

Executive summary

The interim Financial Policy Committee (FPC) agreed the following policy recommendations at its meeting on 23 November:

- Following its recommendation from September, and given the current exceptionally threatening environment, the Committee recommends that, if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months.
- The Committee reiterates its advice to the FSA to encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy.
- The Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.

The Committee judged that this advice was appropriate in light of its conclusions about the outlook for financial stability.

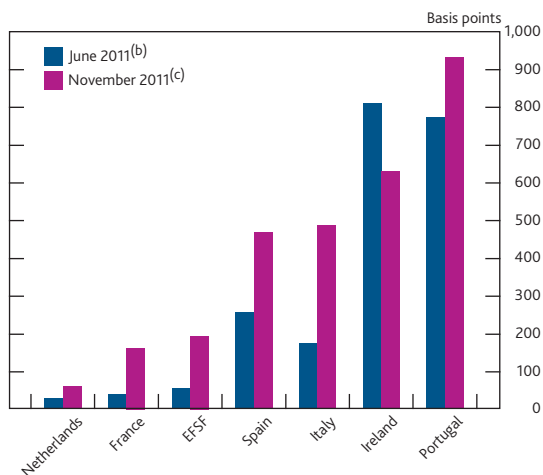
Risks

Sovereign and banking risks emanating from the euro area remain the most significant and immediate threat to UK financial stability. These risks have intensified materially since the June 2011 *Report*. Against a backdrop of slowing global growth prospects, market concerns about the sustainability of government debt positions of smaller economies have broadened to larger euro-area economies (**Chart 1**). Capital market functioning has deteriorated and risky asset prices have fallen sharply. Risk capital has been reallocated, as investors have sought to reduce exposures to vulnerable euro-area countries and to riskier assets more broadly.

European authorities announced a package of measures in October 2011 to stem the crisis. Market reaction, however, suggests that concerns remain over their implementation and effectiveness.

UK banks have significant refinancing needs. And while their direct exposures to the sovereign debt of the most vulnerable economies are limited, they have larger exposures to the private sectors of some weaker euro-area economies. They also have significant exposures to major European banking

Chart 1 Spreads of selected euro-area government bonds over German bunds^(a)



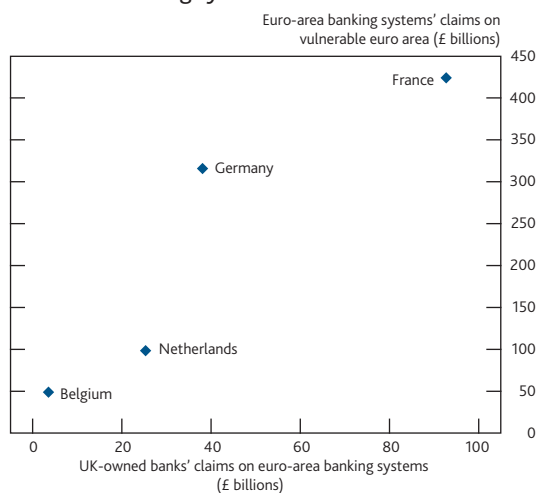
Sources: Thomson Reuters Datastream and Bank calculations.

(a) Ten-year government and EFSF bond spreads over German bunds.

(b) Spreads as at 15 June 2011 except for EFSF spread, which is as at 17 June 2011.

(c) Spreads as at 22 November 2011.

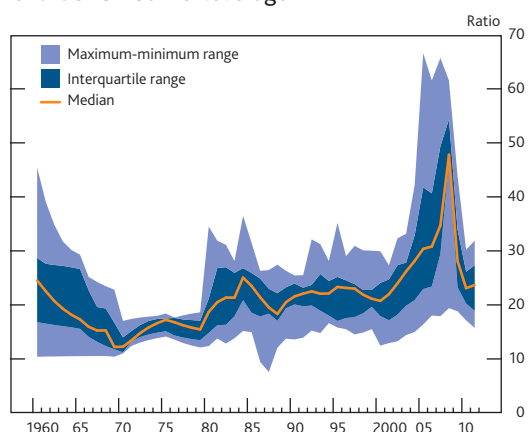
Chart 2 Claims on vulnerable euro-area countries via euro-area banking systems^{(a)(b)}



Sources: BIS consolidated banking statistics and Bank calculations.

- (a) All data are as at end-June 2011. Converted from US dollars into sterling using end-June exchange rate.
 (b) X-axis shows consolidated ultimate risk basis foreign claims by UK-owned banks on the banking systems of selected euro-area countries. Y-axis shows consolidated ultimate risk basis foreign claims on all sectors of Greece, Ireland, Italy, Portugal and Spain by selected euro-area banking systems.

Chart 3 UK banks' leverage



Sources and footnotes: see Chart 2.4.

Table A Deleveraging plans of selected European banks

€ billions	Bridgewater estimates	Deutsche Bank estimates	Morgan Stanley estimates
Barclays	–	20	–
Lloyds Banking Group	–	175	72
Royal Bank of Scotland	–	121	93
HSBC	–	–	83
BNP Paribas	67	81	>50
Société Générale	70	85	75–95
Crédit Agricole	–	17	50
Commerzbank	31	188	100
Deutsche	30	–	90
Dexia	–	113	191
Santander	52	–	17
NAMA Ireland	–	28	74
Bank of Ireland	–	30	19
Credit Suisse	90	103	90
Other Europe	139	319	1,016
Total Europe	480	1,281	2,020

Sources and footnotes: see Table 2.B.

systems, which in turn are highly exposed to weaker euro-area countries (Chart 2).

Resilience

UK banks have made significant progress in improving their capital and funding resilience since the height of the crisis (Chart 3). But progress has been set back recently and they have been affected by strains internationally in bank funding markets. While UK banks' credit default swap premia generally remain below those of many euro-area banks, they are mainly higher today than at their peak in 2008. This indicates ongoing concerns about UK banks' solvency and the weakening outlook for banks' profitability.

The Committee is concerned that current strains are being amplified by ongoing structural vulnerabilities in the financial system, particularly a high degree of intra-financial system exposures. Opaque and overly complex regulatory risk-weight calculations and inconsistent and incomplete disclosure have increased uncertainty about bank resilience. The growing use of central counterparties (CCPs) is reducing interconnectedness, but increasing the financial stability risks in the unlikely event that a CCP were to face severe distress or fail. That highlights the importance of robust risk management practices and the establishment of effective crisis management arrangements.

Credit conditions

Credit conditions could tighten in the United Kingdom if term funding conditions remain strained or banks' profits are reduced by higher credit losses on exposures to the euro area. There are early indications from market contacts that some banks may be starting to pass on higher funding costs to household and corporate customers through higher prices. And there are signs already of a credit contraction in the euro area, with considerable uncertainty around banks' plans to reduce balance sheets (Table A). Tightening credit conditions internationally could exacerbate the adverse feedback loop of weak macroeconomic activity and deteriorating bank asset quality, which could ultimately harm the resilience of the financial system.