1 Global financial environment

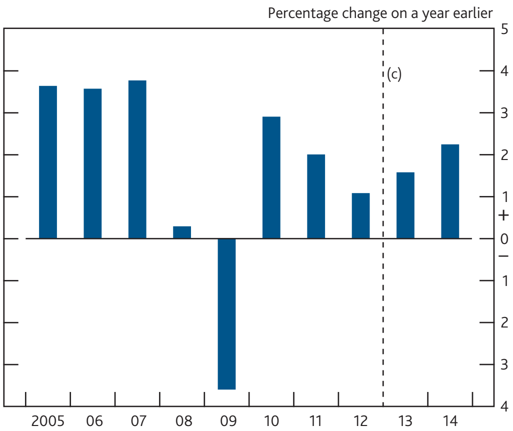
This section reviews developments in the global financial environment over the past six months. Section 1.1 examines macroeconomic developments and their impact on financial markets. Section 1.2 describes associated changes in bank resilience and credit conditions. During the period, perceived tail risks diminished, the resilience of the banking system improved and, despite some short-lived market volatility, there was evidence of a deepening 'search for yield' in some markets (**Table 1.A**).

Table 1.A Key financial developments

Macroeconomic and financial developments
• Perceived tail risks diminished and economic recovery gained traction in some advanced economies (pages 7–8).
• With shifting monetary policy expectations, yield curves in advanced economies steepened and equity prices rose (page 8).
• Capital flowed out of some emerging economies amid short-lived volatility in some financial markets (pages 8–10).
• Over the period there was evidence of falling risk premia and a 'search for yield' in some markets (pages 10–11).
Banking sector resilience and credit conditions
• The largest global banks made progress on recapitalisation (pages 11–12).
• The ECB announced plans for a comprehensive assessment of the largest euro-area banks (pages 12–13).
• UK banks' resilience improved, particularly for weaker banks, and credit conditions eased (pages 13–15).

Chart 1.1 Growth was forecast to strengthen in countries where UK banks have the greatest exposures

Past and projected global growth weighted by location of UK banks' assets(a)(b)



Sources: Bank of England, BIS, IMF *World Economic Outlook* (*WEO*) and Bank calculations.

(a) Actual and projected global growth data are based on the October 2013 *WEO* and include the United Kingdom.
(b) Weights are based on 2011–12 averages of UK monetary financial institutions' (MFIs') non-UK assets, as estimated from BIS consolidated banking statistics that cover non-UK assets held by UK MFIs' worldwide offices, and UK MFIs' UK assets, as estimated from balance sheet data reported by the UK entities of UK MFIs.
(c) Forecasts from 2013 onwards.

1.1 Macroeconomic and financial developments

Global growth was expected to be increasingly driven by advanced economies...

During the period since the June *Report*, growth prospects at the global level were broadly stable. But International Monetary Fund (IMF) forecasts showed the composition of global growth was expected to shift, with stronger growth in advanced economies and weakening prospects for emerging economies. In general, growth was forecast to strengthen in countries where UK banks have the greatest exposures (**Chart 1.1**).

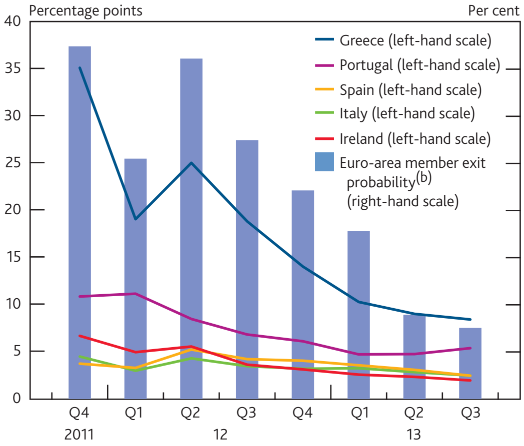
In the major advanced economies, data outturns and near-term indicators strengthened. In the United Kingdom, output growth increased to 0.8% in 2013 Q3 and surveys suggested that Q4 output growth would also be strong. Following six quarters of contraction, euro-area output rose in both 2013 Q2 and Q3. Growth in the United States was estimated to have increased to 0.7% in 2013 Q3, though the IMF judged the near-term outlook may have deteriorated slightly. Japanese output also expanded strongly this year, in part reflecting stimulus measures.

...where tail risks were thought to have diminished.

Perceived tail risks from the euro area receded, reflecting actions by the European Central Bank (ECB) and progress on steps to strengthen banking systems (Section 1.2), and the economic outlook improved. While euro-area output expanded at a slower pace in 2013 Q3 than the previous quarter, indicators suggested that activity was close to stabilising in some periphery countries. And spreads between periphery-country government bonds and German bunds generally narrowed, as the perceived tail risks associated with a country leaving the euro area continued to recede (**Chart 1.2**).

Chart 1.2 Perceived euro-area tail risks declined

Perceived probability of euro-area member exit and spreads over bunds for selected euro-area sovereigns(a)

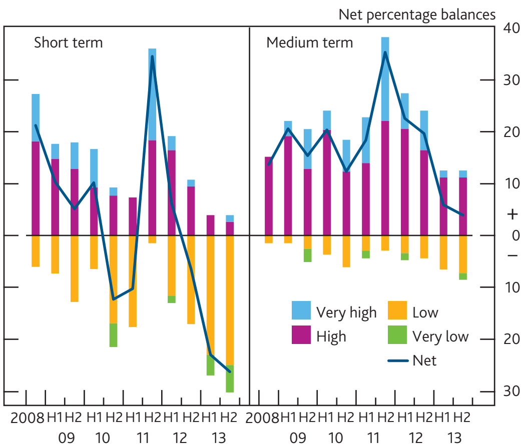


Sources: *Deloitte CFO Survey*, Thomson Reuters Datastream and Bank calculations.

(a) Ten-year government bond spreads over bunds, average taken over *Deloitte CFO Survey* window.
(b) Average probability assigned by UK chief financial officers (CFOs) to the likelihood of any existing euro-area member exiting the single currency within the next twelve months.

Chart 1.3 Expectations of UK financial instability diminished further

Perceived 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.

Against that backdrop, the perceived probability of a high-impact event in the UK financial system fell to its lowest since the financial crisis, according to the Bank's 2013 H2 *Systemic Risk Survey* (**Chart 1.3**). And while sovereign risk and a deterioration in the economic outlook remained the most common concerns, they were cited by fewer respondents as 'key risks' than in the previous survey.

Yield curves steepened and equity prices rose in advanced economies...

The more positive economic outlook in advanced economies coincided with steepening government bond yield curves. During the period since early May, the implied cost of UK and US government borrowing for five years in five years' time rose markedly, by around 120 basis points and 150 basis points respectively (**Chart 1.4**). That was consistent with markets pricing in an improved outlook for these economies and perceptions of reduced tail risks.

Rising equity prices suggested that market participants believed that the recovery was gaining traction. For example, the S&P 500 reached a level 25% higher than at the start of the year — a record high in nominal terms (**Chart 1.5**). This appeared to reflect improved earnings expectations and a fall in equity risk premia towards long-term average levels (**Chart 1.6**). Equity prices rose elsewhere, albeit by less in Europe than in the United States, in part reflecting the more challenging economic outlook in the euro area and remaining tail risks. Corporate bond spreads in some advanced economies tightened slightly as well, with spreads on sterling corporate bonds reaching their narrowest since 2010.

...though indicators of long-term interest rates remained below historical norms.

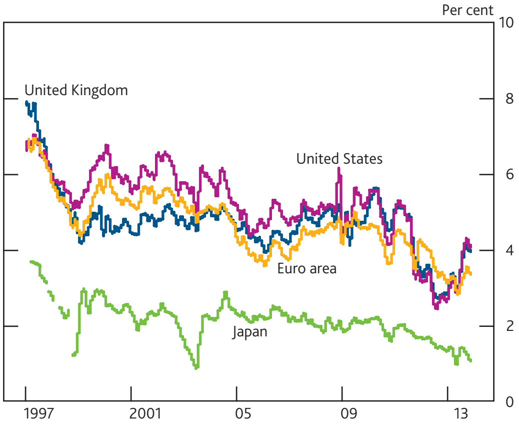
Over the period as a whole, while risky asset prices were supported by an improved near-term growth outlook in some advanced economies, some indicators suggested medium-term growth prospects remained subdued. In the United Kingdom, the market-implied five-year real yield in five years' time, a possible indicator of medium-term growth prospects, was around 0.6%, about 1 percentage point below its average level over the past fifteen years. In the United States, this measure has also remained below pre-crisis levels, albeit at a higher level than in the United Kingdom (**Chart 1.7**).

There were capital flows out of some emerging economies...

During the summer months, alongside slowing growth across major emerging economies, there was speculation that monetary policy in the United States was close to a turning point. A strong expectation built up that the US Federal Open Market Committee would announce the 'tapering' (or slowing down) of its programme of asset purchases at its September meeting. These developments prompted investor outflows and marked declines in emerging-economy asset prices, accompanied by strong flows into developed-economy assets,

Chart 1.4 Market-implied measures of future UK and US interest rates rose

Forward nominal yields on selected government bonds(a)

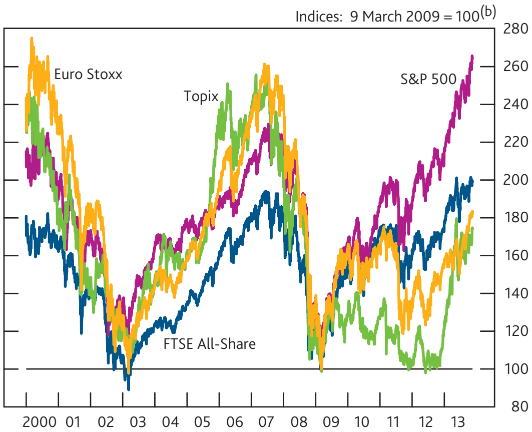


Sources: Bloomberg and Bank calculations.

(a) Five-year nominal interest rates five years forward, derived from the Bank's government liability curves. One-month moving averages.

Chart 1.5 Advanced-economy equity prices rose

International equity indices(a)

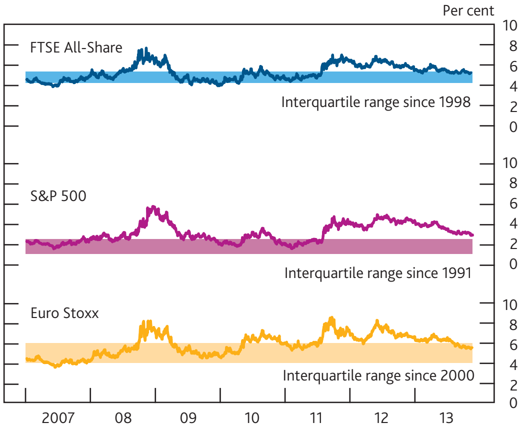


Sources: Thomson Reuters Datastream and Bank calculations.

(a) Denominated in units of local currency.
(b) This corresponds to the lowest value in the S&P 500 across the time period shown.

Chart 1.6 Equity risk premia fell but remained above historical averages

International equity risk premia(a)



Sources: Bloomberg, Thomson Reuters Datastream and Bank calculations.

(a) As implied by a multi-stage dividend discount model.

particularly equities (**Chart 1.8**). Emerging-economy currencies also depreciated.

Capital outflows were initially broad-based and partly reflected investors exiting carry trades — borrowing in one currency at a low interest rate and investing in another currency at a higher rate — that had been based on expectations that developed-economy interest rates would remain low for some time. There was some evidence from indices linked to the performance of currency carry-trade strategies that such trades may have made losses during 2013 Q2. One example is the Deutsche Bank Global Currency Harvest Index, which tracks a portfolio that is systematically long high-yielding and short low-yielding currencies. This index fell as much as 10% between May and August (**Chart 1.9**). Over time, the outflows became more discriminate with a particular focus on those countries with large imbalances.

...and volatility in some financial markets...

As bond yields rose during the summer months, volatility in fixed-income markets increased (**Chart 1.10**). Illiquidity was most noticeable in markets for corporate and emerging-economy bonds, with some evidence of widening bid-ask spreads. And exchange-traded funds — investment funds listed on exchanges — that were tracking these assets also saw reduced liquidity.

US Treasury markets, typically among the most liquid, also experienced a reduction in liquidity. One measure of market depth is the maximum trade size for the best quotes available in the interdealer market on the ten-year US Treasury bond. JPMorgan estimates suggested that this fell below US$100 million in June, around half its level in 2012.

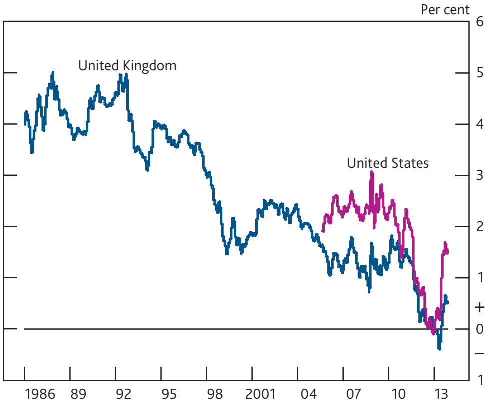
Some market contacts saw this period of volatility as highlighting a structural reduction in market liquidity, as banks pulled back from market-making. By 2012, aggregate bond market turnover was about 40% lower than in 2006. Market contacts partly attributed this structural change to regulatory developments designed to increase the resilience of the banking system — for example, higher capital requirements on trading book assets, leverage ratio limits, and the Volcker Rule restrictions on proprietary trading. Others suggested that trading flows had become harder to intermediate as the fund management industry had become concentrated in similar investment strategies. Section 5 discusses the Financial Policy Committee's (FPC's) priorities, including on market liquidity.

...that returned briefly amid concerns about the US debt ceiling.

In October, the US government shut down following an impasse in negotiations to approve a federal government budget. As this stand-off continued, concerns grew that if the US Treasury borrowing limit were not raised, the federal government would default on its debt — though this was seen

Chart 1.7 A market indicator of medium-term growth expectations remained subdued in the United Kingdom

Forward real yields on UK and US government bonds[(a)]

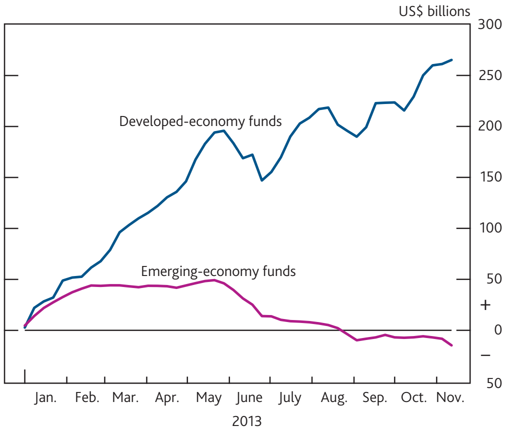


Sources: Bloomberg and Bank calculations.

(a) Five-year real interest rates five years forward, derived from the Bank's index-linked government liability curves. One-month moving averages.

Chart 1.8 Capital inflows to emerging economies reversed

Cumulative net flows into emerging and developed-economy funds[(a)]



Sources: Emerging Portfolio Fund Research Global and Bank calculations.

(a) Cumulative weekly net flows into dedicated equity and bond funds. Net flows are calculated as investor contributions less redemptions, excluding portfolio revaluations.

Chart 1.9 Carry trades may have made losses

Deutsche Bank Global Currency Harvest Index[(a)]

Sources: Bloomberg and Bank calculations.

(a) Deutsche Bank Global Currency Harvest Index is quoted in excess return terms net of transaction costs from investment in a portfolio that is long the five highest-yielding currencies and short the five lowest-yielding currencies from a pool of ten advanced-economy currencies and ten emerging-economy currencies. The portfolio is constructed by investing in three-month currency forwards and rebalanced quarterly.

as generating uncertainty about when, rather than if, payments on US Treasury securities would be made.

Some investors undertook limited contingency measures. There was reported selling of close to maturity US Treasury securities seen as being at risk of default. These assets were removed from schedules of eligible collateral for repo and derivatives transactions. And their yields rose along with the cost of protection for default by the US government (**Chart 1.11**). There were also precautionary sales by, and outflows from, some US money market funds (MMFs) that invest in these assets or use them as collateral. MMF assets declined by US$65 billion in a single week, the largest decline since mid-2011.

While the borrowing limit was subsequently raised, the cost of default protection remained elevated, indicating lingering concerns around the risks from a US government default. The recent episode highlighted the important role of US Treasuries in the global financial system. This is explored in more detail in Box 1.

But measures of market risk drifted down...

Nevertheless, market dislocations in the summer and early autumn were relatively short-lived, affected a narrow set of markets and there was little sign that they created serious issues for individual financial institutions. Indeed, measures of market volatility returned close to historical lows (**Chart 1.10**), market liquidity improved, and some measures of risk premia remained compressed.

...accompanied by signs of increased risk appetite...

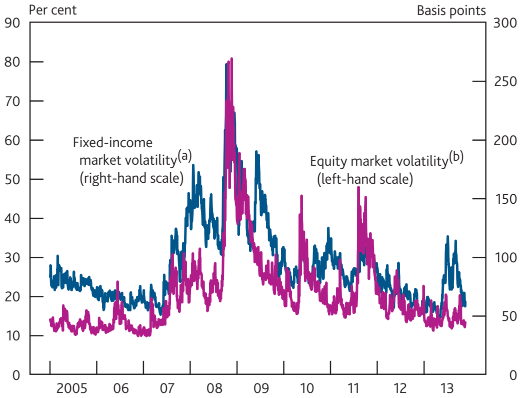
Market contacts reported that the period of increased market volatility had left investors more discerning, with a greater focus on differences in the riskiness of different assets, rather than risk-averse. Indeed, some investors saw a window of opportunity to invest in risky assets before monetary conditions tightened.

Corporate bond issuance remained buoyant. A US$49 billion bond issue by Verizon, a US telecommunications company, was nearly three times the size of the previous largest bond issue. And while corporate bond spreads remained above pre-crisis levels, estimates of the premia that investors require to compensate for liquidity risk fell (**Chart 1.12**), with implied premia for some types of bonds below their long-term average level. This was despite the period of volatility demonstrating the potential for corporate bond markets to become illiquid.

In repo markets, market contacts reported a willingness to accept lower-quality collateral and reduced demand for central clearing. This was supported by a survey of European financial institutions by SIX, the Swiss exchange group, that showed a third of respondents were willing to accept 'low-quality, complex and opaque' collateral.

Chart 1.10 Fixed-income volatility increased in the summer before falling close to historical lows

Measures of fixed-income and equity market volatility

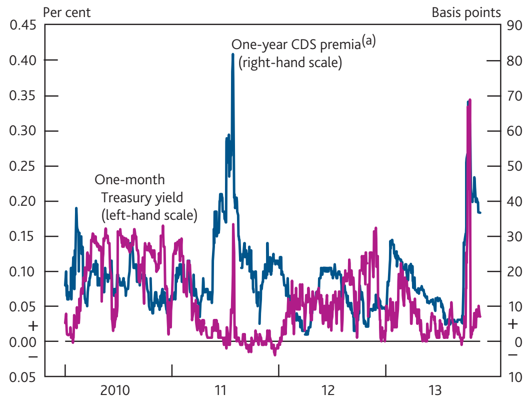


Source: Bloomberg.

(a) Merrill Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalised implied volatility on one-month Treasury options.
(b) VIX is a measure of market expectations of 30-day volatility as conveyed by S&P 500 stock index option prices.

Chart 1.11 In late September, the cost of protection against a US default rose and remained elevated

US one-year sovereign CDS premia and one-month Treasury yield

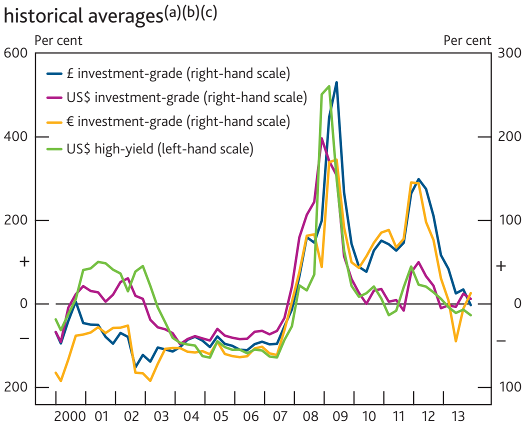


Sources: Bloomberg and Markit Group Limited.

(a) One-year senior sovereign credit default swap (CDS) premia denominated in euros.

Chart 1.12 Liquidity risk premia fell for some types of corporate bonds

Deviations of estimated corporate bond liquidity risk premia from historical averages[(a)(b)(c)]



Sources: BofA Merrill Lynch Global Research, Bloomberg, Thomson Reuters Datastream and Bank calculations.

(a) Implied liquidity risk premia are estimated using a Merton model as in Leland, H and Toft, K (1996), 'Optimal capital structure, endogenous bankruptcy, and the term structure of credit spreads', *Journal of Finance*, Vol. 51, pages 987–1,019, to decompose corporate bond spreads.
(b) Quarterly averages of deviations of implied liquidity risk premia from sample averages.
(c) Sample averages are from 1999 Q4 for € investment-grade and 1997 Q1 for £ investment-grade, US$ investment-grade and US$ high-yield corporate bonds.

There was also evidence of increased risk appetite in the shadow banking sector. The composition of prime US MMF holdings shifted towards unsecured bank debt, rather than secured. And, in 2013 H1, maturity mismatch increased for funds that invest cash collateral received from lending securities on behalf of institutional investors.

...and evidence of a 'search for yield'.

With the low interest rate environment mostly intact and volatility measures returning close to historical lows, there continued to be evidence of a 'search for yield', particularly in US assets. US high-yield loan issuance reached record levels with half of loans characterised by limited covenants ('cov-lite') (**Chart 1.13**). Debt levels in US leveraged buyouts rose to six times earnings in 2013 Q3, the highest level since 2007. In Europe, issuance of European bonds with 'payment in kind' (PIK) features, which allow interest to be paid in the form of additional bonds, reached €3.1 billion — greater than the total issuance of PIK bonds over the period 2006–12.

There were tentative signs of investor willingness to take on more complex forms of risk. Market contacts expected issuance of collateralised loan obligations — loan securitisation structures — in the United States to reach US$75 billion–US$80 billion this year, close to the pre-crisis peak. There were signs of innovation in US asset-backed securities markets, with securitisation of peer-to-peer loans and residential rental income. And the investor base in recent issues of European bank contingent capital instruments, which convert to equity or are written down under specified conditions, broadened to institutional investors. At the same time, there were concerns that investors were placing insufficient weight on the likelihood of such a conversion being triggered.

1.2 Banking sector resilience and credit conditions

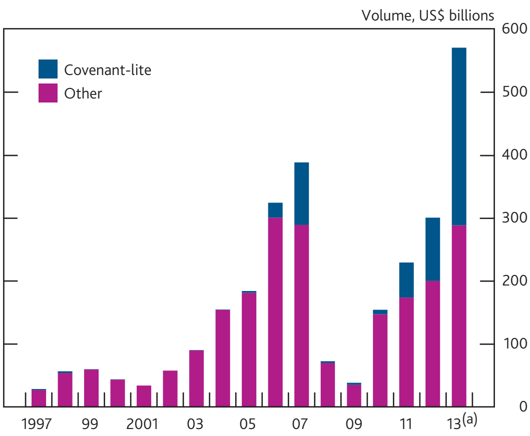
Global banks continued to recapitalise...

Against a backdrop of strengthening activity, reported bank capital ratios continued to improve during the period since the June *Report*. The US and European banks identified by the Financial Stability Board as needing to hold the highest levels of loss absorbency[(1)] all reported estimates of 'fully loaded'[(2)] Basel III common equity Tier 1 (CET1) capital ratios above 9% in their most recent disclosures (**Chart 1.14**). Research by the Bank for International Settlements (BIS), looking at a wider range of banks over a longer time period, found that retained earnings had accounted for the bulk of the increase in regulatory capital ratios over the period 2009–12, with

(1) Designated as global systemically important banks (G-SIBs) as of November 2013 and in the buckets that correspond to additional loss-absorbency requirements of at least 1.5% of risk-weighted assets when those requirements are introduced from 2016.
(2) 'Fully loaded' means based on the rules that will apply at the end of the transition period in 2019.

Chart 1.13 US high-yield loan issuance reached record highs, with covenant-lite issues increasingly prevalent

Covenant-lite and other US high-yield loan issuance

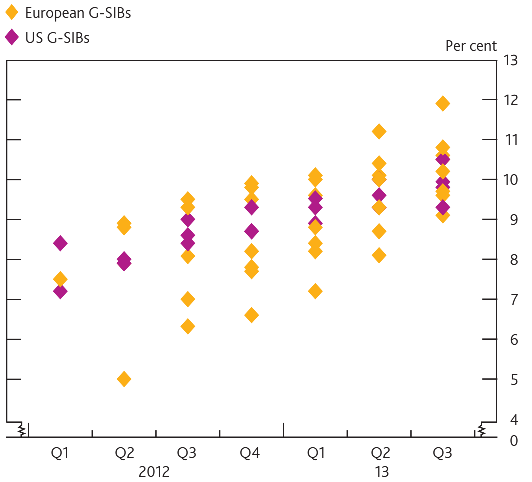


Source: JPMorgan Chase & Co.

(a) Volume as of 15 November 2013.

Chart 1.14 Major global banks recapitalised further

Reported 'fully loaded' Basel III CET1 ratios[(a)(b)]



Sources: SNL Financial, company announcements, published accounts and Bank calculations.

(a) Self-reported Basel III 'fully loaded' (see footnote (2) on page 11) CET1 ratios for European and US banks (as defined in footnote (1) on page 11), excluding Morgan Stanley.
(b) 2013 Q3 capital ratio for Barclays includes the impact of its October 2013 rights issue.

reductions in risk weights playing a lesser role.[(1)] Consensus forecasts suggested further scope for capital generation through profit retention, with retained earnings expected to rise in 2014 and 2015 at many major global banks.

...driving improved perceptions of bank resilience...

As the outlook for economic recovery and bank profits improved, shifting investor perceptions were generally reflected in higher price to book ratios. Improved perceptions of banking sector resilience were also reflected in continued falls in the cost of default protection. During the period since the June *Report*, the cost of default protection fell across advanced-economy banking systems and in aggregate was more than 100 basis points lower for banks in euro-area periphery countries (**Chart 1.15**).

This improved perception of bank resilience was despite conduct-related costs that remained a material downside risk to global banks' profitability. In recent weeks, preliminary settlements were agreed by some US banks — such as JPMorgan which agreed settlements totalling US$18.6 billion with the US authorities and institutional investors — over misrepresentations on mortgage-related securities. Other banks active in the United States could also be implicated in due course. And further headwinds to profitability may arise from regulatory fines and litigation costs relating to alleged manipulation of Libor, benchmark measures for interest rate swaps and foreign exchange rate fixings.

Credit conditions improved in some advanced economies. Access to credit increased further in the United States and there were signs that the pace of tightening in the euro area was slowing (**Chart 1.16**).

...but market concerns over some euro-area banks remained...

While bank resilience was generally perceived to have improved, doubt was cast over banks' estimates of their fully loaded Basel III capital ratios. The Basel Committee on Banking Supervision noted that some differences across banks could be attributed to interpretations of capital standards, rather than underlying differences in risk. In euro-area periphery countries the outlook for banks' profitability remained hampered by weak projected economic recovery. Their use of ECB facilities for funding also remained elevated. These factors were reflected in low price to book ratios for some banks in euro-area periphery countries (**Chart 1.17**).

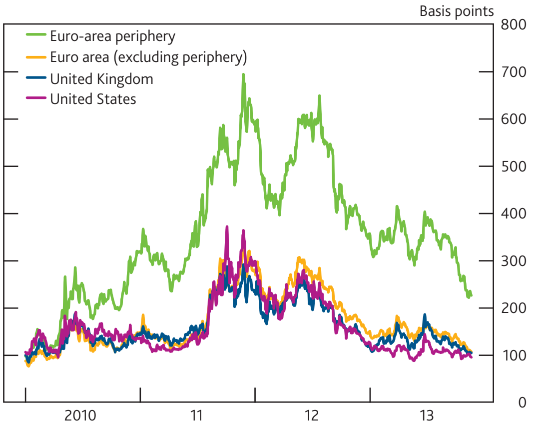
...highlighting the importance of the upcoming ECB asset quality review...

In October, the ECB announced details of a comprehensive assessment of banks due to come under its supervision in Autumn 2014, including an asset quality review and stress test.

(1) Cohen, B (2013), 'How have banks adjusted to higher capital requirements?', *BIS Quarterly Review*, September, pages 25–41.

Chart 1.15 Perceptions of banking systems' resilience improved

Cost of default protection for selected banking systems[a]

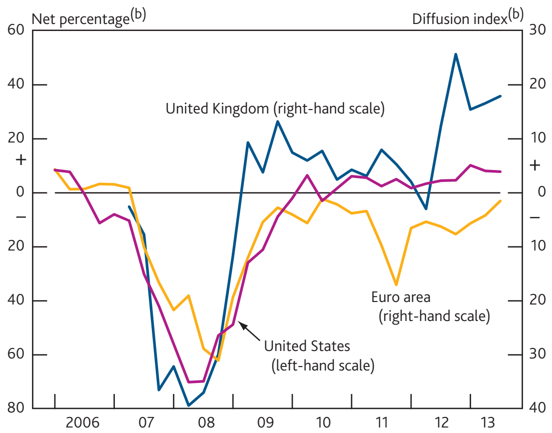


Sources: Markit Group Limited, SNL Financial, Thomson Reuters Datastream and Bank calculations.

(a) Average five-year senior CDS premia of selected banks, weighted by assets as at 2013 H1.

Chart 1.16 Credit conditions stabilised in the euro area and eased in the United Kingdom

Credit conditions in major advanced economies[a]



Sources: Bank of England *Credit Conditions Survey*, ECB, Federal Reserve and Bank calculations.

(a) Survey indicators of credit standards on loans to firms and households (mortgages and consumer credit), weighted by amount of loans outstanding. Data up to 2013 Q3, with the exception of US weights (data up to 2013 Q2).
(b) Net percentage refers to the fraction of lenders that reported having loosened less the fraction of lenders that reported having tightened. Diffusion index weights the fractions according to the intensity of loosening/tightening. A positive (negative) level indicates a loosening (tightening) in standards.

By improving transparency and, where necessary, prompting balance sheet repair, this has the potential to improve confidence in euro-area banks. Indeed investors drew some comfort from the fact that the ECB would be keen to begin its supervisory role with a credible process; according to surveys, investors typically thought that the assessment would require around €20 billion–€100 billion of new capital to be raised, mainly by German, Italian and Spanish banks (**Chart 1.18**).

But there remained uncertainty around the outcome of the exercise, including the sources to meet any identified capital shortfalls. In the first instance, shortfalls were expected to be met through private sources of capital, such as liability management exercises or equity raising. If private sources were to prove to be insufficient, Member States could turn instead to public backstops, though only after subordinated creditors had been bailed in as set out in EU state aid rules. Yet the difference between the cost of default protection on European financials' subordinated and senior debt continued to narrow in the period since the announcement. While this may suggest that bail-in of subordinated debt was not expected to be necessary, it could also indicate that bail-in was underpriced or was not perceived to be credible. And with uncertainty around the role of an area-wide backstop, there were concerns around the potential for renewed sovereign funding issues should public funds be required for bank recapitalisation.

...which could ultimately support euro-area credit conditions.

While credit conditions stabilised in the euro area (**Chart 1.16**), this came against a backdrop of weak lending growth in euro-area periphery economies. But an investor survey by Goldman Sachs found that twice as many respondents thought a credible process for the ECB's comprehensive assessment of banks would improve loan growth rather than harm credit supply.

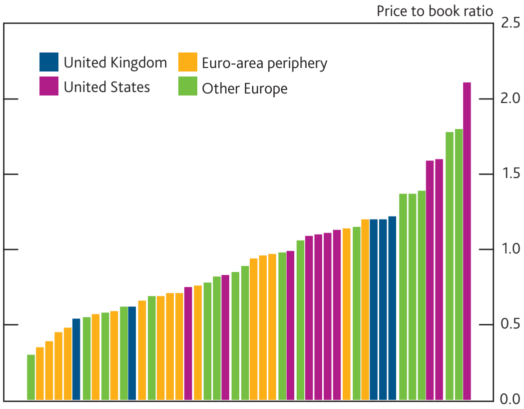
UK bank resilience continued to improve...

There was further evidence of an improvement in UK bank resilience. UK banks continued to implement plans agreed with the Prudential Regulation Authority (PRA) to rectify the capital shortfalls identified in response to an interim FPC recommendation in March (Section 4). By September, banks for whom a shortfall had been identified by the exercise had taken actions to address around three quarters of this shortfall; those banks in aggregate had raised their capital ratios by 1.5 percentage points. Further actions, equivalent to £9 billion of capital raising since the start of the year, were made by banks beyond their identified shortfalls and by those for which no shortfall had been identified. The latter in aggregate raised their capital ratios by 0.5 percentage points.

Capital had been raised through retained earnings, disposals and equity issuance. For example, Barclays raised £5.8 billion

Chart 1.17 Market concerns around some euro-area banks persisted

Price to book ratios for selected banks[a]

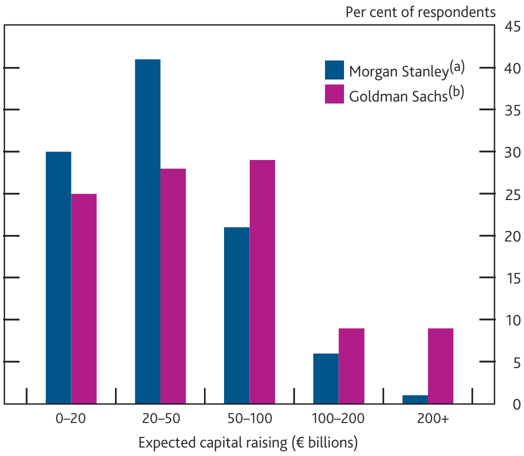


Source: Thomson Reuters Datastream.

(a) The price to book ratio is the ratio of the market value of shareholders' equity to its value as calculated for accounting purposes.

Chart 1.18 The ECB's asset quality review and stress test were expected to identify capital shortfalls

Proportion of survey respondents expecting capital raising of different magnitudes



Sources: Goldman Sachs Global Investment Research and Morgan Stanley Research Asset Quality Review Survey.

(a) Expected total equity raisings for banks participating in the ECB's asset quality review/bank stress test (146 respondents).
(b) Expected capital raisings required for stress-test credibility (117 respondents).

of equity via a rights issue in October. And the PRA had also asked banks to ensure that their plans to meet capital shortfalls did not adversely affect lending to the real economy.

In June 2012, the FPC recommended banks act to mitigate risks to their balance sheets stemming from the euro area. UK banks' exposures to vulnerable euro-area periphery economies were around £140 billion, equivalent to 62% of UK banks' reported core Tier 1 capital, at the end of 2013 H1. This was around £11 billion lower than at the time of the FPC recommendation (Section 4).

...with underlying profits rising...

The improvements in UK banks' resilience were supported by a rise in pre-tax, pre-provision profits, as well as a continued fall in impairment charges. But banks recorded £3 billion of conduct costs in 2013 H1 (£20 billion since 2011). And, as with banks in other advanced economies, prospective conduct costs remained a headwind to future UK bank profitability.

...and funding and liquidity metrics strong...

UK banks continued to reduce their reliance on wholesale debt funding. This partly reflected robust deposit growth despite falling interest rates, as competition among banks for household deposits eased. During 2013 H1, households allocated two thirds of the financial assets they accumulated to bank deposits (compared with a longer-term average of less than half).

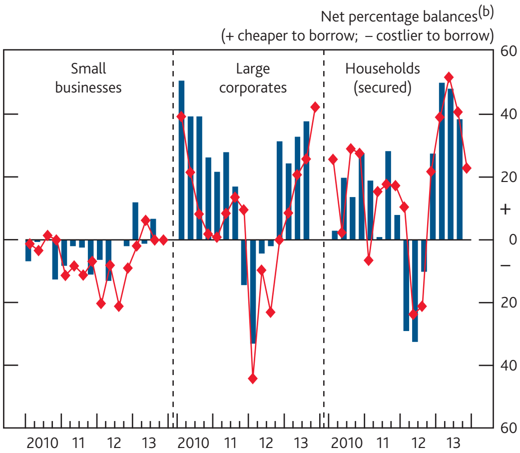
In October, the Bank announced changes to its liquidity facilities.[1] These changes were designed to increase the availability and flexibility of those facilities, by providing liquidity at longer maturities, against a wider range of collateral, at a lower cost and with greater predictability of access. The Bank, in co-ordination with five other central banks, also announced that the current network of temporary bilateral liquidity swap arrangements would remain in place until further notice.[2] These changes reduce the need for banks to self-insure against liquidity risk, supporting their ability to extend credit to good borrowers. This is consistent with the FPC's June liquidity recommendation, which is examined in Section 4 of this *Report*.

...supporting an improvement in credit conditions.

The continued recovery of the banking sector was accompanied by a further easing in credit conditions (**Chart 1.16**) in the United Kingdom. Lenders responding to the Q3 *Credit Conditions Survey* reported a further easing in corporate credit conditions: overall credit availability to the corporate sector was reported to have increased slightly across businesses of all sizes. Conditions improved most for larger

(1) 'Developments in the Bank's approach to liquidity insurance', 24 October 2013, www.bankofengland.co.uk/publications/Pages/news/2013/124.aspx.
(2) 'Central banks announce standing swap arrangements', 31 October 2013, www.bankofengland.co.uk/publications/Pages/news/2013/125.aspx.

Chart 1.19 Credit spreads fell for households and large corporates but were little changed for small businesses
Spreads over reference rates on lending to corporates and secured lending to households[(a)]



Source: Bank of England *Credit Conditions Survey*.

(a) Spreads are over Bank Rate for variable-rate mortgages and the relevant swap rate for fixed-rate mortgages. Spreads are over Libor for large private non-financial corporations and Libor or Bank Rate for small businesses. The bars show the responses over the previous three months. The corresponding lines with diamonds show expectations over the next three months. Expectations balances have been moved forward one quarter so that they can be compared with the actual outturns in the following quarter.
(b) A positive (negative) balance indicates that spreads have fallen (risen) such that, all else being equal, it is cheaper (costlier) to borrow.

corporates, with significant reductions in corporate lending spreads being reported (**Chart 1.19**).

By contrast, the *Credit Conditions Survey* reported lending spreads to smaller businesses, which are generally more dependent on banks for external finance, were little changed in Q3.[(1)] Nevertheless, a survey by the Federation of Small Businesses found that the cost of credit had fallen since mid-2012 and that the availability of credit had improved over the past year or so, albeit from a low base. The *Credit Conditions Survey* also reported that demand for credit from small and medium-sized businesses had picked up.

Credit conditions for households continued to ease markedly. According to the *Credit Conditions Survey*, the availability of secured credit increased in Q3, with mortgage borrowing spreads falling significantly for the fourth consecutive quarter (**Chart 1.19**). This came against a backdrop of increased demand for lending for house purchase and remortgaging. In October, the Government introduced the Help to Buy mortgage guarantee scheme to increase the availability of high loan to value mortgages. In the first four weeks, over 2,000 offers were supported by the scheme, equivalent to £365 million of potential lending. Developments in the UK housing market are examined in Section 2.3.

(1) The full cost of credit facing these businesses also includes fees or cashback deals.