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Financial Stability Report Summary

Bank of England/Central Bank of the United Kingdom

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Financial Stability Report Summary
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In recent weeks, the global banking system has arguably undergone its biggest episode of instability since the start of World War I. This instability was rooted in weaknesses within the financial system that developed during an extended credit boom: rapid balance sheet expansion; the creation of assets whose liquidity and credit quality were uncertain in less benign conditions; and vulnerabilities in funding structures.

Following a year of severe stress in the banking system, growing evidence emerged over the summer of a slowdown in the economy and further bank losses. That heightened fears of a further adverse spiral of falling asset prices, tighter credit conditions and slower economic growth. Failures of some institutions were followed by severe dislocation in the global interbank funding network. That, in turn, led to acute strains in banking systems internationally and in the United Kingdom.

On 8 October, the UK authorities announced a set of system-wide measures that addressed in size and at source perceived weaknesses in banks’ capital and funding structures. The package supports capital raising to strengthen banks’ resilience and offers assurance about banks’ liquidity positions. Other countries have subsequently announced measures with similar underlying principles. Early signs suggest these measures have helped underpin the banking system.

But risks in the financial system clearly remain. Over time, against the backdrop of an economic downturn, banks will need to adjust their balance sheets and funding models, weaning themselves off current exceptional levels of official sector support. Recapitalisation should ease this adjustment, but lending growth will take time to recover. As the system stabilises, a fundamental rethink will be needed of how to address systemic risks, both through improved regulatory frameworks and developing new macroprudential policies to dampen the credit cycle.

This Report sets out:
— An analysis of developments that culminated in the turmoil of recent months.
— The reasons for the exceptional measures taken by the UK authorities and those in other countries.
— The Bank’s view on the short-term prospects for the financial system and on the medium-term reforms necessary to address systemic risks.

Key vulnerabilities in the financial system:
• Heightened uncertainty about the value of banks’ asset portfolios, as macroeconomic and counterparty risk rose.
• Undercapitalisation of banks following a prolonged period of underpricing of risk and balance sheet expansion, which led to an erosion of confidence in the banking system (pages 26–29).
• Banks’ high structural dependence on wholesale funding markets, the impaired functioning of which led to rising rollover risk (pages 7–9).
• Underappreciated interconnections between firms in the global financial system arising from funding models and globalisation of asset exposures.

Measures taken and required:
• Government-supported recapitalisation of the banking system, including direct investment of public funds (Box 5, page 31).
• Direct injection of additional liquidity via various expanded central bank operations (Box 5, page 31).
• A temporary guarantee of new short and medium-term debt issuance for institutions raising sufficient capital (page 30).
• Over the medium term, an adjustment by some banks of their funding structures to refinance large-scale government interventions and to develop more sustainable funding models (pages 36–40).
• A fundamental rethink of safeguards against systemic risk, both through existing regulatory frameworks and new countercyclical policies (pages 41–45).

This document provides a short, visual guide to the analysis within the Report. It is also available on the Bank’s website at www.bankofengland.co.uk/publications/fsr/2008/fsrs0810.pdf.
Benign international macroeconomic conditions contributed to an extended global credit boom, with financial institutions, including UK banks, rapidly expanding their balance sheets (pages 7–9)...

...accompanied by sharp increases in banks’ leverage...

...as financial innovation and a search for yield encouraged risk taking and risk distribution across borders, increasing connections across financial systems...

...with lending increasingly financed from wholesale funding, often from overseas.

Given a weakening of asset quality and funding structures, banks in the United Kingdom and internationally were vulnerable to credit and liquidity risks.
These risks crystallised as the macroeconomic outlook weakened and housing markets deteriorated in several countries (page 10)...

...translating into further, more broadly based, losses on many institutions’ asset portfolios...

...and increasing uncertainty about future potential losses on lending. For example, estimated mark-to-market losses have more than doubled since the previous Report, and now total some US$2.8 trillion (Box 1, page 14).

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**Mark-to-market losses on selected financial assets**

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<tr>
<td><strong>United Kingdom (£ billions)</strong></td>
<td></td>
<td></td>
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<tr>
<td>Prime residential mortgage-backed securities</td>
<td>193</td>
<td>8.2</td>
<td>17.4</td>
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<tr>
<td>Non-conforming residential mortgage-backed securities</td>
<td>39</td>
<td>2.2</td>
<td>7.7</td>
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<tr>
<td>Commercial mortgage-backed securities</td>
<td>33</td>
<td>3.1</td>
<td>4.4</td>
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<tr>
<td>Investment-grade corporate bonds</td>
<td>450</td>
<td>46.2</td>
<td>86.5</td>
</tr>
<tr>
<td>High-yield corporate bonds</td>
<td>15</td>
<td>3.0</td>
<td>6.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>62.7</strong></td>
<td><strong>122.6</strong></td>
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| **United States (US$ billions)** | | | |
| Home equity loan asset-backed securities (ABS)\(\text{(c)}\) | 757 | 255.0 | 309.9 |
| Home equity loan ABS collateralised debt obligations (CDOs)\(\text{(d)}\) | 421 | 236.0 | 277.0 |
| Commercial mortgage-backed securities | 700 | 79.8 | 97.2 |
| Collateralised loan obligations | 340 | 12.2 | 46.2 |
| Investment-grade corporate bonds | 3,308 | 79.7 | 600.1 |
| High-yield corporate bonds | 692 | 76.0 | 246.8 |
| **Total** | **738.8** | **1,577.3** |

| **European Union (€ billions)** | | | |
| Residential mortgage-backed securities\(\text{(e)}\) | 387 | 21.5 | 38.9 |
| Commercial mortgage-backed securities\(\text{(e)}\) | 34 | 2.8 | 4.1 |
| Collateralised loan obligations | 103 | 6.8 | 22.8 |
| Investment-grade corporate bonds | 5,324 | 283.8 | 642.9 |
| High-yield corporate bonds | 175 | 29.1 | 75.9 |
| **Total** | **3,443.1** | **784.6** |

Source: Bank calculations.

(a) Estimated loss of market value since January 2007, except for US collateralised loan obligations which are losses since May 2007.
(b) Data to close of business on 20 October 2008.
(c) 2005 H1 to 2007 H2 vintages. The home equity loan asset class is comprised mainly of US sub-prime mortgages, but it also includes, for example, other mortgages with high loan to value ratios. Home equity loans are of lower credit quality than US Alt-A and prime residential mortgages.
(d) High-grade and mezzanine ABS CDOs, excluding CDO-squareds.
(e) Germany, Ireland, Italy, Netherlands, Portugal and Spain.
As a result, uncertainty about the value of banks’ assets rose sharply, reflected in abrupt increases in banks’ equity price volatility (page 26)...

...while high leverage prompted questions about financial firms’ capital adequacy and funding (pages 17–19)...

...raising concerns about the viability of some institutions...

...which was heightened by severe institutional distress, including at Fannie Mae, Freddie Mac and Lehman Brothers in the United States, Bradford & Bingley in the United Kingdom and Hypo Real Estate in Germany...
...leading to extreme strains in the global interbank funding network...

...and highly correlated risks across financial systems (page 26)...

...especially for banks dependent on wholesale funding.

As some banks sold assets or reduced credit, an adverse cycle of falling asset prices and weakening economic prospects began to develop. Pressures on banks’ funding and concerns about their solvency spread system-wide (pages 27, 29).
On 8 October, the UK authorities announced a package of measures that support capital raising at banks and offer assurance about banks’ liquidity positions (Box 5, page 31)…

…with similar measures subsequently adopted in a number of other countries.

The government-supported recapitalisation has reduced default fears among UK banks significantly (page 34)…

…with signs of reduced pressures on banks’ funding…

…which should help to support lending growth, which in the absence of the package might have contracted more rapidly.
Funding pressures and falling asset prices continue to represent a risk for other parts of the financial system, such as hedge funds (pages 35–37)...

...with growing signs of stress in some emerging market economies.

Over time banks need to adjust funding structures to reduce financing vulnerabilities and to wean themselves off large-scale official support, both capital and liquidity (pages 37–39).

Recent events have demonstrated that banks’ capital holdings, which are low by historical standards, have been insufficient to absorb systemic risks (pages 41–42).
Holdings of liquid assets are also very low by historical standards (pages 39–40)...

...and financial firms will need to strengthen their liquidity risk management.

Key actions to improve resilience

- Macroprudential tools are needed to guard against systemic risk and to ensure banks are in a stronger position ahead of the next downturn.
- Capital levels have been too low and need to rise, and capital needs to be of sufficient quality to deliver higher levels of resilience.
- Liquidity standards have been inadequate and should be strengthened to ensure that firms are sufficiently resilient to a range of shocks.
- The current UK legal framework for depositor protection and dealing with institutions in difficulties needs to be strengthened.
- International arrangements for managing crises at cross-border financial institutions should be developed further.
- Transparency should be improved through more informative disclosure, including the provision of more information on potential future balance sheet volatility, to strengthen market discipline.
- The scope for — and potential benefits of — developing centralised infrastructures for a broad array of over-the-counter instruments should be assessed.

Over the medium term, a fundamental rethink of safeguards against systemic risk is needed, including the development of new countercyclical tools and stronger capital and liquidity regulation (pages 41–45).