FINANCIAL STABILITY REPORT PRESS CONFERENCE
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Opening Remarks by the Governor

Faced with a crisis of the euro-area system, we are seeing at first hand the costs of financial instability.

The symptoms of the crisis have been widely reported. Many European governments are seeing the price of their bonds fall, undermining banks' balance sheets. In response, banks, especially in the euro area, are selling assets and deleveraging. An erosion of confidence, lower asset prices and tighter credit conditions are further damaging the prospects for economic activity and will affect the ability of companies, households and governments to repay their debts. That, in turn, will weaken banks' balance sheets further. This spiral is characteristic of a systemic crisis.

Tackling the symptoms of the crisis without resolving the underlying causes, by measures such as providing liquidity to banks or sovereigns, offers only short-term relief. Ultimately, governments will have to confront the underlying causes. A loss of external competitiveness in some euro-area countries has led to current account imbalances and large build-ups of private and public debt, much of it external. The problems in the euro area are part of the wider imbalances in the world economy. The end result of such imbalances is a refusal by the private sector to continue financing deficits, as the ability of borrowers to repay is called into question.

Resolving these wider problems is beyond the control of any UK authority. The responsibility of the Financial Policy Committee is to focus on measures that can protect and enhance the resilience of the UK financial system in this threatening environment, and ensure it is better equipped to counter even more serious potential problems further down the road. It is crucially important that we avoid causing individual banks to seek to strengthen their balance sheets in such a way that, when taken together with similar actions by others, may cause harm to the wider economy.

So what does the Financial Policy Committee recommend? The recommendations are set out on page 5 of the *Report*.

First, **following its recommendation from September, and given the current exceptionally threatening environment, the Committee recommends that, if earnings are insufficient to build capital levels further, banks should limit distributions and give serious consideration to raising external capital in the coming months.**

This recommendation does not reflect a view on the Committee that the current level of capital in individual UK banks is insufficient. Indeed, UK banks are better capitalised than many of their Continental peers. Rather, it reflects a judgement that it is sensible and desirable to raise capital buffers further in order to improve resilience in light of the continuing threats to UK financial stability, while at the same time enhancing the capacity of banks to provide credit to the wider economy. That is why the recommendation is framed in terms of <u>levels</u> of capital and not capital <u>ratios</u>.

It is important that attempts by banks to improve resilience by adjusting their asset holdings do not reinforce the strains in financial markets or threaten the supply of credit to businesses and households. Therefore in its second recommendation, **the Committee reiterates its advice to the FSA to encourage banks to improve the resilience of their balance sheets without exacerbating market fragility or reducing lending to the real economy.**

It is also important that investors are able to make a clear assessment of the strength of banks' balance sheets. The Committee recognises that concerns about the opacity of the internal risk weights used by banks in calculating regulatory capital ratios can undermine confidence in those measures. As a result, leverage ratios, which do not depend on risk weights, are useful additional indicators of capital adequacy. Under Basel III banks will have to calculate a leverage ratio from 2013, although they will not have to begin reporting it until 2015. Given its potential usefulness to investors, **the Committee recommends that the FSA encourages banks to disclose their leverage ratios, as defined in the Basel III agreement, as part of their regular reporting not later than the beginning of 2013.**

Alongside an account of the analysis underpinning those recommendations, the *Financial Stability Report* covers the progress made in implementing our previous recommendations. Section 4 describes that progress. Let me report back briefly on the work completed so far. The FSA's investigations have shown that the direct exposures of smaller UK institutions to the banks and governments of the European nations worst affected by the crisis are small;

that current forbearance and provisioning practices are, by themselves, unlikely to pose a threat to systemic stability; and that opaque structures such as collateral swaps and similar transactions employed by exchange-traded funds constitute only a small part of UK banks' funding at present.

The crisis in the euro area is one of solvency and not liquidity. And the interconnectedness of major banks means that banking systems, and hence economies, around the world are all affected. Only the governments directly involved can find a way out of the crisis. But here in the UK, we must try to bolster the resilience of our financial system, better to withstand the storms that may come in our direction.