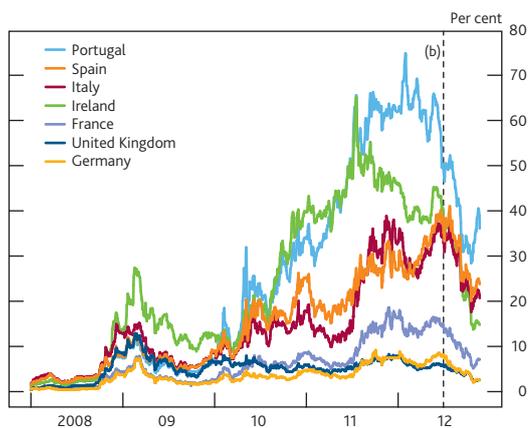


Executive summary

The interim Financial Policy Committee agreed the following policy recommendation at its meeting on 21 November:

- The Committee recommends that the Financial Services Authority (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.

Chart 1 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.

(b) June 2012 Report.

Risks and developments

The outlook for financial stability has improved a little since the previous *Report*. Global growth and financial conditions, however, remain weak. Market concerns about severe near-term stresses in the euro area have reduced significantly following a period of heightened concern over the summer (**Chart 1**). In part, this reflects further policy initiatives by the European Central Bank, including the announcement of a prospective programme of Outright Monetary Transactions. While that has reduced the immediate threat of countries exiting the euro area, the fragmentation of euro-area credit flows, and economic headwinds, have persisted. And imbalances within the euro area remain substantial, with ongoing uncertainty about how they will be resolved in the medium term.

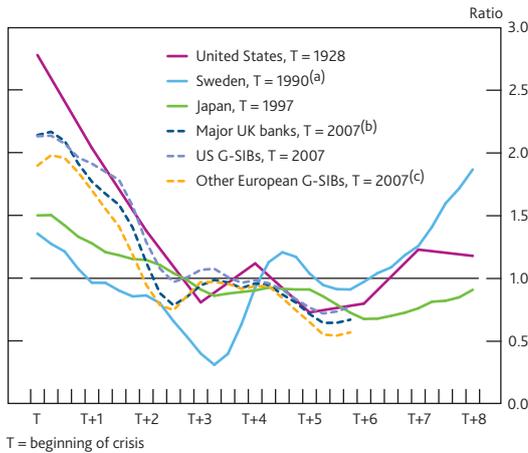
UK credit growth has remained weak since the June 2012 *Report*, though there are some signs of improvement in credit conditions looking ahead, with reduced funding costs being partially passed through to some lending rates.

Resilience

In the United Kingdom, progress by banks in raising capital has slowed and investor confidence remains low. One indicator of that is the market value of major UK banks' shareholder equity, which has fallen on average to around two thirds of the book value (**Chart 2**).

Market concerns are likely to reflect in part uncertainty about bank capital adequacy. One factor which may make stated levels of capital misleading is underrecognition of expected future losses on loans. Information from supervisory intelligence and banks' own public disclosures suggest that

Chart 2 Price to book ratios of banking sectors following past financial crises



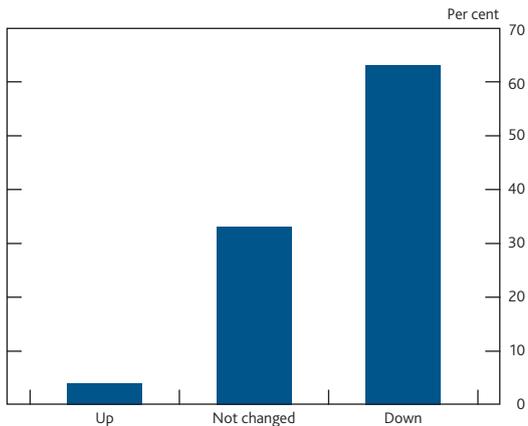
Sources: Calomiris, C W and Wilson, B (2004), 'Bank capital and portfolio management: the 1930s 'capital crunch' and the scramble to shed risk', *Journal of Business*, Vol. 77, No. 3, pages 421–55, Thomson Reuters Datastream and Bank calculations.

(a) Svenska Handelsbanken and SEB.

(b) Excludes Britannia, Co-operative Banking Group, Nationwide and Northern Rock (from end-2007).

(c) See footnote (d) in Chart 2.3.

Chart 3 Investor perceptions: has your confidence in risk-weighted assets gone up or down?(a)



Source: Barclays Research.

(a) Based on survey responses of over 130 investors carried out in 2012 H1, of perceptions over the past year.

expected losses on loans, including those subject to forbearance, are in some cases greater than current provisions and regulatory capital deductions for UK banks' expected losses.

In recent years, UK banks have also underestimated and underprovisioned for costs for conduct redress, notably for payment protection insurance mis-selling. In 2012, the number of identified conduct issues has grown and it seems likely that banks could face additional sizable costs.

Banks' capital positions could also be overstated because of aggressive application of risk weights. The current framework for calculating risk weights used in determining regulatory measures of capital adequacy is complex and opaque and that may have undermined investor confidence (Chart 3). A number of initiatives under way domestically and internationally are aimed at improving the calculation of risk weights.

In combination, these factors would imply that UK banks' capital buffers, available to cushion losses and maintain the supply of credit following realisation of a stress scenario, are not as great as headline regulatory capital ratios imply.

As has been emphasised in previous FPC recommendations, the Committee assesses the risks from the euro area to be considerable. While the immediate risks have reduced, there remains a possibility of disorderly outcomes, which if they occurred would have major implications for UK financial stability. But it is impossible to determine in advance exactly how risks may crystallise or the precise impact that they would have on the UK banking system. While UK banks have significantly reduced their direct exposures to sovereigns and banks in vulnerable euro-area economies, exposures to non-bank private sectors in these countries are likely to remain significant for some time, unless they sell loans or businesses.

Historical experience suggests that more rapid progress in tackling balance sheet problems would support improved funding conditions and the ability of banks to extend new loans to households and businesses. The FPC's recommendation is aimed at achieving such an outcome.