BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

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A Repricing of Risk Tests the Resilience of the Financial System

The Bank of England is today publishing its *Financial Stability Report.* This provides an initial assessment of the causes of the recent financial turmoil, lessons to be learnt and prospects ahead.

The continuing deterioration in US sub-prime mortgage markets exposed vulnerabilities in the valuation and distribution of risks within the global financial system. This led to disruptions to some of the largest and most liquid markets in the world, including the money markets. That has affected banks in all advanced economies, as risks have flowed back to their balance sheets and funding pressures have intensified, and in the UK led to Northern Rock having to turn to the UK authorities for liquidity support.

While it is too early for a full assessment, some lessons are already clear including the need for improved management of liquidity; more transparency in the composition and valuation of structured products and banks' exposures to off balance sheet vehicles; and better stress testing and contingency planning. In the UK, the authorities also need to strengthen their crisis management arrangements.

Actions in these areas and the strong capital position of UK banks should help restore confidence as risk is re-priced. There have been signs of recovery in some financial markets, though a return to earlier conditions of under-priced risk would be undesirable. A period of tighter credit conditions, especially for higher-risk borrowers, should be expected. But in the short run the financial system in the advanced economies remains vulnerable to further adjustments, whether in the credit markets which have been most affected to date or, for example, in the equity or commercial property markets.

John Gieve, Deputy Governor for Financial Stability, said:

"A repricing of risk was due especially in credit markets. But the speed and ferocity with which that adjustment disrupted core markets and institutions internationally had not been anticipated by firms or authorities. There have been signs of recovery in recent weeks but some markets are still illiquid and the financial system remains vulnerable to further shocks. Some important lessons need to be learned by both financial institutions and authorities on liquidity risk management, valuation of complex instruments, disclosures of risk positions and on crisis management."

Notes to Editors

The *Report* is produced half-yearly by Bank staff under the guidance of the Bank's Financial Stability Board, whose best collective judgement it represents.

Under the Memorandum of Understanding with HM Treasury and the FSA, the Bank contributes to the maintenance of the stability of the financial system as a whole. The *Report* is one vehicle for helping meet those responsibilities.