



BANK OF ENGLAND

News release

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18 December 2009

Financial Stability Report

The Bank of England is today publishing its bi-annual *Financial Stability Report*. The *Report* provides the Bank's current assessment of conditions affecting financial stability and discusses ways to strengthen the financial system in the future.

In relation to current conditions, the *Report* identifies that the financial system has been significantly more stable over the past six months, underpinned by the authorities' sustained support for the banking system and monetary policy measures. Low risk-free interest rates and reduced uncertainty have led to a rebound in a range of asset prices. Primary issuance in many capital markets has resumed, reducing financing risks for some borrowers. The market rally has boosted bank profits, lowered concerns about potential future losses, and has enabled banks to raise further external capital. Banks have also been able to issue unguaranteed term debt, helping them to reduce their reliance on short-term funding.

At the same time, the *Report* notes that after such a prolonged period of exuberance earlier in the decade, it is inevitable that some banks around the world have overstretched balance sheets. They will take time to adjust, and in the meantime remain vulnerable to the risk of less rapid than expected economic recovery. Around the world, a number of borrowers, including in the commercial property sector, have large refinancing needs in the coming years. And while funding costs remain low, there is some risk of market participants accumulating excessively risky positions, which could unwind abruptly when yield curves eventually rise.

Over time, and consistent with maintaining lending into the real economy, many banks will need to reduce leverage further, extend the maturity of their funding and refinance substantial amounts of funding as official sector support is withdrawn. While their profitability is relatively buoyant and market conditions broadly favourable, banks should take opportunities to strengthen their balance sheets, including by not distributing an excessive amount of profit. That will reduce the risk of disruption to the flow of credit in the future.

In relation to safeguarding financial stability in the future, the *Report* says that, in the medium term, the root causes of this and previous systemic crises must be tackled - excessive risk-taking in the upswing of the credit cycle and insufficient resilience in the subsequent downturn. An expectation that 'too important to fail' firms will receive public assistance, and that unsecured, unsecured wholesale creditors will not share losses, has exacerbated both the boom and the bust. That calls for a robust, multi-faceted policy response.

Regulatory policies should give greater emphasis to systemic risks across the cycle and across institutions, as set out in a recent Bank discussion paper (The role of macroprudential policy, November 2009). They should be complemented by structural measures to contain the spread of risk across the system. And because failures of financial institutions cannot and should not be prevented, the resolution framework will need to be extended to limit the impact on the wider economy.

A visual summary of the *Report* is can be found below

Notes to Editors

1. The *Financial Stability Report* aims to identify key risks to UK financial stability and to stimulate debate on policies needed to manage and prepare for these risks, including through the Council for Financial Stability. The *Report* is produced half-yearly by Bank staff under the guidance of the Bank's Financial Stability Executive Board, whose best collective judgement it represents, and following review by the Financial Stability Committee of the Court of Directors of the Bank of England.

2. Under the Banking Act, 2009 the Bank's financial stability objective is 'to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'. The *Report* is one vehicle to help it meet that objective.

Key Resources

Financial Stability Report, Issue 26

<http://www.bankofengland.co.uk/publications/Pages/fsr/2009/fsr26.aspx>