

The financial stability conjuncture and outlook

An overview of UK financial stability: threats and resilience

The past six months have been a relatively benign period for UK financial stability. Credit losses suffered by the large UK-owned banks have been small and new provisions have declined (Chart 1). Nor have there been significant pressures on liquidity or solvency in the international financial system. In general, asset prices have been less volatile than usual and most major equity markets have risen somewhat.

The immediate prospects for both the UK and international financial systems also appear broadly favourable, with major economies unlikely to experience marked falls in growth and yield curves suggesting that sharp increases in borrowers' interest payments are not anticipated. Market indicators of credit risk and expected interest rate volatility (Chart 2) are consistent with this near-term outlook.

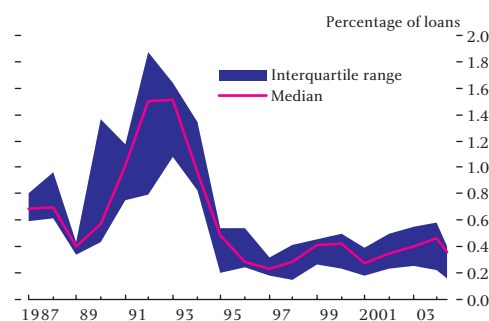
However, financial stability authorities focus on downside risks rather than the most likely outlook, because they attempt to identify potential threats to stability. In that light, there are three main reasons for vigilance.

First, globally, doubts about the sustainability of the current pattern of capital flows have increased, with downward pressure on the US dollar and rising uncertainty about future exchange rate movements – and about their consequences for interest rates, asset prices and activity. That may affect the market risks faced by financial institutions and, over a longer time horizon, the creditworthiness of borrowers in any countries where growth slows sharply.

Second, market indicators may partly reflect a greater appetite for risk. The intensification of the 'search for yield' noted in recent *Reviews* continues to pose risk management challenges, not least because it may have led some financial institutions to build up positions in what could prove to be relatively illiquid assets.

Third, the increase in unsecured debt for many UK households, the rapid rise in lending to the commercial property sector and

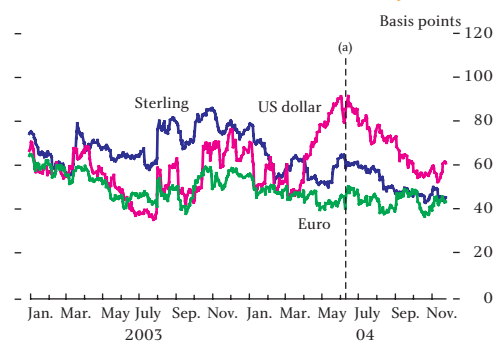
Chart 1
Large UK-owned banks' new provisions for bad and doubtful debts^(a)



Sources: Thomson Financial Datastream, published accounts and Bank calculations.

(a) New provisions charge for bad and doubtful debts in the P&L account as a percentage of loans to customers (including finance leases) and banks.

Chart 2
Short-term interest rate uncertainty^(a)

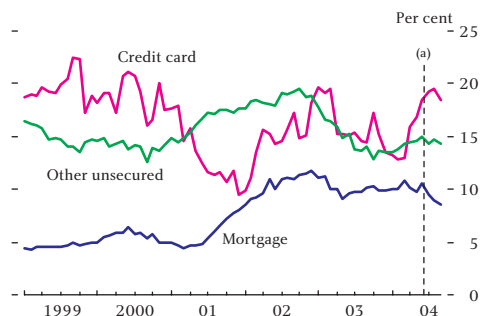


Sources: LIFFE, Chicago Mercantile Exchange and Bank calculations.

(a) Six-month volatilities implied from at-the-money options on three-month interest rate futures.

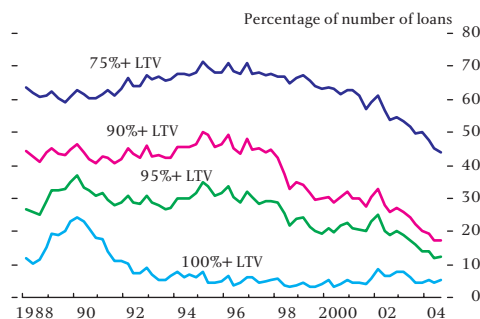
(b) June 2004 *Review*.

Chart 3
Annual growth of large UK-owned banks' lending to individuals



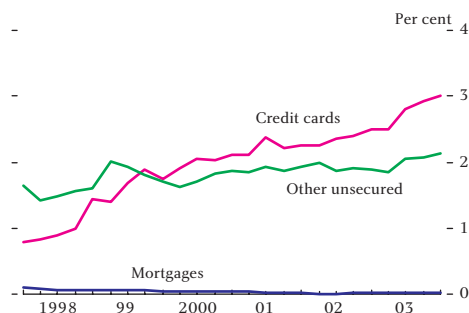
Source: Bank of England.
(a) June 2004 Review.

Chart 4
Loan-to-value ratios on new UK mortgages



Source: Council of Mortgage Lenders.

Chart 5
UK-owned banks' annualised write-off rates on lending to UK individuals^(a)



Source: Bank of England.
(a) Adjusted to reflect one bank's change in accounting method.

signs of higher leverage in some parts of the international financial system suggest a rise in longer-term vulnerabilities. Lenders and borrowers may underestimate these vulnerabilities because at the moment the near-term risks seem low.

Credit risk and the accumulation of debt

The contrast between low near-term risks and heightened longer-term vulnerabilities is evident when the credit risk facing the UK financial sector is considered.

Domestic mortgages are the single largest category of exposures of the major UK-owned banks, which have been expanding mortgage lending at a considerably faster rate than the growth in households' disposable income (Chart 3). In the near term, given the prospects for incomes and employment, default rates on this lending are likely to remain low. And banks continue to benefit from substantial collateral, thanks to falls in loan-to-value ratios on new lending (Chart 4) and past rises in house prices.

However, unsecured lending has recently been increasing even more rapidly than lending secured on property (although its level remains considerably lower). It is not clear that credit pricing has taken due account of the upward drift in banks' write-off rates on unsecured lending (Chart 5); on the contrary, the spread between the effective interest rate charged and banks' funding costs has fallen further since the June 2004 Review, perhaps because of increased competition. Although banks have continued to improve credit-scoring models and stress tests, these techniques have yet to be tested by a period of pronounced economic strain. If, in such a period, lenders attempted to lower risk by making it much more difficult or expensive for borrowers to roll over their unsecured lending, wider repayment problems might be precipitated.

Credit risk from UK companies appears subdued in the near term. Sterling corporate bond spreads have fallen a little since the June 2004 Review, and estimates of the probability of corporate default have generally declined, reflecting rises in corporate profitability and equity prices in most sectors.

Nonetheless, while corporate capital gearing has continued to fall, it remains high by the standards of the past twenty years (although its equilibrium level in a low inflation environment is uncertain). In contrast to 2002, when firms were repairing balance sheets by cutting back on dividends, lowering capital expenditure and refinancing debt, the recent easing in corporate gearing has largely reflected financial surpluses and the increase in the market value of corporate assets.

Over half the new corporate lending in the year to September 2004 was to the commercial property sector

(Chart 6), and the sector now accounts for over a third of the outstanding stock of lending to UK non-financial firms. That raises the issue of whether lenders are sufficiently diversifying their UK corporate credit risk. Property yields have continued to decline (including relative to other returns), and, in the light of recent weak rental growth and high vacancy rates, it is unclear whether investors' expectations of rental income will be met.

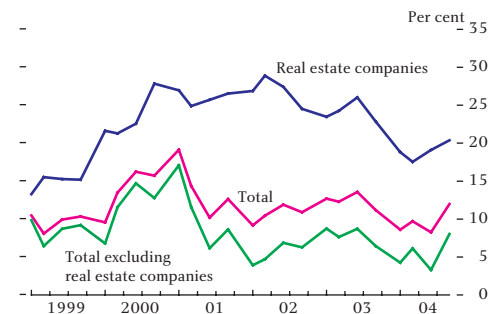
The major UK-owned banks have continued to increase their exposures to other economies. If the major economies perform in the near term as most forecasters expect, credit risks on these exposures are likely to remain moderate. World economic growth has been very strong this year and, as a result, there have been few pressures on domestic banking systems. The picture in the euro area is perhaps less encouraging than elsewhere, given the downward revisions to expectations for GDP growth and concerns about the possible impact of dollar depreciation. And some parts of the German banking system have been finding it difficult to sustain increases in profitability. But for most continental European banks, profitability and capital remain satisfactory (Chart 7). In the United States, the high and increasing indebtedness of the household sector is perhaps of less concern than might first appear, because a much higher proportion of household debt is at low long-term fixed rates than in the United Kingdom. On the corporate side, the general outlook seems to have improved, but some large, highly indebted companies with big pension and health care liabilities, notably in the airline and automobile industries, still appear to be under strain (Chart 8).

As far as the emerging-market economy (EME) exposures of the UK financial system are concerned, despite the rise in oil prices and uncertainty about China's growth prospects, market confidence in EME credit prospects appears to have strengthened. Sovereign spreads (Chart 9) have fallen considerably since their peak in autumn 2002, and by more than would be suggested by ratings agencies' upgrades. Low funding costs have encouraged strong foreign currency issuance of bonds and syndicated loans this year, especially by EME companies.

The international financial system and the 'search for yield'

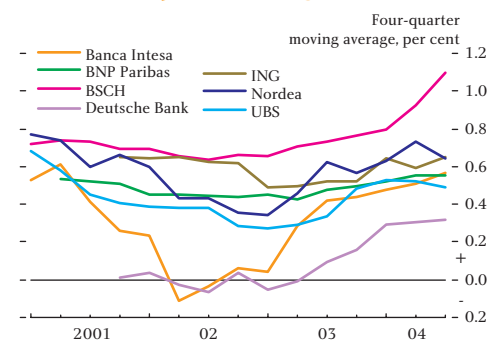
In the past six months, the downside risks in the international financial system highlighted in the June 2004 *Review* have not materialised. The increases in official US interest rates to date, from their lowest point in over forty years, were well signalled and have not triggered the sharp upward shift in market yield curves that some had feared. And asset price volatility has been low. But given this background, it has remained difficult to find investments with the prospective returns that many investors still expect, and so the 'search for yield' has been continuing.

Chart 6
Annual growth of large UK-owned banks' lending to non-financial companies



Source: Bank of England.

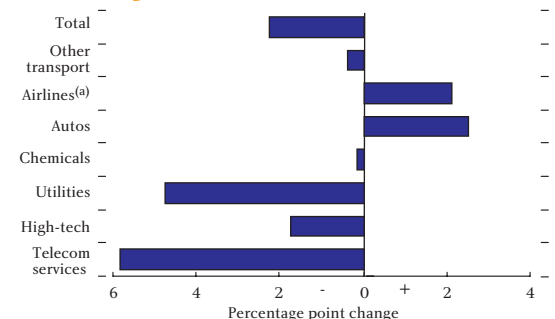
Chart 7
Return on assets for the largest banks in selected European banking sectors^{(a)(b)}



Sources: Bloomberg and Deutsche Bank company reports.

- (a) Rate of return on assets, defined as annualised net income divided by total assets.
 (b) Deutsche Bank and ING series start at 2001 Q4, because of reporting changes and exceptional non-operating items respectively. BNP Paribas reports assets on a half-yearly basis; assets are assumed to remain unchanged from previous half-yearly levels in the intervening quarters.

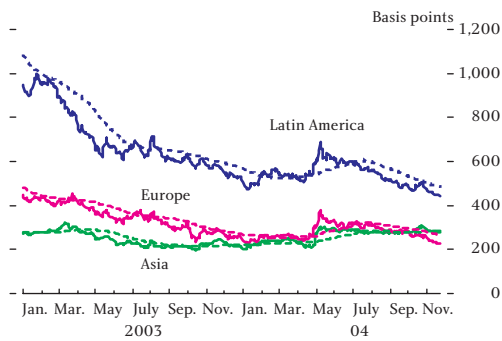
Chart 8
Change in capital gearing of US non-financial corporate sectors, end-2002 to end-2003



Sources: Standard and Poors' Compustat and Bank calculations.

- (a) Excludes UAL and US Airways.

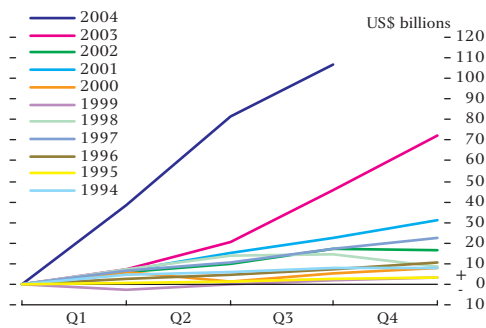
Chart 9
Emerging-market sovereign bond spreads^(a)



Source: JP Morgan Chase & Co.

(a) Dotted lines indicate 60-day moving average.

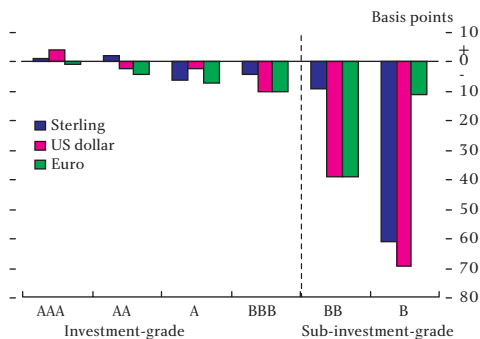
Chart 10
Cumulative flows of capital into hedge funds^(a)



Source: TASS Research.

(a) Figures are based on the TASS hedge fund database, which currently contains 3,023 reporting and 2,036 non-reporting funds.

Chart 11
Changes in credit spreads by rating^{(a)(b)}



Sources: Merrill Lynch and Bank calculations.

(a) Spread over swaps.

(b) Changes since June 2004 Review.

It has taken various forms, including continuing substantial flows of investors' funds into hedge funds (Chart 10), carry trades of different sorts, the rapid development of more complex structured credit products and the growth of the leveraged loan and high-yield debt markets. These activities have permitted greater portfolio diversification but have also entailed increases in gearing for some borrowers and more leveraged assets for some investors. Spreads on corporate debt, especially at the high-yield end, have narrowed further (Chart 11), as have those on emerging-market debt, and some debt covenants have been relaxed. Concerns have arisen that risk may be being underpriced in capital markets, potentially leading to an over-accumulation of risky exposures. Measures of uncertainty in financial markets suggest a mixture of lower perceived risks in the near term and a greater willingness to take on risk, but in what proportion is unclear. It is, perhaps, significant that some market contacts have expressed misgivings at the scale of investor demand for risky and potentially illiquid assets. Unexpected economic developments could trigger the attempted simultaneous unwinding of common positions, possibly leading to strains on market liquidity.

Many large complex financial institutions (LCFIs)¹ are developing new lines of business, in response to the low margins in many well-established financial markets and subdued demand for traditional investment banking services. For example, structured credit markets are expanding rapidly. The combination of relative novelty and dependence on complex pricing models poses risks in such markets. Some LCFIs have reportedly been expanding energy and commodity trading and prime brokerage activity for hedge funds. Against the backdrop of generally high rates of return on equity (Chart 12) and substantial capital, the risks in the short run to the LCFIs themselves appear to remain low, despite the litigatory challenges that highlight reputational risks that could, if they crystallised, threaten some lines of business. But, in the longer run, the vulnerability of LCFIs to unexpected market developments, including episodes of illiquidity or dislocation, may be increasing, enhancing the importance of appropriate stress testing and scenario planning.

The resilience of the UK financial system

Overall, then, the current environment facing the UK financial sector appears favourable, but downside risks remain, particularly in the light of the build-up of debt and the continuing 'search for yield'. If these risks were to crystallise in the near term, the robust profitability and capital of the major UK-owned banks should help to contain any potential systemic impact. These banks' return on equity generally increased in the first half of this year, with both cost-income ratios and new

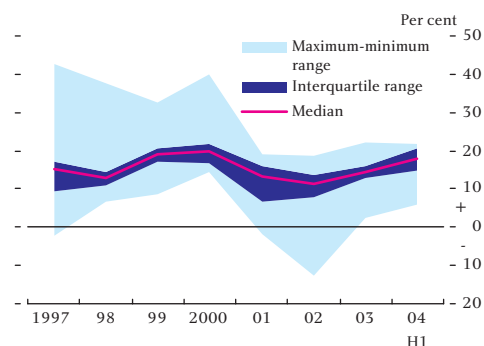
(1) These firms are active globally in a wide range of capital markets and activities, often including banking, securities dealing, prime brokerage and insurance services.

provisions falling. And reported total and Tier 1 capital ratios rose marginally, remaining well above regulatory minima (Chart 13). The continuing need to fill the gap between customer deposits and lending by raising funds in highly liquid wholesale markets has increased the importance of liquidity management, but the indications are that banks' liquidity buffers are adequate. In the financial system outside the banking sector, there are also few signs of stress; even in the life insurance industry, where pressures remain, profitability has been improving. However, in the longer term, the falling share of net interest income (Chart 14) suggests that the major banks may be increasing their dependence on potentially more volatile sources of income. And interest margins, particularly on unsecured lending to households, are narrowing.

In the light of the longer-term challenges set out above, the use of a wide range of scenarios in banks' stress tests is desirable, including combinations of possible adverse shocks to profits, credit quality and market liquidity, and the exit of key counterparties from markets. Quantitative risk modelling is becoming more widespread, which should prove helpful, but such models are largely untested by major periods of stress and may not take full account of feedbacks from the banking system to asset prices and the broader economy.

Both prudential regulation and accounting standards must keep pace with financial innovation and its implications for systemic risk. In the article *Strengthening financial infrastructure* below, credit risk transfer markets are identified as one area where that is becoming more pressing, and appropriate work is under way. The article also discusses some risks associated with a 'tiered' payment structure. The high-value CHAPS Sterling system has relatively few banks as direct members. Non-member banks use the CHAPS Sterling system indirectly through correspondent relationships with direct members, thereby potentially increasing inter-bank exposures. The Bank's recent proposed reforms to its operations in the sterling money markets should encourage a range of UK banks and building societies, in addition to the current direct members of CHAPS Sterling, to hold reserve accounts at the Bank. The Bank hopes that some of these institutions, particularly those with significant sterling payment flows, will also choose to become direct members of CHAPS Sterling. The article also explores whether similar risks arise from clearing and settlement arrangements between direct and indirect participants in other infrastructures important to UK wholesale financial markets – such as CREST, LCH.Clearnet Ltd and the Continuous Linked Settlement System (CLS). This is an area where the Bank intends to do further work.

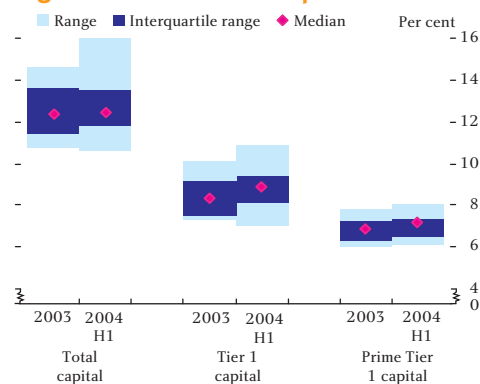
Chart 12
Return on equity for LCFIs^(a)



Sources: Earnings releases and Bank calculations.

(a) Net income divided by average shareholders' equity, annualised for 2004 H1.

Chart 13
Large UK-owned banks' capital ratios^{(a)(b)}

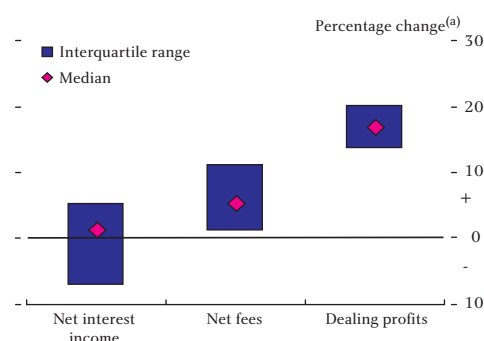


Sources: Published accounts, FSA regulatory returns and Bank calculations.

(a) Percentage of risk weighted assets.

(b) Prime Tier 1 includes ordinary shares, associated reserves and retained earnings.

Chart 14
Changes in selected components of large UK-owned banks' income, 2004 H1



Sources: Published accounts and Bank calculations.

(a) Annualised percentage change from year-end 2003 to 2004 H1.