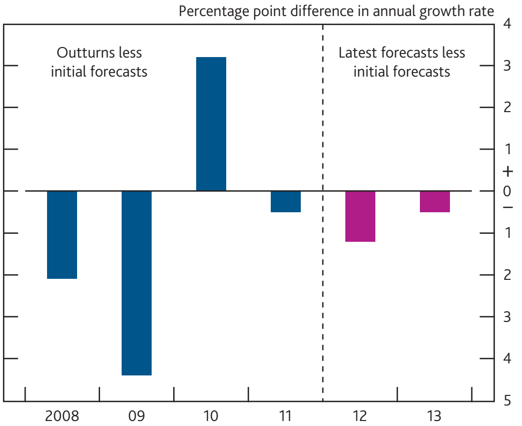
1 Global financial environment

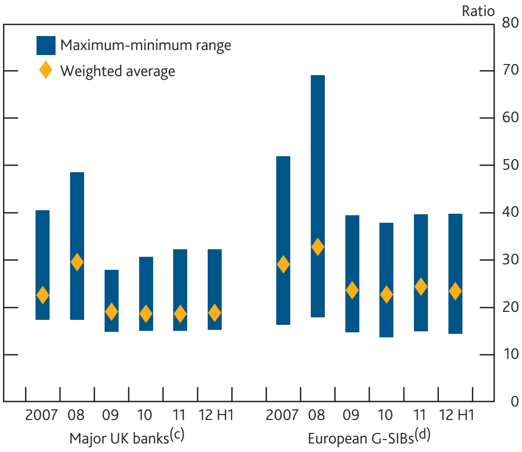
Global growth prospects remained weak reflecting the continuing adjustment of imbalances that built up before the financial crisis. With the economic and financial environment remaining fragile, several central banks announced substantial further policy action. In the euro area, this helped assuage market concerns about the most severe sovereign risks. Financial asset prices increased internationally and there were signs of portfolio rebalancing into riskier assets. Bank funding conditions also improved. Credit conditions in the United Kingdom showed some signs of improvement but remained tight, while in the euro area they tightened further.

Chart 1.1 Global growth revisions



Sources: IMF *World Economic Outlook* and Bank calculations.

Chart 1.2 Leverage ratios(a)(b)



Sources: Bank of England, Capital IQ, SNL Financial, published accounts and Bank calculations.

(a) Leverage ratio is defined as total assets divided by total equity.
(b) 2007 to 2011 show year-end positions. Due to different reporting years, March data are used for Nationwide and October data for National Australia Bank. Where 2012 H1 data are not available yet, end-2011 data have been used.
(c) Banco Santander, Bank of Ireland, Barclays, Co-operative Banking Group, HSBC, Lloyds Banking Group, National Australia Bank, Nationwide and Royal Bank of Scotland.
(d) BBVA, BNP Paribas, Crédit Agricole Group, Deutsche Bank, Groupe BPCE, ING Bank, Nordea, Société Générale, UBS and UniCredit Group. Credit Suisse is not included as it reports financial results according to US GAAP which is not easily comparable to IFRS results due to the treatment of derivatives and off balance sheet vehicles. All other G-SIBs report on an IFRS basis.

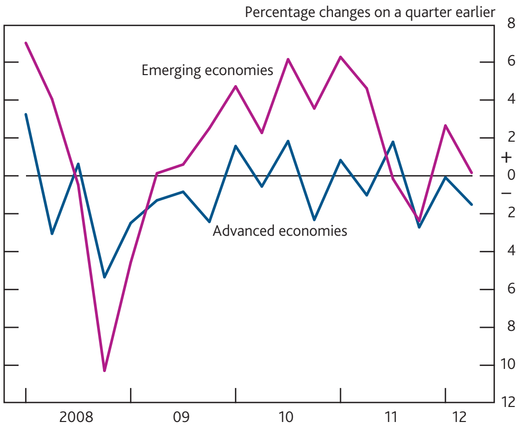
This section summarises key developments in the global financial environment since the June 2012 *Report*, including the provision of financial services to UK households and companies during this period. The rest of the *Report* examines: short-term (Section 2) and medium-term (Section 3) risks to the financial system; the activity of the FPC and progress on previous recommendations (Section 4); and, against that backdrop, the policy actions that the FPC advises to reduce risks to the financial system (Section 5).

Global growth has remained weak…

Since the June 2012 *Report*, prospects for the world economy have deteriorated. Survey indicators pointed to a weaker near-term outlook. And, in October, the International Monetary Fund (IMF) revised down its forecasts for 2013 growth, particularly in Europe but in major emerging economies as well. That was consistent with the pattern of revisions to global growth forecasts since 2007: only in 2010 did growth turn out higher than initially expected (**Chart 1.1**). The IMF also judged that the downside risks to global growth had increased.

The weak global growth outlook reflected continuing adjustment of imbalances that built up before the financial crisis, in particular the process of balance sheet repair in advanced economies. Private sector debt remained elevated relative to GDP, notwithstanding declines since 2009. Public sector debt was at a level around 30 percentage points higher as a share of GDP than at the start of the crisis (Section 3). Banks' leverage ratios fell after 2008 (**Chart 1.2**), as the level of banks' assets fell in 2009 and capital increased, but have since levelled off. And the dispersion of current account deficits and surpluses across countries remains wide, despite improvements since the beginning of the financial crisis. Market contacts continue to highlight uncertainty around the resolution of imbalances, and the risk that weak growth may persist, as key financial stability concerns (Section 3).

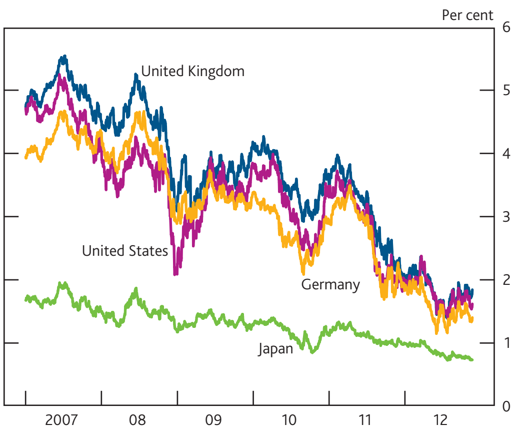
Chart 1.3 Gross cross-border claims by all BIS-reporting banks by recipient region[(a)]



Sources: Bank for International Settlements (BIS) and Bank calculations.

(a) Change in BIS-reporting banks' aggregate cross-border claims by region, exchange rate adjusted.

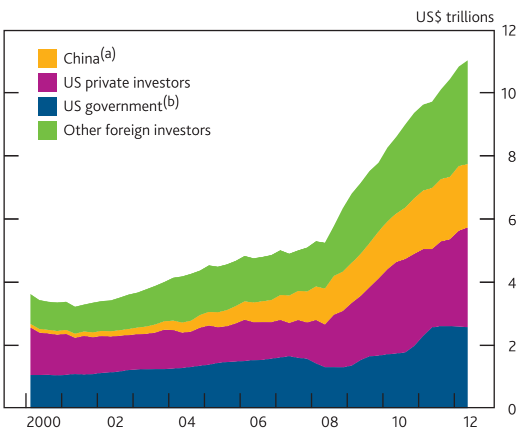
Chart 1.4 International ten-year spot government bond yields[(a)]



Source: Thomson Reuters Datastream.

(a) Yields to maturity.

Chart 1.5 Holdings of US Treasury securities



Sources: CEIC, Federal Reserve US flow of funds, IMF COFER and Bank calculations.

(a) Assumes proportion of Chinese reserves held as Treasuries is the same as the world average. Other foreign holdings are calculated as the residual between total foreign holdings of Treasuries and the estimate of Chinese holdings.
(b) Includes holdings by state and local government, government retirement funds, government-sponsored enterprises and the Federal Reserve.

…as euro-area banks continued to deleverage.

As part of the process of balance sheet repair, deleveraging by banks has continued, albeit with some signs of slowing. Cross-border financing within the euro area continued to fall — referred to as a 'fragmentation' of the euro-area banking system (Box 1). That was reflected in continued non-resident deposit outflows from the vulnerable euro-area countries. And domestic deposit outflows continued in Portugal and Spain, although domestic deposits increased in Greece, Ireland and Italy in the three months to September.

Cross-border financing patterns outside the euro area were more positive. After a sharp fall at the end of 2011, lending outside the euro area by euro-area resident banks was steadier in 2012. However, there were reports that euro-area banks were seeking to make their subsidiaries outside the euro area more reliant on local funding. Globally, aggregating across banks, cross-border bank deleveraging in 2012 was significantly less severe than during 2008–09 (**Chart 1.3**).

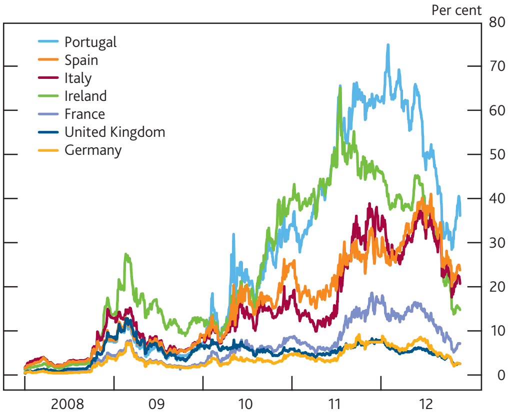
But there was evidence of continuing retrenchment by banks in some types of lending. Issuance of syndicated loans to emerging economies continued to decline. And there were also falls in the provision of trade finance by euro-area banks — to less than half the level in 2010 — and by non euro-area banks. This was unlikely to have been fully offset by increases in non-bank lending.

The fragile environment prompted substantial policy action by authorities…

Several authorities announced substantial further policy action in response to this fragile environment. In July, the Bank of England and the UK Government launched the Funding for Lending Scheme (FLS) to provide banks and building societies with a cheaper form of financing for domestic lending. In September, the European Central Bank (ECB) announced its Outright Monetary Transactions (OMTs) programme to purchase short-term government bonds issued by certain euro-area countries, with the aim of reducing government bond yields where they reflect unjustified market fears of a euro-area country redenominating its currency. A condition for initiating OMTs is that a country must have been granted a European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) programme. In October, EU leaders agreed a timetable for implementing a Single Supervisory Mechanism to give the ECB ultimate responsibility regarding specific supervisory tasks for euro-area banks.[(1)]

(1) Under the proposals, the ECB would become responsible for a number of tasks such as: authorising credit institutions; compliance with capital, leverage and liquidity requirements; and conducting supervision of financial conglomerates. The ECB would be able to carry out early intervention measures when a bank breaches or risks breaching regulatory capital requirements.

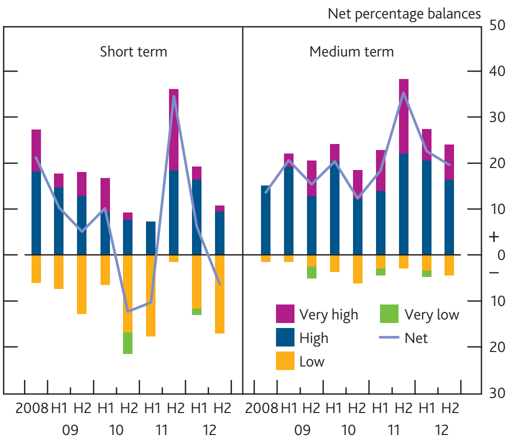
Chart 1.6 Market-implied default probabilities over the next five years for selected sovereign debt[(a)]



Sources: Markit Group Limited and Bank calculations.

(a) Probability of default, derived from CDS premia, from the perspective of a so-called 'risk-neutral' investor that is indifferent between a pay-off with certainty and an uncertain pay-off with the same expected value. If market participants are risk-averse, these measures may overstate actual probabilities of default. A loss given default of 60% is assumed.

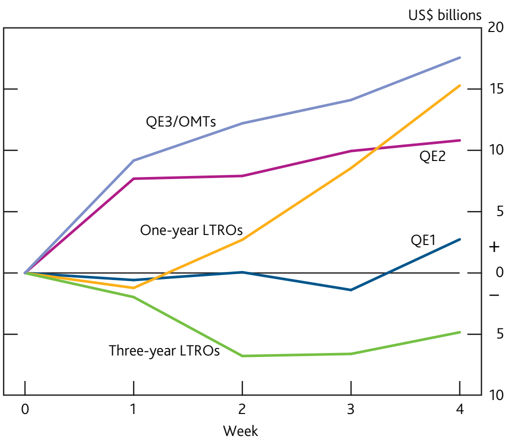
Chart 1.7 Probability of a high-impact event in the UK financial system[(a)]



Sources: Bank of England *Systemic Risk Surveys* and Bank calculations.

(a) Respondents were asked for the probability of a high-impact event in the UK financial system in the short and medium term. From the 2009 H2 survey onwards, short term was defined as 0–12 months and medium term as 1–3 years. The net percentage balance is calculated by weighting responses as follows: very high (1), high (0.5), medium (0), low (-0.5) and very low (-1). Bars show the contribution of each component to the net percentage balance.

Chart 1.8 Cumulative flows into higher-risk assets following central bank policy announcements[(a)(b)]



Sources: EPFR Global and Bank calculations.

(a) 'Higher-risk assets' include emerging market equities, emerging market and US high-yield bonds.
(b) Chart begins at the dates of official policy announcements: the first set of US Federal Reserve asset purchases, known as QE1, on 25.11.08; QE2 on 3.11.10; the ECB's two one-year longer-term refinancing operations (LTROs) on 6.10.11; the ECB's two three-year LTROs on 8.12.11; and QE3 on 13.9.12. OMTs were announced the week before QE3.

These measures were accompanied by other central bank policy actions. The US Federal Reserve announced further asset purchases in September, which will continue until the labour market outlook has improved substantially. It also announced that it anticipated that the federal funds rate would remain at exceptionally low levels until at least mid-2015. The Bank of England announced a further round of asset purchases in July, as did the Bank of Japan in September. In the euro area, the main refinancing interest rate was reduced by 25 basis points in July to 0.75%, a record low. Policy rates were also cut by central banks in Australia and China, as the outlook for GDP growth weakened.

...as yields on less risky assets remained near historical lows.
Against this backdrop, yields on US, UK and German government bonds remained near historically low levels (**Chart 1.4**). Yields remained low despite high levels of public sector debt. US private investors and foreign investors, including China, have significantly increased their US Treasury debt holdings since the start of the financial crisis, by about US$2 trillion and US$3 trillion respectively (**Chart 1.5**).

Policy action reduced the risk of high-impact events...
In the euro area, policy measures helped assuage market concerns about the most severe sovereign risks. For example, the cost of default protection on Spanish sovereign debt, as measured by credit default swaps (CDS), fell to its lowest level since July 2011 (**Chart 1.6**). Respondents to the Bank of England's 2012 H2 *Systemic Risk Survey* reported that the perceived probability of a high-impact event in the UK financial system in the short term had fallen back further from its peak a year earlier (**Chart 1.7**).

...and encouraged portfolio rebalancing into riskier assets...
There were some signs that the low-yield environment was encouraging portfolio rebalancing, with investors seeking higher yields by moving into riskier assets. Following the announcement of further asset purchases by the US Federal Reserve (QE3) and OMTs by the ECB, it appeared that capital flowed into riskier asset classes (such as US high-yield bonds, and bonds and equities in emerging economies) to a greater extent than following other central bank policy announcements (**Chart 1.8**). Market contacts thought this might reflect the open-ended nature of QE3, which distinguished it from previous asset purchase announcements. Flows into riskier assets increased as fund managers progressively ran down their excess cash holdings. Consistent with this, global fund managers' asset allocations were reported to have switched from being overweight in cash in July — relative to past average positions — to being underweight in November (**Chart 1.9**).

In the United States, market contacts reported that the impact of portfolio rebalancing was particularly marked in domestic credit markets. Unlike during the mid-2000s, purchases of

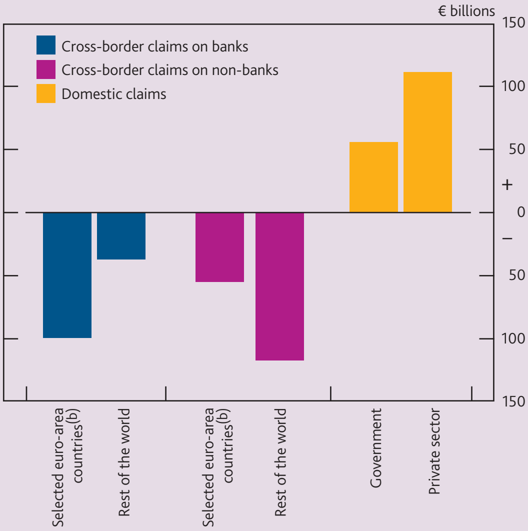
Box 1
Euro-area banking sector fragmentation

Over the past year, international banks and investors have actively reduced their cross-border activities. This trend has been particularly evident in the euro area. This box examines the scale, causes and impact of recent euro-area banking sector fragmentation.

The extent of fragmentation

Since the reintensification of the European sovereign debt crisis in 2011 H2, global banks' consolidated cross-border claims on the euro area have fallen by US$950 billion. Within the euro area, bank deleveraging has further contributed to a fragmentation of banking sectors along national lines. In particular, since June 2011 banks in Germany and France have reduced their claims on banks in vulnerable euro-area countries by €100 billion (**Chart A**) and, to a lesser extent, their claims on the public and non-financial private sectors of these countries by another €55 billion. At the same time, banks in Germany and France have increased their domestic exposures by €170 billion.

Chart A Change in French and German resident banks' claims since June 2011[(a)]



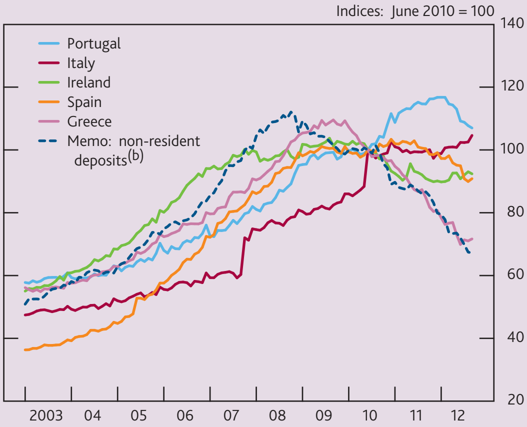
Sources: BIS, ECB, national central banks and Bank calculations.

(a) Data to June 2012.
(b) Refers to Greece, Ireland, Italy, Portugal and Spain.

The reduction in cross-border financing can be seen in a pickup in non-resident deposit outflows from some euro-area banking systems since the beginning of the euro-area debt crisis in 2010. During much of that period, foreign banks became increasingly reluctant to provide funding to banks, first to those in Greece, Ireland and Portugal, and then to those in Spain and Italy. Since mid-2010, total non-resident deposits from these countries have declined by 33% or €570 billion.

Resident retail depositor flight has also been significant over this period for some countries. In Greece, retail deposits have declined by 30% since June 2010, and in Spain by 12% since capital flight began there in June 2011 (**Chart B**).

Chart B Resident retail deposits in selected euro-area countries[(a)]

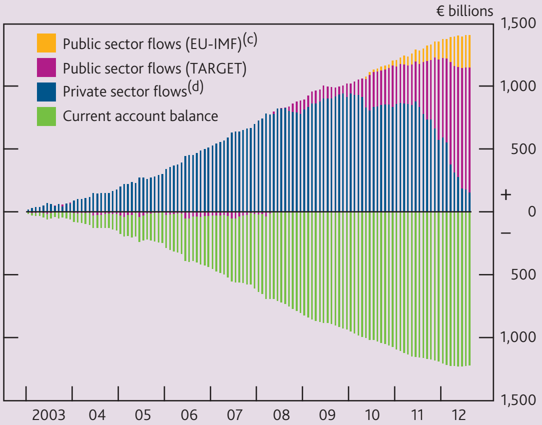


Sources: National central banks and Bank calculations.

(a) Data to September 2012.
(b) The sum of non-resident deposits in Greece, Ireland, Italy, Portugal and Spain.

Since mid-2011, deposit flight, as well as deleveraging of other types of assets by banks and investors, has contributed to €700 billion of private capital outflows from the vulnerable euro-area countries (**Chart C**). That equates to around a quarter of these countries' aggregate nominal GDP in 2011. Inflows of private capital helped to fund the current account deficits of the vulnerable euro-area countries in the period before the crisis. Since then, outflows of private capital have been largely replaced by a rise in public sector inflows.

Chart C Cumulative capital flows for selected euro-area countries[(a)(b)]



Sources: Central Statistics Office, European Commission, IMF, national central banks and Bank calculations.

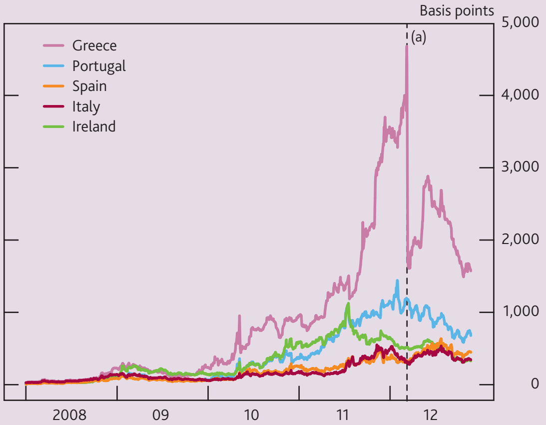
(a) Refers to Greece, Ireland, Italy, Portugal and Spain.
(b) Data to August 2012, with the exception of balance of payments data for Ireland, which is to June 2012 and extrapolated thereafter.
(c) Loans disbursed under joint financing package with contributions from the EFSM, the EFSF, individual EU members under bilateral arrangements, and the IMF.
(d) The sum of the financial and capital accounts net of public sector flows.

Although some vulnerable euro-area countries have benefited from EU-IMF programme finance, public sector inflows have largely taken the form of increased intra-Eurosystem TARGET liabilities[1] as stressed banking sectors have become reliant on ECB liquidity support. While there has been a rapid shrinking of current account deficits in vulnerable euro-area countries since private capital outflows began, the presence of such central bank inflows has slowed the speed of this adjustment and helped to prevent a disorderly unwind of external imbalances.

Causes of euro-area fragmentation

Since the beginning of the euro-area debt crisis in early 2010, investors have been less willing to hold the sovereign debt of the more vulnerable euro-area countries. That has manifested itself in an increased differentiation of risk premia and the cost of credit across countries (**Chart D**), as well as a reduction in cross-border claims on those countries. These in turn reflect the broader deterioration in the credit outlook and an increase in redenomination and legal risks that would arise if the euro area were to break up (Section 2).

Chart D Selected ten-year government bond spreads to German bunds



Sources: Thomson Reuters Datastream and Bank calculations.

(a) Greek debt restructuring agreed on 9 March 2012.

Market contacts suggested that some global institutions were already moving towards a business model in which more activities are funded locally, and that market participants were increasingly managing risk along sovereign, rather than currency, lines. These developments help to reduce the risks of redenomination. And in some countries, this has been reinforced by changing supervisory attitudes.

Conclusion

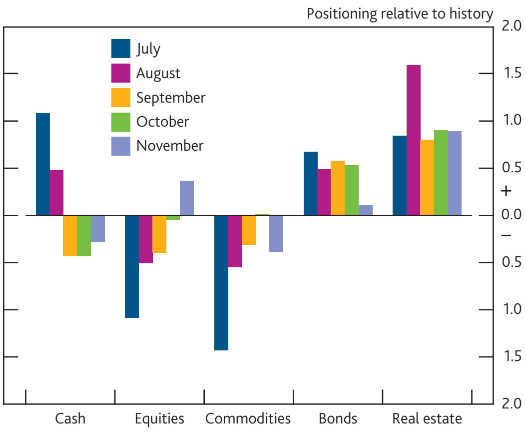
Fragmentation within the euro area, were it to continue at this pace, would pose significant risks to financial stability. Reduced cross-border credit has already contributed to acute funding pressures for vulnerable euro-area banks and a deterioration of their asset quality. It has also led to restricted credit supply in vulnerable euro-area countries.

Since the ECB announcement of Outright Monetary Transactions in September, aimed at lowering the borrowing costs of vulnerable euro-area countries and at providing a backstop against tail risks in the euro area, there have been tentative signs of a slowdown in fragmentation. September data show a fall in TARGET liabilities of €48 billion across the vulnerable euro-area countries and a stabilisation in deposit outflows from banks in vulnerable euro-area countries as domestic retail deposits increased by €42 billion. TARGET liabilities have since fallen by another €34 billion across Spain and Italy in October.

But banks in vulnerable euro-area countries still had foreign deposits of €1.2 trillion as at end-September. And latest quarterly BIS international banking statistics indicate French and German-owned banks alone still had €700 billion of consolidated cross-border claims on vulnerable euro-area countries as at end-June. So despite some signs of easing, the potential for further significant fragmentation remains.

(1) TARGET2 is a payment system owned and operated by the Eurosystem for the settlement in central bank money of central bank operations, interbank transfers and other large-value euro-denominated payments.

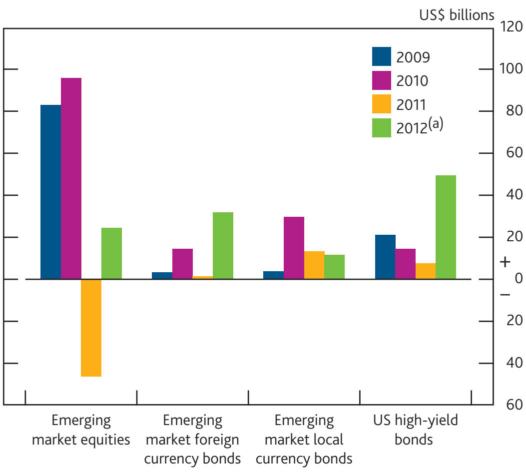
Chart 1.9 Global asset class positioning by investment funds[a]



Source: Bank of America Merrill Lynch Global Research.

(a) Positioning captures whether funds are overweight (positive scores) or underweight (negative scores) in each asset class relative to historical asset allocations. Historical asset allocations are based on data since 2006 for commodities and real estate and since 2001 for equities, bonds and cash.

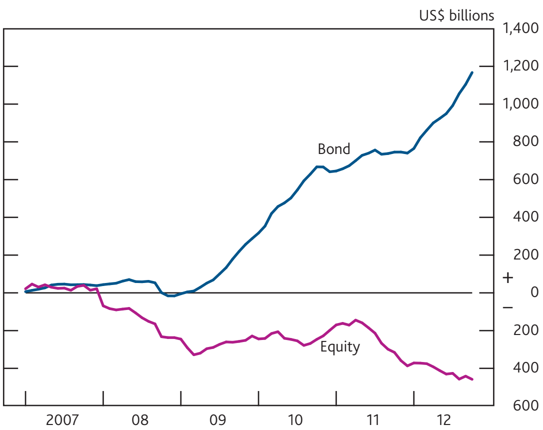
Chart 1.10 Flows into mutual funds investing in higher-risk asset classes



Sources: EPFR Global and Bank calculations.

(a) Year to date.

Chart 1.11 Cumulative investment flows into equity and bond funds



Source: EPFR Global.

credit instruments were not generally financed by borrowing. An exception to that was the rapid growth since 2010 in mortgage-backed securities held by real estate investment trusts (REITs). Market intelligence suggested that REITs have bought mortgage-backed securities with funds raised in wholesale markets.

There were also signs of portfolio rebalancing starting to emerge in the UK insurance sector. Market contacts reported that some insurance companies were considering significant changes in investment portfolios as they chased yields and diversified away from traditional fixed-income securities. The potential changes included increased allocations to infrastructure investment and, to a lesser extent, direct lending to the corporate sector. This was against the backdrop of continued pressure on insurers' profits and capital, reflecting subdued growth, the low interest rate environment and the continuing euro-area crisis.

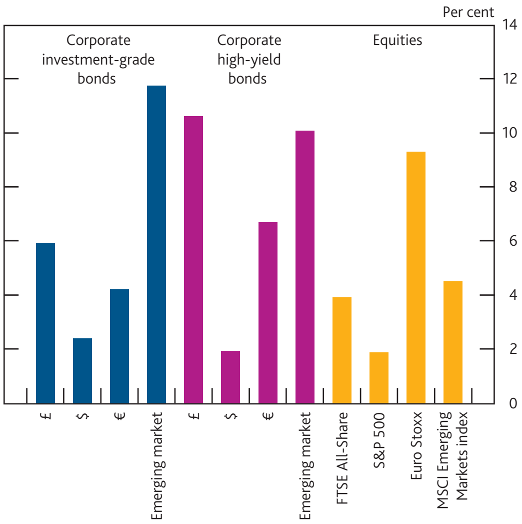
...with investor flows concentrated in simple and transparent assets, particularly bonds.

Investor flows were concentrated in simple and transparent assets, with investors remaining wary of more complex and opaque assets. While contacts reported some flows into standard securitisation products, there was no re-emergence of the synthetic securitisations seen pre-crisis. There was also some discrimination within bond markets. Flows into local-currency denominated emerging market bonds were weaker than in 2010–11 (**Chart 1.10**). Instead, there was a preference for US high-yield bonds and emerging market bonds denominated in US dollars.

One aspect of pre-crisis bond markets that saw a revival in activity in 2012 was payment in kind (PIK) toggles on bonds — where the interest may be paid in cash or additional debt securities. But contacts noted that recent deals were concentrated among a small group of investors who were thought to be aware of the risks, while the issues themselves offered more investor protection than pre-crisis issues and were priced at a greater discount to vanilla bonds.

Pension funds have increasingly moved into bonds in recent years, as they have sought to match their assets more closely to their liabilities. In 2012, UK defined benefit pension funds held 43% of their assets in gilts and fixed-interest instruments compared with 39% in equities. This was the highest allocation to gilts and fixed-interest instruments recorded by The Pensions Regulator since the series began in 2006. Since the start of the financial crisis, there has been a broader trend in financial markets for investors to move into bonds. Flows to global equity funds have been relatively weak since 2007, while flows to bond funds have been relatively strong (**Chart 1.11**).

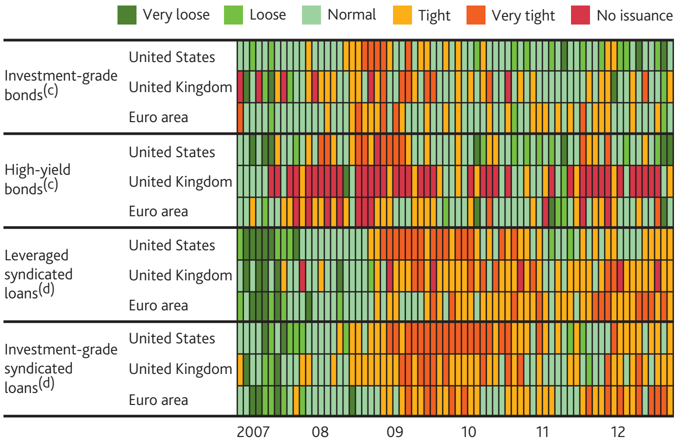
Chart 1.12 Changes in asset prices since the June 2012 *Report*(a)



Sources: Bank of America Merrill Lynch, Thomson Reuters Datastream and Bank calculations.

(a) Calculated in local/stated currency, except emerging markets which are calculated in US dollars.

Chart 1.13 Primary corporate debt market conditions(a)(b)



Sources: Dealogic and Bank calculations.

(a) Shading is based on a score that reflects gross issuance (relative to nominal GDP) and spreads in primary markets, expressed as a number of standard deviations from its historical averages, using available data from January 1998. Where spreads are not available, indicators are based solely on issuance. Latest data point is October 2012 (using most recent GDP data).
(b) Only private non-financial corporates are included and their financial vehicles are excluded.
(c) Gross issuance of bonds.
(d) Gross issuance of syndicated loans, excluding cancelled or withdrawn facilities.

Policy action underpinned rises in asset prices...

Portfolio rebalancing supported a rise in global asset prices, despite the weaker prospects for world growth. Emerging market dollar-denominated sovereign bond spreads fell significantly, by about 80 basis points. And spreads on corporate bonds fell across advanced and emerging market economies. In equity markets, European and emerging market indices recovered, rising by 9% and 4% respectively, since the June 2012 *Report* (**Chart 1.12**).

...and increased financial market activity...

Some companies were able to take advantage of improved market conditions to issue new debt, as conditions generally improved in both investment-grade and high-yield corporate bond markets, although conditions in syndicated lending markets remained tight (**Chart 1.13**). Issuance of bonds by UK private non-financial corporations (PNFCs) was around 40% higher than a year earlier. And there were large increases in US and euro-area PNFC bond issuance. There was also some improvement in conditions in government bond markets for vulnerable euro-area countries. Italy was able to raise €18 billion in a single issuance of index-linked government bonds — a European record.

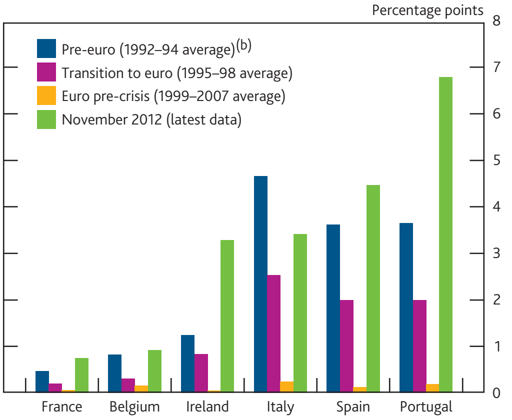
While issuance increased, bond market liquidity remained low. For example, market-making inventories in US corporate bond markets (which facilitate trades between buyers and sellers of the bonds) have declined significantly since the start of the financial crisis, in part because low interest rates reduce the income that dealers earn. Trading volumes as a percentage of the outstanding corporate bond market have fallen to less than half pre-crisis levels. Contacts thought that anticipation of regulatory developments constraining proprietary trading may have contributed to this development.

...including in derivatives markets...

Activity also continued to recover in some derivatives markets. By the end of 2012 H1, measured by notional value, the amount of over-the-counter (OTC) interest rate swaps outstanding was 23% higher, and foreign exchange derivatives 19% higher, than at the end of 2007. But CDS activity remained subdued, with the stock of outstanding derivatives down by half since the start of the financial crisis. And there was little progress in increasing the proportion of standardised OTC derivatives cleared through central counterparties (CCPs).

Since the June *Report*, there have been several developments that help to enhance CCPs' ability to absorb losses. In August, LCH.Clearnet Ltd (LCH) established a new ring-fenced default fund of approximately £500 million in respect of its clearing of repo transactions. This followed the introduction earlier in the year of ring-fenced default funds in respect of its clearing of interest rate swaps (IRS) and foreign exchange non-deliverable forwards (FX NDF), of approximately £2.5 billion and £175 million respectively as of August 2012. Previously LCH

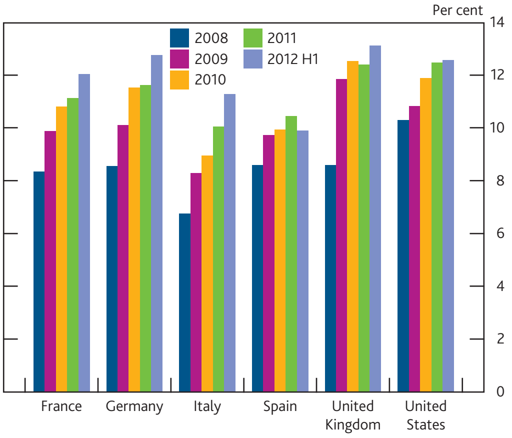
Chart 1.14 Spreads of selected euro-area government bonds over German bunds[(a)]



Sources: Thomson Reuters Datastream and Bank calculations.

(a) Ten-year benchmark government bond spreads over German bunds.
(b) Data for Portugal cover July 1993 to December 1994.

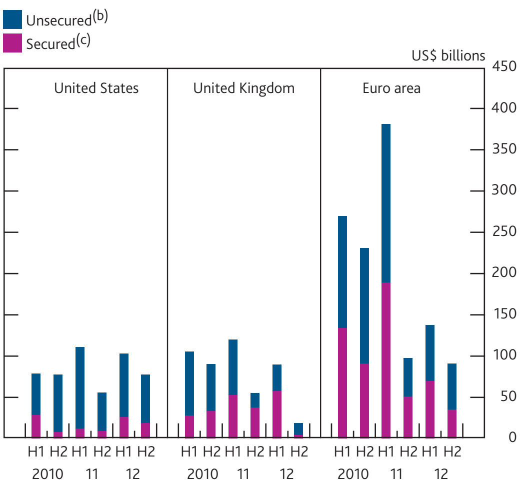
Chart 1.15 Tier 1 capital ratios[(a)(b)]



Sources: SNL Financial, published accounts and Bank calculations.

(a) Data are to end-year 2008–11 and to end-June for 2012.
(b) Aggregated Tier 1 capital divided by aggregated (risk-weighted) assets. All figures are under local accounting conventions.

Chart 1.16 Issuance of term bank senior secured and unsecured debt in public markets[(a)]



Sources: Dealogic and Bank calculations.

(a) Securities with an original contractual maturity or earliest call date of at least 18 months. Includes primary market issuance only and excludes issuance under government-guarantee schemes. 2012 H2 data are up to and including 20 November 2012.
(b) Unsecured issuance includes investment-grade and high-yield bonds and medium-term notes.
(c) Secured issuance includes asset-backed securities, mortgage-backed securities and covered bonds.

had maintained a single default fund across all its services of £585 million.[(1)] New default 'waterfall' arrangements were also introduced earlier this year for IRS, FX NDF and repo clearing, allowing LCH to call for additional resources from clearing members, up to a limit, in the event that a loss were to exceed the default fund.[(2)]

...while financial infrastructure generally operated effectively.

More generally, central financial infrastructure in the United Kingdom continued to function effectively. Over the period July-October 2012, the operational availability of CREST improved relative to the first half of the year, with no material interruptions to settlement. While there was a brief outage of the SWIFT secure messaging system, the timing meant that there was no disruption to UK wholesale payment systems. However, Royal Bank of Scotland experienced a serious problem with its internal systems in June, causing difficulties for its banking customers that in some cases continued into July. While UK financial infrastructure generally operated effectively, market infrastructure in the United States was disrupted by the effects of Hurricane Sandy in late October, with the New York Stock Exchange closing for two days.

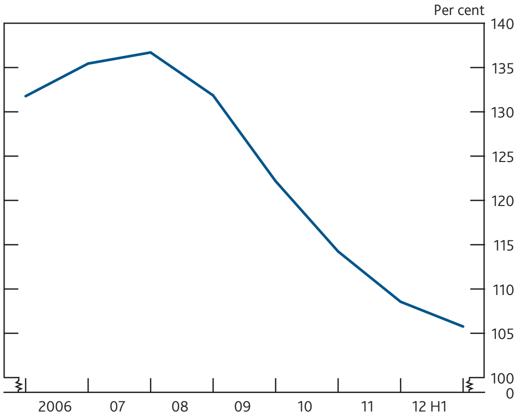
But there were some signs of continuing risk aversion...

Despite the improvement in financial market conditions, respondents to the Bank's 2012 H2 *Systemic Risk Survey* continued to highlight sovereign risk and an economic downturn as the two main risks to the UK financial system. The perceived probability of a high-impact event in the financial system in the medium term remained material (**Chart 1.7**). For a number of countries, spreads of government bonds over German bunds remained higher than before the introduction of the euro (**Chart 1.14**). Market contacts also increasingly focused on the potential impact of the prospective fiscal tightening in the United States in early 2013, when large tax increases and spending cuts are scheduled to come into effect (Section 2).

Risk aversion in equity markets also remained high. Estimates of premia required by investors to hold equities remained high relative to pre-crisis levels. And some measures of market volatility were consistent with uncertainty in vulnerable euro-area country equity markets remaining higher than in other advanced-economy equity markets.

(1) The size of the default fund covering other products was £410 million as of August 2012. The default funds form an important part of the resources that a CCP maintains to absorb losses that it may suffer due to the default of a member (see Chart 3.16 on page 35 of the June 2012 *Report*). The recently updated international 'Principles for financial market infrastructures' produced by the Basel Committee on Payment and Settlement Systems and the International Organization of Securities Commissions would require those CCPs which are involved in activities with more complex risk profiles to maintain sufficient resources to meet the loss that would arise from the default of their two largest members in extreme but plausible market conditions.
(2) In the case of IRS and FX NDF, there is provision for LCH ultimately to allocate any further losses to members by writing down the value of members' in-the-money net positions. The FPC has previously flagged the importance for CCPs of introducing rules for allocating among their participants any losses that are not covered by margin, default fund and other financial resources. See pages 20–22 and 52–53 of the December 2011 *Report*.

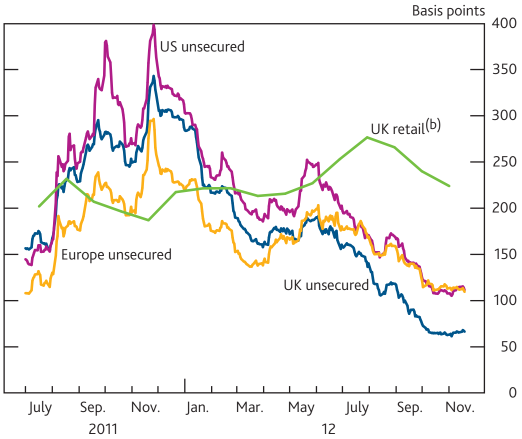
Chart 1.17 Major UK banks' loan to deposit ratio[(a)(b)]



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

(a) Major UK banks' customer lending as a percentage of customer deposits, where customer refers to non-banks.
(b) As Co-operative Banking Services and Nationwide have not reported their 2012 H1 results, their end-2011 results have been used.

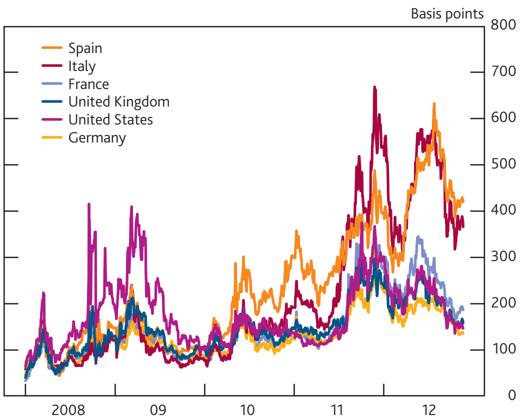
Chart 1.18 Major banks' indicative senior unsecured bond spreads[(a)] and UK retail funding spread



Sources: Bloomberg and Bank calculations.

(a) The data show an unweighted average of the spread between euro-denominated senior unsecured bonds and equivalent-maturity swap rates for a selected bond issued by each of a selection of large banks in the region. The selected bonds have residual maturities of between two and six years.
(b) Sterling only. Spread over the three-year swap rate. The three-year retail bond rate is a weighted average of rates from banks and building societies within the Bank of England's normal quoted rate sample with products meeting the specific criteria (see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household_int.aspx).

Chart 1.19 Cost of default protection for selected banking systems[(a)]



Sources: SNL Financial, Thomson Reuters Datastream and Bank calculations.

(a) Average five-year CDS premia from selected banks and large complex financial institutions, weighted by assets as at 2012 H1.

...amid continuing concerns about banking systems' resilience.

Regulatory capital ratios rose for most major European banking systems in 2012 H1 (**Chart 1.15**). In December 2011, the European Banking Authority recommended that European banks should raise their core Tier 1 ratio to 9%, in addition to setting aside a buffer against sovereign risk holdings.[(1)] Participating banks (excluding Greek banks and those being restructured) subsequently raised around €115 billion in core Tier 1 capital between September 2011 and June 2012. In combination with a reduction in risk-weighted assets, this resulted in an increase in banks' aggregate core Tier 1 ratio by around 160 basis points to 11.0%.

Despite this, concerns remained about the resilience of banking systems. Profitability remained subdued for European, as well as US and UK, banks. That mainly reflected a continuation of the declining trend in investment banking revenues observed in recent years. Profits were also affected at some banks by compensation payments for mis-selling and regulatory fines. Market contacts also remained concerned about prospects for future profits and banks' asset valuations more generally (Section 2).

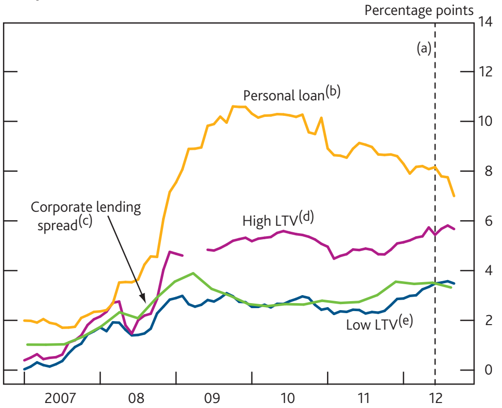
Funding market conditions improved...

Despite continuing concerns about banks' resilience, wholesale funding market conditions improved. Euro-area banks reported an improvement in their access to retail and wholesale funding across most funding categories in 2012 Q3, according to the ECB's *Bank Lending Survey*. They also expected those trends to continue in Q4. Euro-area banks' issuance of term debt in public markets appeared on course to be lower in 2012 than in 2011, with a slight shift in composition from secured to unsecured issuance (**Chart 1.16**). Reports suggested that the higher proportion of unsecured issuance was linked to an improvement in investor sentiment. And, according to Fitch Ratings, US money market funds increased their exposure to euro-area banks by 16% during September, albeit from low levels.

In the United Kingdom, the major banks completed the majority of their planned public wholesale term debt issuance for 2012 in the first half of the year. They were able to raise further funding from private markets and through the ECB's longer-term refinancing operation. As a result, wholesale term issuance by the major UK banks fell significantly in 2012 H2. The FLS also reduced UK banks' need to issue wholesale term debt.[(2)] Since the start of the financial crisis, UK banks have taken steps to decrease their reliance on wholesale funding. And the major UK banks have significantly reduced their customer funding gap — the difference between customer

(1) All participating UK banks had a core Tier 1 ratio of above 9% in December 2011.
(2) By 29 October, 30 lenders, accounting for about 80% of lending to the UK private sector, had signed up for the FLS. For further details, see the boxes on pages 14–15 of the August 2012 *Inflation Report* and pages 14–15 of the November 2012 *Inflation Report*.

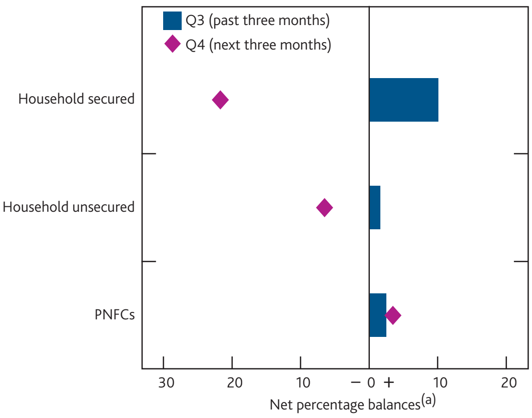
Chart 1.20 Spreads on lending to UK households and corporates



Sources: Bank of America Merrill Lynch, Bank of England, British Bankers' Association, Council of Mortgage Lenders, De Montfort University and Bank calculations.

(a) June 2012 *Report*.
(b) Spread between average quoted rates on £10,000 personal loans and Bank Rate.
(c) The corporate lending spread is a weighted average of SME lending rates over Bank Rate; CRE lending rates over Libor; and as a proxy for the rate at which banks lend to large, non-CRE corporates, UK investment-grade corporate bond spreads over maturity-matched government bond yields (adjusted for any embedded option features such as convertibility into equity).
(d) Spread between average quoted rates on two-year fixed-rate mortgages with a 90%–95% loan to value (LTV) ratio and two-year UK government bond yields. Gap in 2009 data due to small sample of reporting institutions.
(e) Spread between average quoted rates on two-year fixed-rate mortgages with a 75% LTV ratio and two-year UK government bond yields.

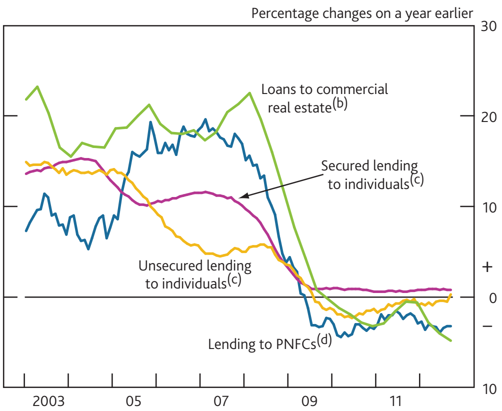
Chart 1.21 *Credit Conditions Survey* lending spreads



Source: Bank of England *Credit Conditions Survey*.

(a) A positive balance indicates that spreads have risen such that, all else being equal, it is more expensive for households or PNFCs to borrow.

Chart 1.22 Sterling lending to UK private non-financial corporations and individuals[(a)]



Source: Bank of England.

(a) Twelve-month growth in the stock of lending. Data cover sterling lending and are seasonally adjusted unless otherwise stated.
(b) Loans and reverse repos by UK-resident banks and building societies to companies undertaking development, buying, selling and renting of real estate, not seasonally adjusted.
(c) Lending by UK-resident monetary financial institutions and other specialist lenders.
(d) Lending by UK-resident monetary financial institutions, excluding the effects of securitisations.

loans and deposits — through both a reduction in loans and a rise in retail deposit funding. By the end of 2012 H1, the ratio of loans to deposits for major UK banks had fallen to around 105% from more than 130% at the start of the financial crisis (**Chart 1.17**). Retail deposits continued to increase in 2012 H2, rising by almost 2% in the three months to September.

...as reflected in lower funding costs.

Banks' term funding costs fell significantly across the major economies as conditions in funding markets improved (**Chart 1.18**). For example, UK unsecured bank funding costs have fallen by about 100 basis points since June. Retail funding costs also fell, though to a lesser degree. There was also an improvement in short-term interbank funding markets, as three-month sterling, euro and dollar Libor spreads over overnight index swap rates narrowed to pre-crisis levels.

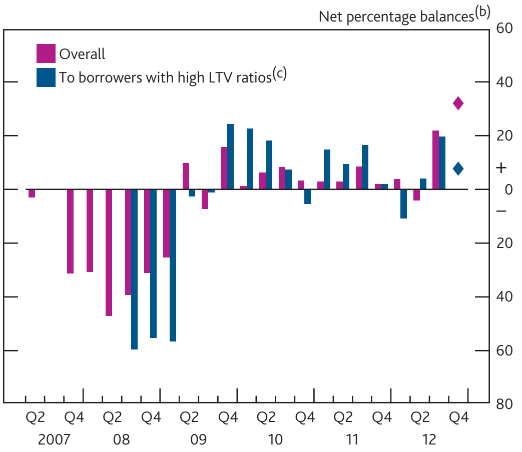
The cost of default protection on banks' unsecured bonds in the major economies fell on average by around a third since the June 2012 *Report* (**Chart 1.19**). Perceptions of bank risk were closely related to sovereign risk, which fell over the period as markets reacted to central bank policy measures, including the announcement of OMTs by the ECB. But the cost of default protection on banks' bonds was still substantially higher than before the crisis. UK policy measures that supported the fall in funding costs included the FLS and the Extended Collateral Term Repo Facility.

UK credit conditions showed some signs of improvement but remained tight...

Since the financial crisis, spreads on lending to households and companies have remained high (**Chart 1.20**). As funding costs declined in recent months, there were some signs of pass-through to UK-quoted lending rates, with average rates on some fixed-rate mortgage products falling by around 20 basis points since the start of August. And some lenders had begun to make offers at lower interest rates to businesses. But the Bank's Agents reported that some business lenders appeared still to be tightening terms. While respondents to the Bank's *Credit Conditions Survey* reported that spreads increased in Q3 on secured lending rates to households (**Chart 1.21**) and on lending rates to medium-sized firms, the increases were smaller than previously expected. Lenders expected household lending spreads to narrow in Q4, particularly for household secured lending. But for businesses, spreads were expected to widen further in Q4.

UK lending growth remained weak. Annual household lending growth has averaged less than 1% over the past two years, reflecting further falls in unsecured lending and only small increases in secured lending. Lending to businesses has been even weaker, contracting by 3% a year over the same period (**Chart 1.22**). The Bank's *Credit Conditions Survey* provided some signs of improvement in UK credit availability. For households, mortgage availability was reported to have

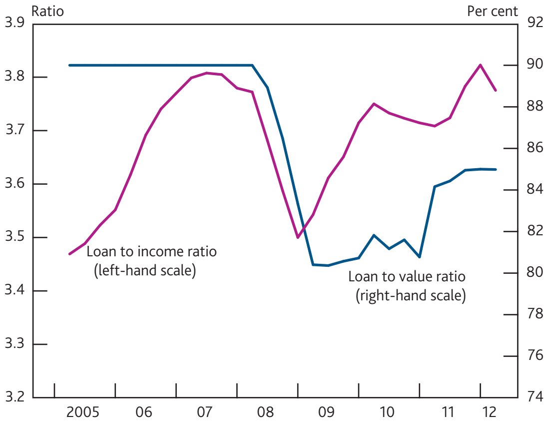
Chart 1.23 UK household secured credit availability[(a)]



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. The blue and magenta bars show the responses over the previous three months. The corresponding diamonds show the expectations over the next three months.
(b) A positive balance indicates that more secured credit is available.
(c) This question was introduced in 2008 Q3. High LTV ratios are defined as being more than 75%.

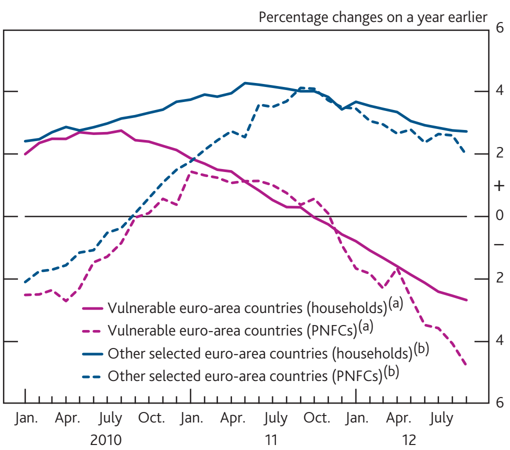
Chart 1.24 Loan to value and loan to income on new UK mortgage lending: 75th percentile[(a)(b)]



Sources: FSA and Bank calculations.

(a) Shows data for borrowers at the 75th percentile (towards the higher end of the distribution) and excludes remortgaging.
(b) *Mortgage Product Sales Data* includes regulated mortgage contracts only, therefore excludes other regulated home finance products such as home purchase plans and home reversions, and unregulated products such as second charge lending and buy-to-let mortgages. The figures in this *Report* may differ from those published in the *Mortgages Product Sales Data Trend Report* by the FSA, as the *Trend Report* excluded business loans.

Chart 1.25 Euro-area lending growth



Sources: ECB and Bank calculations.

(a) Refers to Greece, Ireland, Italy, Portugal and Spain.
(b) Refers to Austria, Belgium, Finland, France, Germany and the Netherlands.

increased markedly in Q3 and was expected to improve further in Q4 (**Chart 1.23**). The improvement in Q3 was reported to be concentrated on borrowers at higher loan to value (LTV) ratios (over 75%). This was consistent with announcements from some lenders that they were targeting higher LTV lending. In the year to June 2012, LTV ratios and loan to income ratios offered at the riskier end of the market in new UK mortgage lending were broadly unchanged (**Chart 1.24**).[(1)]

There were fewer signs of improvement in corporate credit availability. For companies, the Bank's *Credit Conditions Survey* reported that loan availability was broadly unchanged in Q3 and was expected to remain unchanged in Q4 as well. Some lenders suggested this response in part reflected the fact that they did not expect to see an increase in companies' demand for credit, even at lower rates. And it could take longer for the FLS to feed through to corporate lending — for example, because mortgage products are more standardised than corporate loans, which tend to be tailored for each customer. Improved bond market conditions (**Chart 1.13**) suggested that larger companies could bypass the banks and access finance by tapping capital markets directly. That fitted with evidence from the *Deloitte CFO Survey* suggesting that low interest rates on corporate debt made corporate bonds more attractive as a form of finance for companies than at any time in the past five years, though many smaller companies cannot access bond markets.

...while in the euro area, credit conditions deteriorated further.

Euro-area lending growth remained weak, particularly in the vulnerable euro-area countries, where loans to households fell by 3% on average and loans to companies fell by 5% on average in the year to September 2012 (**Chart 1.25**). Credit conditions tightened further in the euro area as a result of bank deleveraging. The ECB's *Bank Lending Survey* suggested that euro-area banks tightened credit conditions again in Q3 and loan demand continued to fall. Credit conditions were expected to tighten further in Q4 and loan demand was expected to fall further. While there were some tentative signs of easing in credit conditions elsewhere — notably in the United States, where the Federal Reserve's *Senior Loan Officer Opinion Survey* indicated a small further easing in standards for business lending and some categories of consumer lending over the past three months — market contacts remained concerned that a further tightening of credit conditions in the euro area might pose financial stability risks across Europe, including in the United Kingdom. Section 2 examines short-term risks to financial stability, including those that could cause further weakness in credit supply.

(1) Refers to borrowers at the 75th percentile and excludes remortgaging.