FINANCIAL STABILITY REPORT PRESS CONFERENCE

Thursday 29 November 2012

Opening Remarks by the Governor

Since we met in the summer, sentiment in financial markets has improved a little, supported by policy actions from a number of central banks. But the underlying picture for global growth remains weak, and significant adjustments in indebtedness and competitiveness are still required in the euro area. Inevitably, that has implications for our own banking system and economy.

Against that background, the Financial Policy Committee's (FPC) primary concern has been to ensure that UK banks have sufficient capital to underpin the resilience of the banking system, so that they are on a solid footing to support economic growth. The danger to be avoided is that of inadequately capitalised banks holding back our recovery.

Over the past year, the FPC has emphasised the need for banks to continue to build and maintain capital buffers against unexpected losses, for example arising from euro-area stresses. And UK banks currently report substantial buffers over the minimum level allowed. But, in judging whether banks are adequately capitalised, we need to ensure that reported capital ratios do in fact provide an accurate picture of banks' health. At present there are good reasons to think that they do not. That uncertainty around capital adequacy is in part responsible for low investor confidence in banks, whose equity is valued by the market at on average only two thirds of its book value. Investors need confidence that banks have adequate buffers against stress in order to be willing to fund them at the low rates necessary to support a recovery.

In today's *Report* we draw attention to **three** reasons that lead us to think that UK banks' capital ratios – and hence the buffers available to absorb unexpected losses – are currently overstated. First, expected future credit losses may be understated; second, costs arising from past failures of conduct may not be fully recognised; and third, the risk weights used by banks in calculating their capital ratios may be too optimistic.

While the significance of these factors varies across banks, the Committee judges that together they are likely to have material implications for the adequacy of banks' capital buffers. The Committee was guided in reaching this judgement by a number of different approaches that led to broadly the same conclusions.

It is important to keep this judgement in perspective. The problem is manageable, and is already understood at least in part by markets. But it does warrant immediate attention.

The FPC therefore **recommends that the FSA takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs, and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.**

In its recommendation today, the FPC has set out the framework the FSA will use to determine the actions that individual banks need to take in order to strengthen their resilience, and get them to the start line to support the economic recovery. This can be achieved not only by external equity capital raising, but also by issuing contingent capital, restructuring their businesses, disposing of non-core assets, or undertaking liability management exercises. The appropriate strategy will vary from bank to bank. The FSA will begin to take action immediately in response to this recommendation, and will report back to the FPC in time for its March meeting.

We continue to face an exceptionally challenging environment for financial stability. The problems facing the world economy are not ones that we or other UK authorities can resolve alone. The financial crisis and its aftermath have had a lasting effect on our banks. The choice we face is to tackle the situation head on, which will be difficult and in some quarters unpopular, or to suffer a prolonged period of adjustment in which an inadequately capitalised banking system holds back recovery in the wider economy.

At present a range of policy measures, including the Funding for Lending Scheme, have given banks a breathing space in which to reinforce their balance sheets. It is important that they take advantage of that breathing space. Our aim must be to get to a point where private investors again have confidence in banks and banks themselves have the confidence to lend. We believe that the recommendation we have made today, when implemented by the FSA, will soon get the UK banks back to a position where they can support our economic recovery.