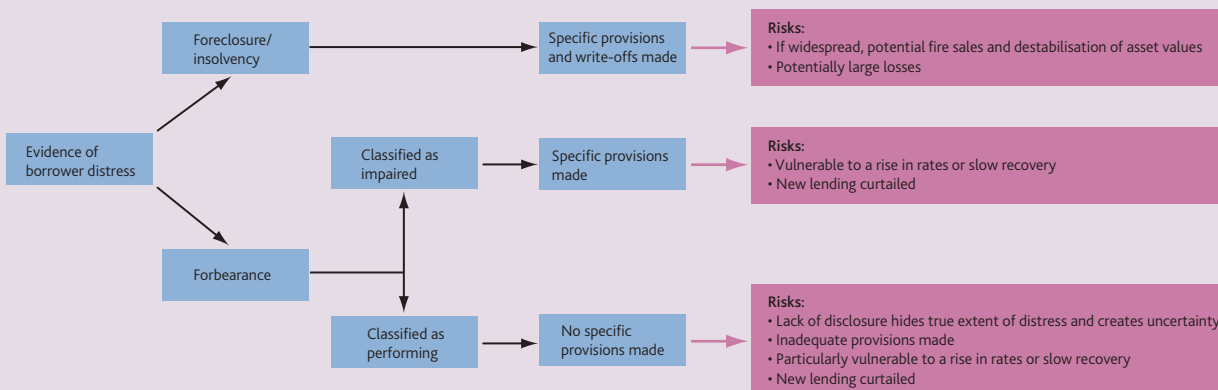
What are the risks from forbearance?

Forbearance can enhance financial stability. By reducing write-offs in temporary periods of borrower distress, it can protect the resilience of banks and thereby enhance their ability to make new loans. It can also ease cash-flow problems for their customers and prevent fire sales of assets that may depress prices further. During the recent recession, levels of reported distress have remained low relative to the early 1990s, despite high levels of private sector debt. For example, the share of mortgages in arrears equivalent to six or more months' payments rose to 1.4% in the recent recession, compared with 3.5% in the early 1990s. And the annual corporate liquidations rate reached 0.9%, compared with 2.6% in the early 1990s. Contacts suggest that forbearance played an important part in this, alongside low interest rates. This was discussed in Box 4 of the June 2010 Report.

As illustrated in Figure 1, however, forbearance may lead to a number of distortions. The extent of these will vary between different types of forbearance and will depend on reporting and provisioning practices. They include:

- **Uncertainty and mispricing risk.** Forbearance can disguise credit risk on banks' balance sheets. If widespread it would mean that data on loan arrears and write-offs give a misleading picture of levels of borrower distress. And as lenders do not comprehensively or consistently record or

Figure 1 Risks from forbearance^(a)



Source: Bank of England.

(a) In reality the process is not as straightforward as set out in the diagram. For example: foreclosure and insolvency are typically last resorts and in practice specific provisions are made before these take place; and although no specific provisions may be made, banks could make collective provisions.

report forbearance it is difficult to know the extent of this distortion. As a result, the pricing of risk could potentially be distorted and uncertainty about lenders' future capital and profit figures could be greater than it would otherwise be.

- **Overestimating resilience.** A change in macroeconomic conditions, such as a sharper-than-expected rise in interest rates or slower-than-expected recovery, could make a strategy of forbearance unviable. In the event of a change in conditions, some types of forbearance pose a greater risk than others. For example, a loan that has been switched to interest-only payment is likely to be more vulnerable to a rise in interest rates than one which is in breach of an LTV covenant but performing in all other respects. If banks have not provisioned sufficiently against forborne loans, losses on these loans would result in a reduction in banks' capital.
- **Constraining other lending.** If banks keep loans on their balance sheets that are generating no return, or which the borrower may struggle to repay, this could limit their income. Forbearance could also tie up existing funding and, by generating uncertainty over their capital positions, limit banks' ability to attract new funding. Particularly where banks' capital buffers are already limited, this could result in a reduction in new lending, weighing on economic growth. An example of this effect was witnessed in the 1990s in the Japanese 'lost decade'. Then, bad loans remained on banks' balance sheets and dragged down growth.⁽¹⁾

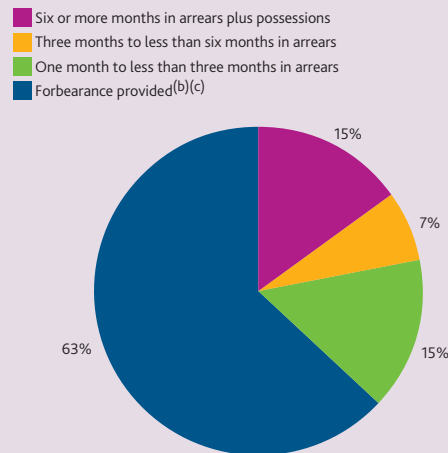
How widespread is forbearance?

In order to assess these possible effects, information on the scale of forbearance is required. But lenders do not comprehensively record or report forbearance. And practices potentially vary significantly between institutions. This lack of disclosure means that the precise scale of forbearance is unclear. There is some evidence, however, to suggest it could be material.

The FSA has recently collected evidence on the flow of residential mortgages into some kind of forbearance. In the year to March 2010, this was around four times the stock of mortgages in possession or in arrears of six or more months' payments (**Chart A**). It is impossible to know how these mortgages would have performed without forbearance. It is also difficult to know how recent forbearance compares with previous recessions.⁽²⁾ But it is likely that the reported figures for mortgage arrears would have been higher in the absence of forbearance.

To illustrate the potential extent of forbearance, consider a rough estimate of the proportion of UK banks' residential mortgage exposures subject to forbearance. This requires a

Chart A Breakdown of UK residential mortgages entering forbearance or in arrears^(a)



Source: FSA Prudential Risk Outlook, March 2011.

(a) The arrears figures are as at December 2009.

(b) Represents the number of changes made to mortgage contracts in the twelve months to March 2010 for forbearance purposes.

(c) Forbearance processes included are: capitalisation of existing arrears into the balance; a temporary or permanent transfer onto interest-only terms; term extensions; and reduced payments or payment holidays which do not accrue arrears.

number of crude assumptions. Assume, as a worst-case scenario, that the flow into forbearance shown in **Chart A** has persisted for two years and that none of these loans recovered or were foreclosed on. This would imply that, as an upper bound, 12% of UK residential mortgages could be receiving some kind of forbearance at present.

Market contacts suggest that forbearance has also been widespread in the commercial property sector. Where borrowers continue to service their loans, some lenders have reportedly waived breaches of LTV covenants and been willing to extend the duration of maturing lending or restructure loans on non-commercial terms.

A survey by De Montfort University suggests that, at end-2010, 12% of commercial property loans were in breach of financial covenant but had not been declared in default. This may, however, understate the number of loans in breach of their original terms. A report by the Property Industry Alliance suggests that around 80% of loans issued since the end of 2004 could be in breach of their LTV covenant. This is indicative of the uncertainty surrounding the extent of forbearance in this sector. Research by De Montfort University also suggests that up to 70% and 30% of the commercial property debt that should have matured in 2009 and 2010 respectively were extended for between one and three years.

Again, as an illustration, assume that the proportion of maturing loans estimated to have been extended for short periods in 2009 and 2010, and which are still outstanding, is indicative of the extent of forbearance across the whole book.

This rudimentary approach would suggest that around a third of UK commercial property lending could be receiving some kind of forbearance.

Contacts have suggested that, at the start of the financial crisis, banks were also forbearing on loans to large, highly leveraged firms in breach of covenants due to a fall in earnings. This, however, seemed to ease in late 2009 and 2010, as these borrowers benefited from improved investor appetite for high-yield bond issuance and refinancing.

Forbearance may also have been significant in the UK small and medium enterprise sector. Contacts suggest that forbearance is one reason why corporate default rates in the United Kingdom have remained low relative to past recessions. The extent to which UK banks have exercised forbearance on their overseas and unsecured household exposures is also unclear.

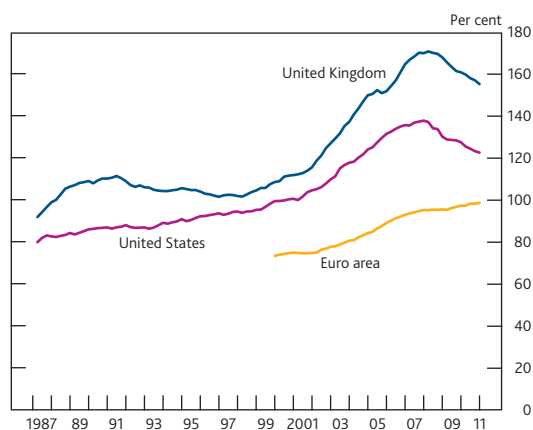
Forbearance would be less of a financial stability concern if provisions have been made against potential losses on forborne loans. But it is very difficult to gauge the extent to which banks have provisioned against these loans. The current 'incurred loss' accounting approach means that objective evidence of impairment and a measurable loss is required to make provisions. As loans subject to some types of forbearance are unlikely to be classified as non-performing, they may not have attracted specific provisions.⁽³⁾ Much of the improvement in banks' profits since 2009 has been the

result of a fall in provisions made against bad loans. If the scale of forbearance is significant, as the data suggest, banks' total provisions may not be sufficient to cover losses on these loans. This may heighten uncertainty among bank creditors about profit and capital positions.

Overall, it is difficult to quantify the scale of the risks outlined above. More information is required about the extent of forbearance, the methods employed, and associated provisioning practices to assess its impact on UK banks' robustness.

- (1) There is a body of evidence which suggests Japanese banks continued lending to borrowers at or near insolvency and that this had a negative impact on the investment and employment levels of 'healthy' industries. See Caballero, R J, Hoshi, T and Kashyap, A K (2008), 'Zombie lending and depressed restructuring in Japan', *American Economic Review*, Vol. 98, No. 5, pages 1,943–77. Although market contacts suggest this phenomenon has not been widespread in the United Kingdom, widespread forbearance could reduce banks' willingness and ability to supply new credit.
- (2) There are no data on the scale of forbearance in the 1990s recession and how it might have affected indicators of borrower distress. But there are reasons to believe it is likely to have been less prevalent, and that the type of forbearance offered would have had less of an impact on reported arrears figures. Lower interest rates, steeper falls in property prices and lower unemployment mean lenders are likely to have had stronger incentives to exercise forbearance in this recession than in the early 1990s. And contacts suggest that mortgage forbearance in the early 1990s tended to involve not taking action against borrowers in arrears, whereas more recently it has often involved taking mortgagors out of arrears, or helping them to avoid arrears altogether.
- (3) In its 2011 *Prudential Risk Outlook* the FSA noted that forbearance techniques should not be used to prevent loans being categorised as non-performing to avoid prudent provisioning. Lenders and their auditors should ensure that any loan impairments are fully recorded and that provisioning practices reflect fully estimates of future cash flow. The FSA has also published more detailed guidance on forbearance and impairment provisions for consultation. See www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_10.shtml.

Chart 2.18 Household debt relative to income^(a)



Sources: ECB, Thomson Reuters Datastream and Bank calculations.

(a) Households' gross debt as a percentage of a four-quarter moving sum of their disposable income.

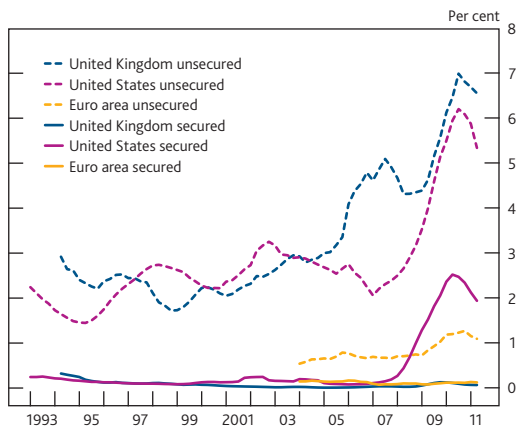
2.3 Household sector risks

Leverage remains high and collateral values are still at risk...

Household debt levels in some advanced economies increased sharply in the run-up to the financial crisis (Chart 2.18). Exceptionally low interest rates have helped to smooth the deleveraging process. Households in the United Kingdom and the United States have made some progress in reducing debt levels relative to income. But that has not happened in the euro area where nominal income growth has been weaker. Although the recovery in house prices in some countries in the first half of 2010 increased the value of banks' collateral, prices have since stalled in the face of weak consumer confidence. Most forecasters expect UK house prices to fall this year. Economists also expect lower prices in Ireland, Spain and the United States, to which UK banks are also exposed.

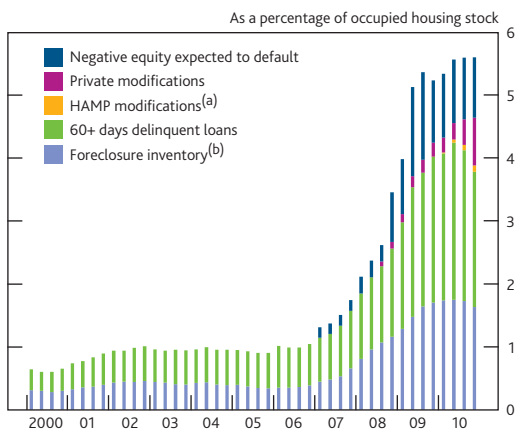
...particularly in the United States where a large inventory of houses potentially for sale has accumulated.

In the United States, write-offs on secured debt have been unusually high relative to past experience (Chart 2.19). The inventory of houses potentially for sale also remains very high by historical standards, posing downside risks to house prices

Chart 2.19 Household sector write-off rates^(a)

Sources: Bank of England, ECB, Federal Reserve and Bank calculations.

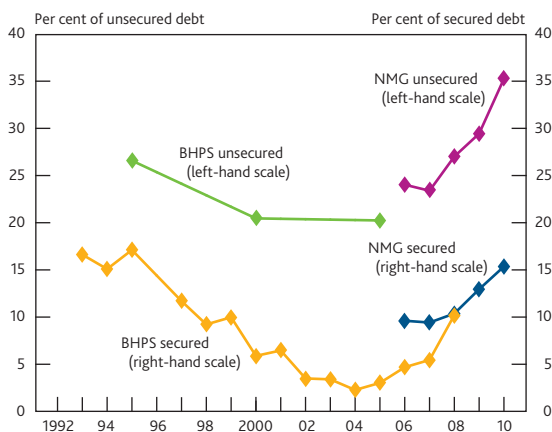
(a) Annualised quarterly write-offs divided by the corresponding loans outstanding at the end of the previous quarter, expressed as a four-quarter moving average.

Chart 2.20 Inventory of houses potentially for sale in the United States

Sources: IMF Global Financial Stability Report (April 2011), Thomson Reuters Datastream and Bank calculations.

(a) Home Affordable Modification Program. Loan modifications are where the lender has changed the terms of the loan to ease the repayment burden.

(b) Excludes banks' investments in real estate not held as loans or securities.

Chart 2.21 Illustrative estimates of debt held by vulnerable households^{(a)(b)}

Sources: British Household Panel Survey (BHPS), NMG Consulting survey and Bank calculations.

(a) Vulnerable mortgagors are those with housing equity below 5%, or housing equity below 25% and at least one characteristic suggesting debt-repayment difficulties. Vulnerable unsecured debtors are those with less than 25% housing equity (including renters) and at least one characteristic suggesting debt-repayment difficulties.

(b) Based on historical BHPS data and more timely information from the annual NMG survey. Differences in survey questions and sample size mean the estimates from the two surveys are not directly comparable.

and hence credit risks (**Chart 2.20**). That inventory includes borrowers who are still current on their payments but are in negative equity. In some states, borrowers in negative equity have an incentive to default as they are not liable for debt in excess of the value of the property. The IMF estimates that, even if house prices were to remain flat, more than 5% of the performing mortgages as of mid-2010 would be likely to default. In that scenario, some UK banks would face further credit losses on their exposures to the US housing sector.

So far losses have been contained with the help of forbearance...

To date, losses on secured credit have been exceptionally low in the United Kingdom, accounting for less than 4% of UK banks' total losses in 2010. Arrears and repossessions have reached much lower levels than in the United States and have been falling in recent quarters. The greater incidence of floating-rate mortgages in the United Kingdom, and the exceptionally low level of short-term interest rates, has made forbearance methods — such as switching a customer onto an interest-only loan — particularly effective in reducing the burden of repayment (**Box 2**).

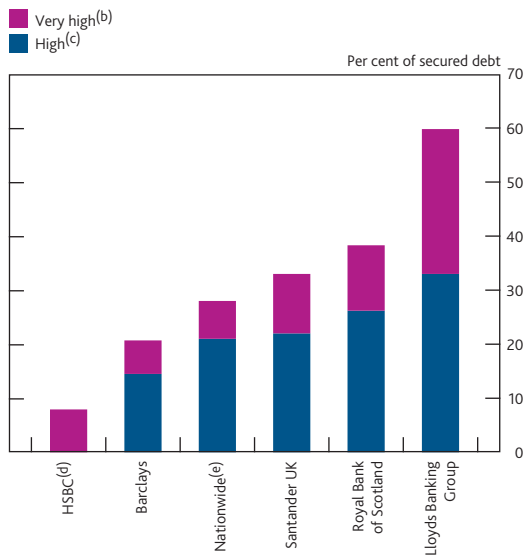
...which may have been disguising underlying risks.

But forbearance also means that the arrears data could significantly underestimate the underlying level of distress in the household sector, and hence the credit losses that banks could face were household payment difficulties to prove more persistent. In the Bank's *Credit Conditions Survey*, lenders reported an increase in the default rate and loss given default on secured loans in 2011 Q1 and expected both to increase further in Q2. They expressed concerns about the potential impact of increases in interest rates and falling house prices on credit losses.

The proportion of debt held by vulnerable UK households has been increasing...

An indication of underlying household vulnerabilities can be inferred from survey data. The NMG and BHPS surveys help identify households at an elevated risk of falling into arrears and potentially defaulting. Such 'vulnerable' households can be defined as those having limited housing equity and characteristics that suggest difficulties in making debt repayments, for example reporting that repayments are burdensome. **Chart 2.21** shows that the proportion of secured debt held by these vulnerable households has been increasing. The proportion of unsecured debt held by vulnerable households is relatively high and also rising. Significant variation in the proportion of high LTV borrowers across banks suggests that exposures to vulnerable households are likely to be concentrated in a few banks (**Chart 2.22**).

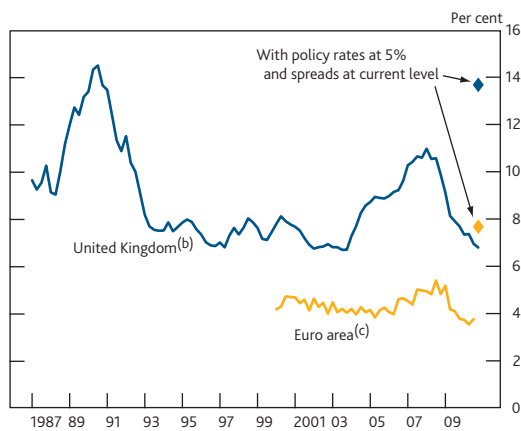
Chart 2.22 Major UK banks' domestic exposure to high and very high LTV secured debt^(a)



Source: Published accounts.

- (a) Year-end 2010 data except for Barclays (30 June 2010) and Nationwide (4 April 2011).
 (b) A very high LTV ratio is defined as one over 90%.
 (c) A high LTV ratio is defined as one between 70%–90% except for Barclays and Santander UK (75%–90%).
 (d) Data only available for LTV ratios of more than 90%.
 (e) Nationwide data include foreign exposures but these are very small.

Chart 2.23 Household income gearing^(a)



Sources: ECB, ONS and Bank calculations.

- (a) Income gearing is measured as household interest payments as a percentage of disposable income.
 (b) Includes an adjustment for Financial Intermediation Services Indirectly Measured (FISIM).
 (c) Includes a Bank estimate for FISIM based on individual euro-area data.

...and risks from these households could be crystallised by fiscal tightening...

These vulnerable households' incomes could be affected by fiscal consolidation. Responses to the 2010 NMG survey imply that around two thirds of secured and unsecured debt identified as 'vulnerable' is held by households who are concerned about job or income loss as a result of the fiscal tightening. But such concerns may partly reflect uncertainty about which public sector jobs will be lost. A survey by the Chartered Institute of Personnel and Development reports that almost one in three public sector workers are worried about losing their jobs. The Office for Budget Responsibility estimates that around one in fourteen public sector jobs will actually be lost.

...or an unexpected increase in interest rates.

In the United Kingdom, in common with some other European countries such as Italy, Portugal and Spain, a relatively high proportion of mortgages taken out since 2009 have floating interest rates. This means that they are exposed to increases in short-term interest rates. **Chart 2.23** illustrates that if policy rates were to rise to 5% — assuming for simplicity that debt, spreads and income remained unchanged — then income gearing in the United Kingdom could reach levels seen in the early 1990s, when nominal interest rates were much higher. That reflects much higher debt levels relative to income than prevailed in the early 1990s. In practice, the impact of higher interest rates would depend on the wider economic environment, with higher interest rates against a backdrop of robust growth likely to have a more benign impact than if growth were weak.