BANK OF ENGLAND

News release

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Bank of England Publishes Mid-Year Financial Stability Review

The Bank of England is today publishing its mid-year issue of the Financial Stability Review.

Commenting, Deputy Governor David Clementi said:

"On balance we judge that the risks to stability from global imbalances and exaggerated equity market prices have moderated somewhat over the past six months. But there are still material risks. Global imbalances persist, risks in the wider economic environment are probably greater because of rapid structural changes, and equity markets remain volatile. Financial intermediaries and investors, as well as the authorities, need to keep these risks in mind. By being transparent about our own assessment of downside risks, I hope the Bank's Financial Stability Review can help that process."

The Bank's regular assessment of the financial stability Conjuncture and Outlook is for the first time brought together in an Overview (pages 9-14). Some of the key points are as follows:

- Evidence of stronger growth in Europe and Japan, tighter US monetary policy and the euro's recent rise against the dollar should help to ease global imbalances.

- But US external and private sector debt remain high. Shocks could come from higher than expected interest rates on account of excess demand; and/or from downward adjustments to expected underlying productivity growth. This is probably not the most likely scenario, but it cannot be ruled out. Lenders and borrowers need to recognise that past economic strength may not continue uninterrupted.

- Equity prices – especially for high tech stocks - still seem high according to conventional benchmarks, notwithstanding the (welcome) correction in April/May. There are risks if investors are assuming that recent very high returns will persist.

- In Japan, the macroeconomic picture seems to be improving slowly, but financial sector risks remain (in both the banking and insurance industries) and it is possible that growing government debt may limit scope for future rescues should conditions deteriorate.

- Some of the smaller euro-area countries, for example Ireland, show signs of overheating. Whether that creates risks to stability outside the countries concerned depends partly on links between financial sectors, which need to be monitored by central banks, regulators and others concerned with financial stability.

- The telecoms sector is accounting for a significant proportion of debt issuance in the USA and EU, sub-investment grade as well as investment grade. The possibility of sectoral credit risk concentrations raises an issue for prudential supervisors and risk managers.

- Reductions in current and prospective government bond supply in some countries, notably the USA and UK, are affecting the environment in which firms manage risk (see Box 4, page 52). That is part of the background to the debate about the status of some US agencies (eg Fannie Mae and Freddie Mac), which are very large in dollar interest rate-swap markets and whose debt is heavily held by US banks. It is important that the market understands accurately the status of these institutions. Some adjustment in spreads has occurred since testimony to Congress in March by US Under Secretary Gensler (see Box 5, pages 54-59).

- The outlook for growth in emerging market economies (EMEs) has generally continued to improve. But pockets of risk remain. For example, short-term debt is still high relative to foreign exchange reserves in some countries, and in many there is a need to push on with banking and corporate sector reform. Credit spreads have recently risen. But there seems to be differentiation between risks, which offers a degree of reassurance that contagion may be limited in the event of any individual country problems. It is important that measures are taken to strengthen banking system liquidity in EMEs using the new Basel Committee guidelines (Box 8, page 79) and that the planned IMF/World Bank debt and foreign exchange reserves guidelines (Box 2, page 35) are actively pursued.

- In the United Kingdom, debt is increasing in the household sector and in some parts of corporate sector. This probably does not create significant risks so long as a benign macroeconomic environment is sustained. The recent rise in the euro against sterling will also help to reduce pressures in those parts of the corporate sector especially exposed to international competition. But sectoral balance sheets could be adversely affected if equity prices were to fall significantly and/or if nominal interest rates rose materially relative to current expectations.

- The UK banking system as a whole seems to be well capitalised and profitable. There is intense competition in UK retail banking markets at present, accompanied by some anecdote of easier lending conditions. The FSA review of unsecured consumer credit lending practices is therefore a welcome precaution.

- There have recently been a number of changes affecting securities exchanges and settlement systems. Given that financial risks tend to be concentrated in clearing houses, the integrity of their risk management is vital, which generally points to clearing houses being independent, not-for-profit, user-owned organisations.

The other articles, summarised in the ‘Editorial’ (pages 3-6), are as follows:

- G10 seminar on systems for assessing banking system risk: Reviews recent G10 work on indicators of bank and banking system vulnerability.
- Stylised facts on UK corporate sector financial health, evidence from micro data: Indicators of corporate sector health are more dispersed than at any time in the past quarter century.
- A possible international ranking for UK financial stability: Countries are ordered by the size of UK-owned banks’ exposures and proxies for credit risk derived from bond market spreads and rating agency ratings.
- Fair value accounting, capital standards, expected loss provisioning, on financial stability: In response to the exchanges between accounting standard setters and the banking industry, the Bank advocates an active debate, under the Basel Supervisory Committee umbrella, on provisioning against expected loss; and also a period of disclosure of bank balance sheets on a full fair value basis before moves to put statutory accounts on that basis.
- Core principles for systemically important payment systems: The G10 principles explained by John Trundle of the Bank of England, chairman of the Task Force which drew them up.
- Asset price inflation and private sector participation in financial crisis stability: The recent Roy Bridge Memorial Lecture delivered in London by Gerry Corrigan (Goldman Sachs and former President of the New York Federal Reserve Bank).
- Collective action problems and collective action clauses (CACs): The UK and Canada are already using CACs. The Bank urges other countries to follow suit, especially emerging market economy governments seeking regular access to international capital markets.

The report is available on the Bank’s website at www.bankofengland.co.uk/fsr/

Notes to Editors

The FSR is the Bank of England’s twice-yearly publication covering the Bank’s financial stability mandate, which is macroprudential rather than related to the regulation of individual firms.

Key Resources

Financial Stability Review, June 2000

http://www.bankofengland.co.uk/archive/Pages/digitalcontent/historicpubs/fsr/fsr08.aspx