BANK OF ENGLAND

# News release

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## Strengthening the Financial System

The Bank of England is today publishing its bi-annual *Financial Stability Report*. The *Report* assesses the current state of the financial system and discusses ways to strengthen the system in the future.

The *Report* states that market sentiment has improved recently, along with perceptions of banks' resilience. Funding conditions have also improved slightly. But banks inevitably remain vulnerable. Leverage is still high and wholesale and retail funding pressures remain. So banks in the UK and internationally remain sensitive to further adverse economic or financial sector developments, which could in turn affect economic recovery and flow back to the banking system.

In response to the events of the financial crisis, authorities internationally are working to strengthen financial system resilience over the medium term. The *Report* discusses five broad areas where policy changes are needed. A theme throughout is that policies should be based on their impact on the overall system, not just on individual firms.

Commenting on the *Report*, Paul Tucker - Deputy Governor, Financial Stability - said: "The policy debate now underway matters enormously if we are to achieve a more stable financial system in the future. No particular initiative will be sufficient by itself. Greater resilience will need to be based on a variety of measures, some of which are discussed in this Report as a contribution to the wider national and international debate."

The five policy areas discussed in the *Report* are:

(i) *Strengthening market discipline*. Richer and more frequent public disclosures by banks are required. To control risk-taking, financial institutions need to face a credible threat of closure or wind down, via resolution regimes. And to encourage more effective market discipline on deposit-takers, the Bank supports a risk-based, pre-funded deposit insurance system.

(ii) *Greater self-insurance by financial institutions*. Institutions' own resources should be the first line of defence against financial pressures. That will require: higher levels of loss-absorbing bank capital and larger, high-quality liquidity buffers; a cushion to be built up to absorb future losses during the upswing of a cycle;

reduced reliance on ratings agencies; contingency plans for accessing capital and funding in times of stress, and for restructuring or winding up an institution in the event of distress.

(iii) *Improved management of risks arising from interactions among financial institutions*. The authorities need better information on connections between institutions. Capital and liquidity buffers need to reflect the impact financial institution's distress or failure could have on the system as a whole, and so larger and more interconnected banks need to hold larger buffers. To prevent the build-up of financial imbalances, countercyclical instruments are needed. The Bank also supports greater use of central counterparties for standardised and liquid financial contracts and more trading of key financial instruments on exchanges or other open platforms.

(iv) *Size and structure of the financial system compatible with maintaining financial stability*. Banks should not be too big or complex. Authorities, domestically and internationally, should consider whether they need more actively to influence or constrain the future size and structure of the system to support stability. For groups providing economically critical functions, it has to be possible to supervise them effectively and if need be resolve them in the event of severe distress. Possible measures could include limiting the scope of banks' businesses to a narrower range of relatively low-risk activities, or imposing higher capital and liquidity charges on institutions that pose greater risks to the economy or taxpayer in the event of failure. Such measures ought to go hand in hand with improved resolution powers to wind down large and complex financial institutions in an orderly manner. Determining the optimal policy mix poses major challenges but merits further debate internationally.

(v) *Principles for future support from public authorities*. When in future self protection fails, interventions to contain crises should be guided by explicit principles - for example, for acting as market maker or capital provider of last resort - to ensure that they do not encourage imprudent behaviour by financial institutions and minimise risks to the public finances.

**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 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.

A visual summary of the FSR is available below.

Visual Summary of the Financial Stability Report
http://www.bankofengland.co.uk/publications/Documents/fsr/2009/fsrsum0906.pdf

Financial Stability Report, Issue
http://www.bankofengland.co.uk/publications/Documents/fsr/2009/fsrfull0906.pdf