

**United Kingdom: Financial System Stability Assessment
including Reports on the Observance of Standards and Codes on the following topics:
Banking Supervision, Insurance Supervision, Securities Regulation, Payments Systems,
Monetary and Financial Policy Transparency, Securities Settlement Systems,
and Anti-Money Laundering and Countering Terrorist Financing**

This Financial System Stability Assessment on the **United Kingdom** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on information available at the time it was completed on **February 7, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **United Kingdom**, or the Executive Board of the IMF.

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Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and the European I Departments

Approved by Stefan Ingves and Michael Deppler

February 7, 2003

- This Financial System Stability Assessment (FSSA) is based on work of an IMF mission that visited the United Kingdom (U.K.) as part of the Financial Sector Assessment Program (FSAP) in February, May and July 2002. In addition, mission members visited supervisors in New York and Germany to discuss cross-border supervision issues related to the U.K., and undertook work related to global markets in London during an International Capital Markets Department mission there in March 2002. Follow up discussions on the FSAP findings took place from November 21-27, 2002 in the context of the 2002 Article IV consultations.
- The FSAP team over the three missions was led by V. Sundararajan and included (at various times) Mark Swinburne, John Abbott, R. Sean Craig, Frank Engels, Julio Escolano, Eric Parrado, Liliana Schumacher, Rhoda Weeks-Brown and Mark Zelmer (all IMF), Rodney Lester (World Bank), Martin Andersson (Riksbank, Sweden), Alan Cameron (World Bank Consultant, Australia), Paolo Costanza (Ufficio Italiano dei Cambi, Italy), Laurie Edlund (OCC, US), Carl Hiralal (OSFI, Canada), Tom Kukkola (European Central Bank), Jan Rein Prunel (De Nederlandsche Bank, Netherlands), and David Shillman (SEC, US). Paul Atang (IMF/MAE) provided research assistance and Claudia Mariel, Charmion O'Connor and Funke Fasalojo (all IMF/MAE) were mission assistants. Martin Brooke and Alison Stuart (Office of the Executive Director for the U.K.) joined a number of the mission meetings.
- The U.K.'s large, sophisticated and internationally-oriented financial sector features fundamentally sound financial institutions, markets and infrastructure. The banking sector appears sufficiently profitable and well-capitalized overall to be able to absorb the more likely shocks without major distress, although a number of key risks will need to be watched. In contrast, the U.K. insurance sector (like some other insurance sectors internationally) is under considerable stress, but this does not appear to constitute a systemic vulnerability. The U.K. financial markets work well, although given its structure the unsecured interbank market could act as a contagion channel in extreme circumstances. Global financial market activity in London does not appear to pose significant risks to the U.K. system, in part because the major reforms in payments and settlement systems in recent years are an important mechanism for keeping the linkages with the U.K. financial system manageable.
- The financial sector is supported by a financial policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally. In general, the supervision framework complies or largely complies with most international standards and codes, and there is a constant drive amongst the authorities to rectify weaknesses. The most important area for reform is insurance supervision, where proposals are being developed to bring the framework up to the standards applicable to a major international center; in other areas too, there remain a few aspects where further refinements would be desirable in recognition of London's major international orientation and the emphasis on market discipline in the financial policy framework. Supervision in the U.K. is in turn supported by well-functioning safety net, systemic liquidity, system-level surveillance, and insolvency arrangements and a high quality accounting and disclosure regime.
- This report is divided into two sections. The first section provides an overall stability assessment for the U.K. financial system. As an input into the overall assessment, the second section reports on the observance of standards and codes on banking, securities and insurance supervision, payment and securities settlement systems, transparency in monetary and financial policies, and AML/CFT.
- The main authors of this report are V. Sundararajan, Liliana Schumacher, Mark Swinburne, and Mark Zelmer.

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LIST OF ACRONYMS AND ABBREVIATIONS

AML	Anti-money laundering
ASB	Accounting Standards Board
BACS	The U.K. electronic retail payments system (previously, Bankers' Automated Clearing System)
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
CFT	Combating the financing of terrorism
CHAPS	Clearing House Automatic Payments System. NewCHAPS is latest variant of the system
CLS	Continuous Linked Settlement
CMO	Central Money Markets Office (settlement system for money market instruments)
CPSS	Committee on Payment and Settlement Systems
CREST	The U.K. securities settlement system
CRESTCo	Company operating the CREST and CMO systems. (Now merged with Euroclear, the European securities settlement agency.)
DMO	Debt Management Office
DVP	Delivery versus Payment
ERI	Exchange Rate Index (Nominal effective)
EU	European Union
FI(s)	Financial institution(s)
FIU	Financial Intelligence Unit
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
FSR	Financial Stability Review
FSSA	Financial System Stability Assessment
FSSC	Financial stability Standing Committee
GAAP	Generally Accepted Accounting Principles
GAD	Government Actuary's Department
HLFI	Highly Leveraged Financial Institutions (hedge funds)
HMCE	HM Customs and Excise
HMG	HM Government
HMT	HM Treasury
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
IPE	International Petroleum Exchange
IT	Information Technology
LCFI	Large Complex Financial Institution
LCH	London Clearing House (central counterparty clearing house)
LIFFE	London International Financial Futures and Options Exchange. Now Euronext LIFFE.
LME	London Metal Exchange
LSE	London Stock Exchange
MFP Code	IMF Code of Good Practices on Transparency in Monetary and Financial Policies
MMIs	Money market instruments
MoU	(U.K. financial stability) Memorandum of Understanding
NCIS	National Criminal Intelligence Service
NPLs	Non-performing loans
OFCs	Off-shore Financial Center

OTC	Over the counter
PVP	Payment-versus-payment
RBS	Royal Bank of Scotland
RTGS	Real-Time Gross Settlements
ROE	Return on equity
ROSCs	Reports on Standards and Codes
RSSS	Recommendations for Securities Settlement Systems
RTO	Risk to objectives
TARGET	Trans-European Automated Real-Time Gross Express Transfer System
UKLA	U.K. Listing Authority

SECTION I. STAFF REPORT ON FINANCIAL SYSTEM STABILITY

I. OVERALL STABILITY ASSESSMENT

1. **The U.K.'s large and sophisticated financial sector features fundamentally sound and highly developed financial institutions, markets and infrastructure.** It is supported by a financial stability policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally. That is not to deny, firstly, that there have been specific and often high-profile problems in the U.K. financial system (and currently in the insurance sector); nor, secondly, that there are potential risks and vulnerabilities that policymakers need to pay particular attention to; nor, finally, that there are aspects of the policy framework that could desirably be strengthened somewhat further (see Box 1 below). But these issues do not constitute systemic concerns, in part because they are typically already well recognized by the authorities themselves, who are constantly striving for further improvement in the policy framework to address weaknesses. Indeed, it is notable that the U.K. financial system has shown itself to be resilient to significant shocks of various sorts in recent years. Just as important, the system itself and the underlying financial policy framework have generally been flexible enough to take on board the important lessons from past episodes.

2. **A key feature distinguishing the U.K. system is of course its major international orientation.** There are important but not dominating links between the international financial market activity in London and the U.K. financial system *per se*, and the recent reforms to bring key parts of the U.K. financial infrastructure up to the best international standard are an important mechanism for keeping the direct and indirect linkages manageable. Further, among the larger institutions at least, risk management practices have been strengthened significantly over the last decade or so—the larger U.K. banks as a group are among the highest-rated in the world.

Institutions, Markets, and Infrastructure

3. **For the U.K. banking system, potential risks arise from both domestic and foreign sources.** On the foreign side, the banks have so far been able to weather the credit deterioration stemming from the sharp slowdown in global growth in 2001 and 2002, weak equity markets, and large corporate and sovereign defaults. Nevertheless, a slower-than-envisaged recovery in global demand, or further declines in global equity prices, are potential sources of risk. On the domestic side, high household and corporate debt levels have so far been offset by the effects on servicing capacity of low interest rates and a relatively mild slowdown in activity in late 2001 and early 2002. However, risks to the financial system could arise from deteriorating domestic economic conditions, rising unemployment, or higher interest rates than currently expected, especially if these are accompanied by significant declines in property prices from their current high levels. These factors also need to be seen against the trend towards some narrowing in profit margins, at least among the bigger banks, due in part to continuing competitive pressures, regulatory pressures to limit some service fees, and rising loan loss provisions.

4. **Based on a variety of quantitative approaches alongside more qualitative analysis, U.K. banks (and building societies as a group) appear sufficiently profitable and well-capitalized overall to be able to absorb the effects of the more likely macroeconomic shocks without systemic distress.** This partly reflects healthy profits and capital accumulation during the past decade of strong economic performance. It also reflects the relatively broad range of the banks' domestic and foreign activities, and continuing improvements in their risk management practices. The quantitative analyses tend to confirm other evidence that credit risk, rather than market risk, would be the main channel through which banks would be affected by shocks.

5. **In contrast, the insurance sector in the U.K. as in many other countries is under considerable stress—especially the life and private pensions sector although the general insurance sector, including the Lloyds market, has its own challenges.** The stress reflects depressed investment returns, declining profitability in basic life insurance products, increasing regulatory compliance costs as the FSA introduces (appropriately) more stringent prudential supervision of the sector and tightens supervision of long-term savings products, and rising uncertainty about the financial consequences of general insurance companies providing insurance against very low probability and catastrophic events. The life industry appears headed for large-scale consolidation in coming years in response to these issues. Although Lloyds members and London general insurance market participants were hard hit after 9/11, U.K. underwriters appear on the whole to have coped remarkably well, and are currently benefiting from higher premiums following the terrorist attacks.

6. **The difficulties in the insurance sector, while significant, do not currently appear to constitute a systemic vulnerability for several reasons.** In the life sector, most difficulties are concentrated in small-to-medium sized insurers rather than the larger companies—though some of the latter may also be adversely affected if equity market weakness continues—and the FSA is actively involved in addressing the problems. While there are some important ownership linkages with banks, generally these are less of an issue than in some other countries. Bank lending to insurers is also a small fraction of U.K.-owned banks' claims. Nevertheless, close monitoring of the situation is clearly required, due to the importance of the insurance industry in capital markets and the potential, at least, for current conditions to create incentives for some firms to move into higher risk-higher return strategies, such as greater involvement in credit-risk transfer markets than has occurred to date.

7. **Turning to the major U.K. financial markets, the U.K. financial exchanges function well.** Concerns associated with market fragmentation have not yet arisen to a significant degree in the U.K. compared to some other industrialized countries. The London Stock Exchange (LSE) and the London International Financial Futures and Options Exchange (now Euronext LIFFE) have taken steps to enhance their trading systems and adapt their rules to ensure their markets remain attractive to investors. In the derivative markets, and as noted above in the context of insurance companies, activity in credit-risk transfer markets will need to be monitored closely in case their systemic importance, or their relevance for supervision of risk taking at the individual institution level, grows further.

8. **The money market does a good job in distributing the liquidity supplied by the BoE.** While the unsecured interbank segment of the money market functions well, it could potentially act as a contagion channel in the unlikely event that a major participant experienced financial distress. The traditional structure of the U.K. banking system (a few large, direct clearing banks, and a large number of smaller, indirect clearers) may exacerbate this risk, since the smaller institutions tend to hold most of their liquidity in the form of unsecured deposits with the largest institutions. It may also contribute to the “too big to fail” perceptions that exist at the margin for the largest banks, to the extent it further adds to the systemic importance of these banks. The authorities were encouraged to continue intensifying their surveillance of these exposures, so that they can obtain a better sense of the distribution of claims in the banking system, and the risk of contagion in the event of a significant failure. Obtaining a complete picture of these exposures ultimately requires close collaboration between the U.K. authorities and their foreign counterparts, since many of these exposures involve foreign FIs that are not supervised by the U.K. authorities.

9. **The global financial market activity that takes place in London does not, in itself, appear to pose significant risks to the stability of U.K. financial markets, or to the domestic and international financial system more generally.** Although some U.K.-owned institutions are significant players in some of these markets, and some foreign-owned firms have a material presence in U.K. banking and insurance markets, trading activity is to an important extent insulated from the domestic financial system, in part because it primarily involves wholesale market transactions between branches of foreign institutions that have little connection to the domestic financial system. U.K.-owned institutions, meanwhile, obtain most of their profits from the provision of financial services to the domestic economy. In addition, the nature of this activity is such that the location of trading in London is largely divorced from the final processing and settlement of transactions, except in respect of LCH and CHAPS-Euro.

10. **With respect to infrastructure, major reforms of the U.K. payments and securities settlement systems have been made in recent years, and the CHAPS and CREST systems are of a very high standard internationally.** These reforms protect direct settlers from intraday exposures, although the two-tier structure of the banking system may still result in important intraday exposures between direct and indirect settling banks. That aspect aside, the authorities are rightly focusing on bringing the settlement of money market instruments into the CREST real-time DVP arrangement; and on addressing the payment arrangement for the central counterparty clearing house, LCH, which results in large albeit short-lived intraday exposures. The authorities were encouraged to continue their work on resolving these issues, including making supporting legislative amendments as necessary, and also to continue seeking risk management improvements in BACS, the largest retail payment system.

Institutional and Policy Framework for Financial Stability

11. **The U.K. financial stability policy framework is at the forefront internationally in many respects.** Clearly a great deal of thought has gone into making the institutional structure work—how to sharpen focus, accountabilities, and transparency; how at the same time to encourage and facilitate coordination between the main players, under the umbrella of the

financial stability Memorandum of Understanding and the associated financial stability Standing Committee (FSSC); how, at the level of the FSA, to manage the potential trade-offs between the various objectives and principles of good regulation in the FSMA, within the context of integrated supervision; and how, in the BoE, to strengthen surveillance of broad conjunctural and structural factors affecting systemic stability and payment system oversight, and making the results of much of this work public in its semi-annual *Financial Stability Review*. The FSA is accountable for how it is balancing its various statutory objectives and principles; shifts in priorities and trade-offs can be expected to be made quite explicit in FSA publications, with operational implications laid out through its “risk-to-objectives” (RTO) framework.

12. **Though the differences should not be overstated, it seems fair to characterize the U.K. supervision regime as somewhat less prescriptive overall than in some other countries, but with relatively more emphasis on policies to promote good corporate governance and market discipline.** Regulatory principles on the responsibilities of owners/managers and proportionality of regulation are noteworthy in this context. Also of note is the requirement for explicit cost-benefit analyses of supervisory initiatives. The logic of the FSA’s risk-based framework, and specifically the flexibility to shift supervisory resources between objectives and risk areas, requires a strong underlying disclosure and governance regime to facilitate smooth shifts in focus when unexpected developments occur. This consideration also has implications for the nature of supervision, which needs to rely on independent assessments of the effectiveness of systems and controls, a strong baseline monitoring of key risks, including through regular coverage of core themes (such as validation of returns, AML, and credit risk management), and early intervention arrangements.

13. **Continued further efforts to promote market discipline—if necessary ahead of the completion of international efforts—may be necessary to complement and underpin the U.K. supervisory philosophy.** At the same time the move to International Accounting Standards poses important challenges for supervision and disclosure practices. The FSA is developing new proposals on “harnessing market forces,” but at this stage it seems that more could be done in several areas. While the emphasis on consumer education in general is laudable, the authorities were encouraged to closely consider further aspects such as more depositor-friendly prudential disclosures to enable retail customers to differentiate better between FIs; required FI ratings by rating agencies, and publication thereof; and the development of standardized market and credit risk disclosure requirements applicable cross-sectorally, and a consistent methodology for measuring insurance risk. Of course in a number of these areas the technical issues are not straightforward, but London’s status argues for continuing to probe the boundaries in this area.

14. **Broader financial sector surveillance is a key component of an overall stability policy regime; thus, the work and publications of the BoE and FSA reflect a considerable emphasis on financial stability analysis and research.** Such surveillance is essential for a focused assessment of the risks and vulnerabilities that may develop in the future, and for shaping supervisory policy and allocating supervisory resources. In addition to work on potential contagion channels already noted, the authorities were encouraged to also continue to standardize and extend the availability of aggregate financial soundness indicators; and to

consider the scope for using macro-financial stress testing analysis of the sort undertaken for the FSAP exercise as an ongoing instrument of stability analysis.

15. The safety net arrangements and underlying legal framework for failure management enable the U.K. authorities to effectively manage instances of serious financial difficulties in FIs. There is no special insolvency/administration statute for FIs in the U.K., but the FSA has various important rights in insolvency proceedings as well as wide-ranging enforcement powers under the FSMA that can be used before the formal statutory proceedings are invoked. If circumstances arise where systemic issues appear possible, and where emergency liquidity support might be considered, the authorities' response would be coordinated through the FSSC. Protection to depositors, investors, and insurance policy holders is provided through an ex-post industry-funded scheme that features a form of co-insurance arrangement up to maximum limits for investment and deposit compensation. Insurance compensation has no maximum limit, and there is no co-insurance for compulsory insurance. An upcoming review should consider, inter alia, the desirability of an explicit government credit line.

Supervisory, Transparency and Market Integrity Standards

16. The quality and effectiveness of financial sector supervision in the U.K. is strong in the banking and securities areas. As indicated in Section II, the FSA either fully or largely observes the *Basel Core Principles for Effective Bank Supervision* and the *IOSCO Objectives and Principles of Securities Regulation*. In both areas, some further technical improvements were suggested, largely reflecting the highly sophisticated nature of the U.K. financial system and London's role as a key international financial center, and the desirability in that context of further strengthening and rebalancing various supervisory tools. For banking supervision, in particular, the issues mainly revolved around strengthening "baseline" supervision (i.e., the elements applying to all supervised FIs, irrespective of their risk/impact rating) and ensuring strong assessments of systems and controls.

17. In the case of insurance industry, U.K. authorities are developing proposals to significantly strengthen supervision, and are adding resources to the FSA for this purpose. Although the U.K. observes the *regular* prudential *IAIS Insurance Core Principles*, the proposed reforms are likely to deal with most of the weaknesses observed in the current supervisory framework relative to the *enhanced* standards that are more pertinent for an advanced and international insurance center like the U.K. Some additional technical recommendations were offered for consideration, again mainly reflecting that status.

18. With respect to the oversight of payments and securities settlement systems, the major progress in infrastructure reform in recent years illustrates how these functions have been significantly improved. Assessments against the relevant standards in Section II show a high degree of observance, with the main recommendations being for the authorities to push ahead with their efforts noted above to bring money market settlement fully into a real time delivery versus payment framework, and to address LCH's cash payment arrangement.

19. **The authorities' strong commitment to policy transparency is reflected in the assessments of a very high degree of observance of the IMF *Code of Good Practices on Transparency in Monetary and Financial Policies*.** There are a few areas in which both the BoE and the FSA could usefully go a little further to clarify still more their roles or policies, and progress is already being made in most of these areas.

20. **The U.K. has a comprehensive legal, institutional and supervisory regime for AML/CFT.** It is broadly in line with the criteria set forth in the FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations for Combating the Financing of Terrorism, and with the criteria set forth in the AML/CFT Methodology that is used to assess observance of those recommendations. The system has been made more robust over the last few years, and further important improvements are expected once key provisions of the Proceeds of Crime Act 2002 become effective and requirements are adopted for the inclusion of originator information on wire transfers originating in the United Kingdom. There is also scope for additional refinements in several areas.

Box 1: Summary of Key FSAP Recommendations

While the U.K. benefits from a strong financial stability policy framework, the FSAP team put forth some technical recommendations in a number of areas to make the framework even stronger. This box summarizes the most important ones. The U.K. authorities recognize the significance of these issues overall, and are actively addressing them. Cost-benefit analyses would rightly need to be undertaken for supervisory initiatives and may imply that some of the recommendations might (e.g.) be best resolved in the context of broader international agreements. However, the U.K. authorities were encouraged to consider acting alone if it becomes apparent that international agreements will not be forthcoming within a reasonable period of time.

- Especially given the current stress and trends confronting the insurance industry, continue work on rectifying the shortcomings that exist in the current insurance supervision framework, and implementing the recommendations of the Tiner Report so that insurance supervision is fully consistent with the importance of the U.K. insurance sector. Progress on this high-priority, albeit more medium-term, structural issue needs to be achieved at the same time as the supervisors deal forcefully with the current problems in the industry.
- Actively pursue the remaining steps needed to strengthen the payments and securities settlement infrastructure. Here, the major issues are to bring money market instruments into the CREST real-time DVP system, and to improve LCH's payment arrangements, including promoting the requisite legislative changes. Improved risk management in the BACS retail payment system is also desirable.
- Continue to strengthen the surveillance and monitoring of the inter-institutional linkages that could be important channels for contagion, especially the unsecured intraday and overnight interbank exposures between banks; activity in the risk transfer markets is also important to monitor more closely. Consider making greater use of quantitative techniques to assess the resiliency of the financial system to potential shocks.
- Continue efforts to promote market discipline through improved disclosure and governance in FIs, if necessary ahead of the completion of international efforts, while factoring in the implications for disclosure and supervision of the challenges arising from the move to IAS.
- Within the supervisory framework in general, pursue technical improvements to strengthen further the assessment and verification of FIs' systems and controls, and ensure a strong "baseline" monitoring of key risks, including regular coverage of core themes, and ensure that all institutions are subject to a credible threat of on-site inspection even if on a sampling basis.
- In the area of AML/CFT, pursue a range of refinements to enhance the regime's strength and effectiveness, in the wake of the new Proceeds of Crime Act.

II. FINANCIAL SYSTEM OVERVIEW

A. Institutions

21. **The U.K. financial sector is a large contributor to domestic economic activity, and has a major international orientation.** In 2001, the financial sector contributed 5.2 percent of GDP, and net exports of insurance and financial services represented 1.3 percent of GDP. As of March 2002, banks and insurance companies' financial assets were over 4.5 times GDP. Table 1 in the Statistical Appendix summarizes the structure of the sector. With respect to the banking sector, the U.K. *resident banking system* comprised 395 banks that held total assets of around £3,500 billion (3.5 times of GDP). There were also 65 building societies and 700 credit unions that together held assets of around £400 billion. The four major U.K.-owned commercial banks accounted for about 24 percent of the resident banking activities in the U.K.¹ Assets of *U.K.-incorporated banks*, consolidated across branches and subsidiaries in the U.K. and worldwide, were around £2,500 billion.²

22. **The U.K.-owned banks have a diversified set of claims against domestic and foreign counterparties** (Table 2 of Statistical Appendix). Around 40 percent of total bank claims were against foreign counterparties, of which around half were cross-border claims,³ while the rest were foreign exposures in local currencies in banks' branches and subsidiaries worldwide. In addition, off-balance sheet items of U.K.-owned banks represented around £925 billion, of which 17 percent are over-the-counter (OTC) derivative instruments—measured by their credit equivalent—mainly with domestic and foreign bank counterparties.

23. **A few of the major U.K. institutions are Large Complex Financial Institutions (LCFIs), but most LCFIs operating in the U.K. are headquartered elsewhere.** Generally, LCFIs are active in a range of commercial banking, investment banking, and insurance activities, have a significant presence in other major financial centers, and are active, often as market makers, in key OTC markets such as derivatives and foreign exchange. They have significant links to U.K. markets and counterparty credit relationships with domestic financial institutions that represent potential channels for contagion in the U.K.

¹ The four major U.K.-owned banks are Barclays, Lloyds TSB, Royal Bank of Scotland Group and HSBC. In addition, a fifth large bank has recently been created as a result of the merger of Bank of Scotland and Halifax, both mortgage banks.

² The *resident* concept comprises bank assets booked in the U.K. by U.K.-owned banks or foreign branches and subsidiaries. *U.K.-incorporated banks* comprise consolidated bank assets held by U.K.-owned banking conglomerates worldwide. Only U.K. assets of foreign subsidiaries are included in the U.K.-Incorporated bank assets.

³ Foreign counterparties included: banks, governments and corporations. They represented 41.9, 15.8 and 42.3 percent respectively of total cross-border exposures.

24. **Insurance and pension funds account for roughly another third of the financial sector's contribution to GDP and employment.** The U.K. general insurance industry is the third largest in the world (accounting for about 10 percent of worldwide net premium income) and consists of insurance companies, the Lloyd's insurance market, underwriters, brokers, and intermediaries. The U.K. is the world's leading market for internationally traded insurance and reinsurance. It includes the most important cross-border non-life insurance markets in Lloyds and the London Market, which together account for 65 percent of annual global cross-border non-life premium flows. It is also a significant supplier of life insurance products to residents of other EU countries.

25. **U.K.-based insurers and self-administered pension funds are the most important repositories of U.K. household financial wealth.** Of the £3 trillion in total financial assets held by households and related non-profits, more than half consisted of insurance policyholder related liabilities. Total investment assets under management exceed £1 trillion, and the life and pensions sectors are major providers of finance to government and private borrowers and major holders of equities.

26. **The U.K. is one of the largest centers in the world for the management of institutional equity holdings.** More than US\$2.5 trillion of institutional equity holdings are managed by London managers—more than Amsterdam, Paris, Frankfurt, and Zurich combined. Two-thirds of this is managed for U.K. institutional clients and about 20 percent for foreign clients (the rest is for private U.K. clients). Edinburgh and Glasgow are also important centers in this regard—they rank fifteenth in the world. U.K.-owned and foreign investment banks operating out of London control over 40 percent of funds under management in the U.K.

27. **The securities industry mainly consists of affiliates of domestic and foreign banking groups plus a large number of small independent firms.** Also important in the U.K. is the substantial number of Highly Leveraged Financial Institutions (HLFIs), typically in the form of the funds management operations of hedge funds. While the funds themselves are offshore, they could become a source of market and credit risk in the U.K. financial system in the future should their leverage and risk taking increase. The amount of leverage that HLFIs can raise is limited by the financing that financial institutions are willing to extend to them, which in turn depends on the stringency of their risk management systems and the quality of information HLFIs provide to them. From a consumer protection angle, there would also be a concern if they started managing funds on behalf of retail investors: so far, however, this has only happened in a very limited way.

B. Markets

28. **U.K. financial markets are highly-developed and international in nature.** There are now six financial exchanges in London, of which the most active are the LSE and the Euronext LIFFE. More foreign companies are listed on the LSE than on any other exchange, and daily trading volumes for foreign equities are almost double those for domestic companies. Overall, the U.K. is the fifth most active center for exchange-traded derivatives contracts, with a seven percent share of global trading activity. Its success in attracting overseas business can be attributed to several factors, including: the network economies associated with a concentration of

expertise in one place; a well-developed legal system; and the perception that the U.K. has a “proportionate” approach to regulation.⁴

29. **The international character of U.K. markets is also reflected in the fixed income, foreign exchange and derivatives markets that operate on an OTC basis.** The U.K. is unique among major industrialized countries in that a very large share of this trading represents cross-border transactions between financial institutions denominated in currencies other than the British pound.⁵ For example, the interbank market mainly consists of interbank deposits denominated in U.S. dollars and euros. In the foreign exchange market, the U.K. accounts for more than 30 percent of global market turnover, and is typically the most active trading center for currencies outside their home market. The U.K. also accounts for more than 70 percent of the global market for international bonds, which is dominated by U.S. investment banks operating out of London. Gilts account for almost half of domestic bonds outstanding and almost all secondary market trading. In derivatives, the U.K. is the most active center for OTC derivatives in the world (36 percent market share even though sterling transactions only account for 8 percent globally). Again, most transactions are in either U.S. dollars or euros.

30. **The sterling money market is primarily a market for unsecured short-term interbank deposits and certificates of deposits, with a market for gilt repos growing in importance in recent years.** In June 2002, unsecured obligations represented more than half of money market claims outstanding. The interbank market is also rather concentrated, 57 percent of interbank claims in the U.K. were held by ten institutions in 2001—a share that has been slowly rising in recent years as the banking industry consolidates. However, the unsecured segment of the sterling money market has declined markedly from the 80 percent level that prevailed prior to the introduction of repos in the mid-1990s. Since then, repos backed by gilts have become more prevalent as banks entered the repo market to shift from holding gilts on an outright basis to a repo basis, so that they could better manage their sterling liquidity.

31. **A recent addition to OTC markets is the development of a market for risk transfers.** This market comprises a range of transactions designed to enable financial institutions to trade different forms of risk between themselves or with other investors. Typical forms of risk transfers involve the transfer of credit risk from banks to insurance companies and institutional investors (e.g., through credit derivatives or asset-backed securities), and to a lesser extent, the transfer of insurance risk from insurance companies to other FIs (e.g., through a catastrophe bond). So far, U.K.-owned insurance companies have not been very active in these markets.

⁴ One of the principles FSA must pay heed to is that supervisory policies and actions should be commensurate with the seriousness of the problem (“proportionality”).

⁵ This trading is mainly conducted by London-based branches of foreign institutions, although several large U.K.-owned banking groups are also significant players.

C. Payment and Settlement Systems

32. **The value and volume of payments passing through the various U.K. payment systems has increased considerably in recent years, the value now being equivalent to around half of GDP on a daily basis.** The main high-value payment system is CHAPS, the second most active RTGS system in the world. In addition to handling sterling transactions, there is also a CHAPS euro system, which provides for euro payments between member banks as well as the U.K. connection to TARGET (the system linking national RTGS euro systems within the EU). The two main retail payments clearing arrangements are BACS for non-paper items and the Cheque and Credit Clearing Company for paper items. On the foreign exchange side, potential vulnerabilities in settlement arrangements are being addressed through the creation of CLS Bank, which introduced real-time payment-versus-payment for foreign exchange transactions in September 2002.

33. **CREST is the main securities settlement system.** In late 2001, it moved to real-time delivery-versus-payment in central bank money in order to eliminate intraday risk that previously existed. However, this risk still exists for money market instruments, where payments are settled through the CMO at the end of the day on a net settlement basis. The necessary legal, operational and market processes are now in hand for integration of the settlement of money market instruments into CREST. In July 2002, an agreed merger between CREST and Euroclear was announced as a step towards building a European-wide securities settlement system. LCH acts as the central counterparty for transactions on financial exchanges and increasingly for some OTC markets such as interest rate swaps, offering economies of scale advantages in risk management.

D. Institutional and Policy Framework for Financial Stability

34. **The U.K. financial stability policy framework is well-designed with clear focus, accountability and transparency arrangements, and effective modalities for formal and informal coordination across agencies.** This institutional architecture is strongly supported by a strengthened macro-policy framework, well-functioning systemic liquidity and public debt management policies, a high quality accounting, auditing and disclosure regime, and effective safety net and insolvency arrangements.

35. **A lynchpin of the financial stability policy framework in the U.K. is the FSSC, governed by the Memorandum of Understanding (MoU) between the BoE, the FSA and HMT.** U.K. authorities have gone further than most of their counterparts by formulating an MoU that clearly articulates the roles and responsibilities for each of these agencies in the financial stability domain. The MoU and the associated FSSC composed of senior officials from each institution have helped to sharpen the focus and accountabilities of each of the players, as well as facilitate appropriate coordination and information sharing across the three institutions. In addition, these arrangements help ensure that the government is fully cognizant of the FSA's approach to the regulation and supervision of financial institutions and markets.

Regulation and supervision

36. **Under the FSMA 2000, which came into full-effect in December 2001, the U.K. has moved to a single regulatory agency (the FSA) and one governing statute.** Generally, the FSMA provides a framework of four statutory objectives within which the FSA prepares more detailed rules. After lengthy consultations with stakeholders, a handbook of such rules has now been published. This reflects the FSA's evolving approach to supervision. Some new rules are introduced for application commonly across all institutions, while others replace those set by the FSA's predecessors in individual areas of regulated activity.

37. **The FSA is implementing a general principle that similar risks across regulated entities should, to the extent feasible, be regulated in the same way, regardless of the type of institution.** Full implementation of this strategy, with supporting rulebooks, will be a major item on the FSA's agenda for several years to come. The FSA has also adopted a risk-based operating framework that focuses on the risks to its statutory objectives, taking into account the seven principles of good regulation that are also listed in the FSMA. The framework is applied both with respect to the FSA's own strategic priorities, and to its supervision of regulated individuals and institutions, so that a close and continuous supervisory relationship is maintained for high risk/high impact institutions, while lower risk/lower impact entities are subject to more routine oversight. Another feature is the continued (albeit somewhat reduced) use of institutions' own internal and external auditors and other "skilled persons" in the supervision process. Supervisory initiatives require preparation of explicit cost-benefit analyses.

Accounting, corporate governance, and information disclosure

38. **U.K. accounting standards emphasize a "substance over form" approach, and are internationally recognized as being of a high quality.** However, in listed company consolidated financial statements at least, they will be replaced by International Accounting Standards in 2005, in line with the EU's "Convergence Regulation." While U.K. standards are reasonably close to IAS, significant changes will be required. Few U.K. financial institutions currently report reconciliations of their accounts, prepared on the basis of U.K. standards, to international or U.S. GAAP standards. Thus, while convergence to international standards will help to harmonize accounting standards in concept, it will have significant implications for disclosure practices, and may accordingly affect financial market prices. The FSA is considering the implications of these accounting changes for regulatory reporting and supervision.

39. **The U.K. disclosure regime is primarily based on the requirements of the U.K. Listing Rules and the annual publication of insurance company prudential returns.** Among other things, the Listing Rules require publicly-traded financial institutions and non-financial corporations to annually publish financial statements that are fully audited and six-monthly interim statements, with continuous public reporting of significant events. They also incorporate disclosures on compliance with the governance arrangements contained in the Combined Code of Corporate Governance. The FSA is currently engaged in a number of initiatives to strengthen prudential and governance disclosures as well as consumer disclosures.

Insolvency framework

40. **The U.K. insolvency regime contains a number of tools to address the problems of financially troubled companies.** These include contractual receiverships and various procedures for the winding-up (liquidation) of companies, together with “administration” and “company voluntary arrangement” (CVA) procedures to, inter alia, facilitate the rehabilitation and rescue of troubled companies. Informal consensual workouts are also undertaken outside of these formal statutory processes, generally using principles embodied in the “London Approach” and the more recent INSOL Statement of Best Practices for Multi-Creditor Workouts.

41. **The importance of rehabilitation and giving companies a fresh start has been a major theme of the Government over the last few years as it strives to promote enterprise and improve economic productivity.** This has led to passage of the Insolvency Act 2000 (whose important CVA moratorium provisions for small businesses became effective on January 1, 2003), and to passage in late 2002 of the Enterprise Act. The latter legislation severely restricts the ability of “floating charge” holders to appoint administrative receivers (thereby shifting the balance away from individual administrative receiverships in favor of collective creditor proceedings); modifies and streamlines the existing administration procedure in significant respects (inter alia, by providing for non-court routes into administration); and abolishes the Crown’s status as a preferential creditor, preserving for unsecured creditors a portion of the amounts that are no longer payable to the Crown.⁶

42. **The U.K. has no special statutory regime to address the insolvency of financial institutions.** As such, banks and other financial institutions are subject to the same formal insolvency procedures as unregulated companies, with certain exceptions. For example, the FSA (the Financial Services Compensation Scheme—FSCS—in some circumstances) has various rights in insolvency proceedings involving financial institutions, and banks and insurers will not be able to benefit from the CVA moratorium that is to be made available to small companies. More generally, the insolvency practitioners appointed as, say, administrator or receiver of a financial institution would normally consult closely with the FSA in carrying out their responsibilities. In administrative proceedings, bank depositors might be subject to a stay that prevents the repayment of deposits. However, administrative proceedings trigger compensation arrangements through the FSCS for bank depositors. Administration does not in itself prevent repayment of deposits if administrators decide to do so.

43. **The authorities, however, can take a number of enforcement actions before an institution reaches the stage of statutory insolvency proceedings.** The FSMA gives the FSA a broad range of enforcement powers that can be used to deal with a troubled institution, including

⁶ The U.K. insolvency regime is consistent in most respects with the general principles and policy choices outlined in the Fund Legal Department’s Report on *Orderly and Effective Insolvency Procedures: Key Issues*, and a number of the recent reforms strengthen this conclusion.

the ability to seek remedial plans from a firm to restore its financial position; it can also facilitate or coordinate market solutions for dealing with a troubled institution. Events with a systemic aspect would be dealt with at the level of the tripartite Financial Stability Standing Committee. Decisions on emergency liquidity support to an individual institution or to the market more generally would likewise be coordinated by this committee. In some cases, however, informal pre-statutory efforts may end in a statutory process (for example, Barings was ultimately resolved using statutory administration procedures after the BoE's attempts to arrange an informal "lifeboat" operation proved unsuccessful).

Financial sector safety nets

44. The U.K. authorities prefer to facilitate private sector solutions to liquidity or solvency crises when practical, rather than provide public funds to support ailing institutions. There is no formal guidance, or examples in the last few years, as to how emergency financial assistance would work in practice beyond the principles laid out in the MoU between HMT, FSA, and the BoE. When public sector assistance was required, the authorities focused more on the possible systemic implications than on the size of the institution per se. Any official assistance might take a variety of forms—ranging from liquidity assistance from the BoE to the market or to an afflicted firm, to solvency support where it might typically still be channeled through the BoE's balance sheet, but where a Treasury guarantee might be required. In addition to direct last resort lending, the BoE has occasionally inserted itself between the counterparties of a transaction when this is required to ensure that markets continue to function smoothly, or to facilitate the orderly liquidation of a troubled institution. The U.K. also provides protection to depositors/investors who may obtain compensation from an ex-post industry funded scheme (FSCS) covering not only deposits, but also investments and insurance, a form of co-insurance arrangement applies (except for compulsory insurance) and compensation is limited to certain maximum limits for depositors and investments.

Systemic liquidity and public debt management arrangements

45. The BoE's monetary operating procedures have been significantly revised in recent years, helping to promote well-functioning financial markets which also benefit from the conservative management of public debt. The range of counterparties and collateral accepted by the BoE was significantly broadened in the late 1990s to facilitate more efficient liquidity management in the money market. U.K. markets have also benefited from the anchoring of inflation expectations that accompanied the adoption of inflation targeting as the monetary framework in October 1992, a move that was reinforced by the granting of operational independence to the BoE in 1997 and measures to improve the transparency and accountability of monetary policy. On the public debt front, public sector net debt totaled less than 30 percent of GDP in March 2002, the lowest ratio since 1992. There is minimal rollover risk and exchange rate risk in the U.K.'s public debt. Most of it consists of long-term bonds (gilts); there is only a limited amount of Treasury bills and foreign-currency debt outstanding. Most of the debt is held by U.K. insurance companies and pension funds. Non-residents hold less than 20 percent of gilts outstanding.

E. Financial Crime

46. **The legal framework has a number of components that deal with the prudential and criminal aspects of AML/CFT.** There are also important statutory instruments, including in particular the Money Laundering Regulations 1993 and Money Laundering Regulations 2001. Moreover, the FSA has issued a Money Laundering Sourcebook for prudentially regulated firms that is intended to add a regulatory (as opposed to criminal law) focus on anti-money laundering systems and controls, and as such is parallel to, but separate from, the Money Laundering Regulations. The institutional arrangements are complex and include the following organizations:

- the **FSA**, which not only has responsibility for regulatory and supervisory oversight, but also has the power to initiate criminal proceedings against regulated persons for breach of money laundering regulations;
- **HMCE**, which was recently given responsibility for the oversight of money service businesses, and also exercises a wide range of law enforcement and even prosecution responsibilities;
- **HM Treasury** and the **U.K. Home Office**, each of which has responsibilities for aspects of the policy and legal framework;
- the **NCIS**, which has an Economic Crime Unit that serves as the U.K.'s FIU and also has broad responsibility for collating and coordinating the U.K.'s intelligence for AML/CFT and other serious crimes;
- over **50 national and local law enforcement agencies** with jurisdiction over AML/CFT;
- agencies with responsibility for prosecution of AML/CFT and for confiscation and other judicial proceedings, including the **Crown Prosecution Service**, the **Serious Fraud Office** and **HMCE**. In addition, a new Asset Recovery Agency was provided for in the Proceeds of Crime Act 2002.
- A variety of **HMG agencies and interagency groups** with responsibility for various aspects of AML/CFT and other serious crimes, including the **Serious Fraud Office** and **National Crimes Squad**.

III. MACROECONOMIC ENVIRONMENT

A. Recent Macroeconomic Developments

47. **The U.K. financial system has benefited from a stable macroeconomic environment, with sustained growth and low inflation for nearly a decade.** These achievements owe much to sound macroeconomic policies, a strong policy framework, and sustained structural reform. In recent times, the monetary policy framework, based on inflation targeting and operational

independence of the Bank of England, has emphasized transparency and predictability of monetary policies, and has succeeded in anchoring inflation expectations and fostering a stable monetary environment. As a result, nominal and real long-term interest rates have been low and stable. Also, the introduction in 1998 of a fiscal policy framework with a medium-term orientation and the marked strengthening of the public finances have been instrumental in minimizing demand shocks and fostering a climate conducive to high levels of investment. Sustained labor market and welfare reforms have allowed unemployment to fall to historical lows without triggering inflation. Output has increased by an average of 2.9 percent per year during 1992-2001, while inflation was the lowest in the EU in 2001.

48. Accompanying this strong economic performance, however, has been the emergence of some imbalances. Since 1996, as sterling appreciated sharply, growth has primarily been sustained by domestic demand—more recently by private and public consumption—while the current account has remained in deficit and has typically been a drag on growth. Buoyant domestic demand has been fueled by low unemployment and gains in disposable income and, particularly in the last two years, by burgeoning house prices and strong credit growth. As a result, private sector indebtedness has risen to high levels, and while corporate borrowing growth has declined recently, household credit growth remains unabated. On the supply side, the service sector has sustained strong growth, but manufacturing has slumped—hit by the strength of sterling and the recent decline in world demand.

49. Turning to the current conjuncture, the U.K. economy has experienced a slowdown in activity reflecting global developments and the recession in the information and communications technology and other “new economy” sectors. Output deceleration has been milder than in most other G-7 countries on account of fairly resilient consumer demand and expansionary policies. House prices have accelerated to a 12-month rate of 25 percent in 2002. The signals from financial and money markets remain somewhat mixed. Equity prices remain weak and prospects uncertain, partly reflecting the risks of conflict in the Middle East. Fixed income markets expect a stable monetary policy stance through the first half of 2003; the BoE’s official repo rate has been left unchanged at 4 percent since November 2001. Partly as a result of the recent appreciation of the euro against the U.S. dollar, sterling has depreciated somewhat against the euro and on a trade-weighted basis, but remains strong by historical standards.

B. Macroeconomic Sources of Risk to Financial Stability

50. The importance of domestic business to the balance sheets and profitability of U.K.-owned banks has helped to cushion them so far from the global slowdown. However, potential risks could emerge from the rapid growth in household and corporate borrowing that has taken place in recent years and some weakness in parts of the corporate sector. Also, external developments could pose risks given U.K. banks’ sizable foreign exposures.

51. Household debt-to-income is at a record high, due primarily to the rapid growth in mortgage lending that has fueled the strong growth in house prices. So far, however, households have not had difficulty in repaying debt and the default rate of households is at a historical low level (0.09 percent). This is partly due to the low unemployment rate and the low

level of nominal interest rates. Measures of household gearing are significantly lower than their peaks in the late 1980s and early 1990s, and the default rate is also significantly lower than in the early 1990s.⁷ Nevertheless, as recent official publications have noted, the longer the growth in indebtedness continues, the more important the risk to sustainability becomes.⁸ Likewise, the longer that house prices grow rapidly, the more the risk of a sharp correction. A slowdown in household income growth or a rise in unemployment, particularly if accompanied by such a sharp correction in house prices, could adversely affect the sustainability of household debt levels, as could increases in interest rates given the floating rate nature of much of the debt.

52. Corporate debt-to-profit ratios are also high and are still growing in some sectors, while some corporate sectoral weakness remains, particularly in telecommunications and manufacturing. However, loans to manufacturing companies have continued to shrink, reflecting the pattern of domestic economic growth, while lending to the service and commercial property sectors has grown. The corporate bankruptcy rate has remained low (0.27 percent).

53. The domestic picture could thus change under different scenarios. For example, if economic conditions were to deteriorate due to a slowdown in domestic demand, banks' profits would be affected in several ways. The high competition that prevails in the U.K. banking market, which in recent years has translated into smaller interest margins, has been offset by higher lending volumes and fee income. In the event of a slowdown in domestic credit demand, this strategy could be jeopardized. Scenarios with higher interest rates or rising unemployment are also a threat to banks' profitability, especially if they are accompanied by falling house and commercial property prices from current peaks. Under those circumstances, the high indebtedness of the corporate and household sectors compounded with a concentration of corporate loans to the commercial real estate sector could prove problematic, leading to higher provisions, reduced profits, and a potential negative impact on banks' capital.

54. Potential risks for U.K. banks also arise from the slow-down of the global economy and any additional deterioration of credit quality worldwide, due to their large exposures to foreign counterparties. U.K. banks have recently proved resilient to credit deterioration stemming from the sharp slowdown in global growth in 2001 and 2002, weak equity markets, and to large corporate and sovereign defaults (Enron and Argentina). However, potential sources of risk could emerge from a more protracted downturn in global demand than currently

⁷ Another difference is that annual growth in corporate debt was in the 30-40 percent range in the early 1990s, while at present it is around 5 percent. It also seems fair to suggest that banks as a group are probably better placed to handle macro-related risks, as discussed in the next section, than they were in that period, which ultimately saw the failure of 25 small banks. There has been a considerable amount of consolidation amongst smaller banks since then.

⁸ The publications have also noted some microdata from the British Household Panel Survey indicating that the household sector may be more vulnerable to adverse shocks than the aggregate data suggests.

envisaged (for instance, as a result of tensions in the Middle East), and from a further fall in equity prices that could result from a downward revision in expected corporate earnings, particularly in the U.S.

55. Insurance companies' and pension schemes' income has been eroded by lower interest rates and weak equity markets; the latter factor in particular is a continuing risk element. The life insurance and pension sector has been especially affected by these trends, owing to its large holdings of bonds and equities. Difficulties in this sector have been magnified by some long-term liabilities based on guaranteed annuities or defined benefit schemes—often extended during periods of high interest rates and strong return on equities.

56. Apart from being affected by market risk, the insurance sector also constitutes a potential source of market risk, since insurance companies hold around a fifth of total U.K.-quoted equities. Insurance companies are currently subject to a “resilience test” that requires them to be able to withstand a given percentage fall in equity markets, and can have the unintended consequence of causing large sales of equities if all companies seek to rebalance their portfolios simultaneously. Indeed, in September 2001, the FSA temporarily suspended this test, forestalling destabilizing sales of equities by these companies at the time; and in June 2002 amended the test (to apply until at least May 2003) to reduce the impact of short-term market volatility by allowing companies to take account of equity price changes over the preceding 90 days, subject still to testing against a fall in equity prices of a further 10 percent.⁹

57. General insurance companies in the U.K. and other countries have also been hit by declining investment income. This is particularly significant because, in common with insurers elsewhere, they have been relying on investment income to offset underwriting losses. Moreover, this sector suffered substantial losses as a consequence of the September 11 terrorist attacks—estimated at about £2.5 billion, with a high concentration in the Lloyd's market.¹⁰ However, it has benefited from subsequent increases in insurance premiums, and possibly from increased demand prompted by a heightened perception of risk.

IV. VULNERABILITIES AND SOUNDNESS OF THE FINANCIAL SYSTEM

A. U.K.-Incorporated Banks

58. U.K. banks appear to be sufficiently profitable and well capitalized overall to be able to absorb, without systemic distress, the losses that might arise if the potential risks above were to crystallize. U.K. financial soundness indicators need to be interpreted with some caution (e.g., the need to rely on data from different sources with different levels of aggregation make compilation highly complex), but that said, the return on assets and equity have been

⁹ Resilience tests are likely to be superseded by new forms of risk-based capital requirements and “dynamic solvency testing” as part of the proposed insurance supervision reforms.

¹⁰ This estimate represents the sum of estimated losses from U.K. firms and Lloyds.

coming down from their peaks of 1999, mostly due to narrowing interest spreads and reduced fee income, as well as higher non performing loans (NPLs) and provisions. However, bank profitability has remained reasonably high—although with some dispersion—when compared with historical and international performance.¹¹ Tier 1 capital adequacy ratios are around 8 and 7 percent for the large commercial and mortgage banks respectively, and there has also been a fall in their unprovisioned NPLs relative to capital.¹²

59. A range of stress tests were developed by staff in conjunction with the U.K. authorities, in order to assess the ability of banks to absorb potential losses that may arise under alternative stress scenarios. A range of methodologies were used as a way of cross checking the reasonableness of results. A sample of large banks were asked to estimate the impact on their profits of shocks selected by the authorities and IMF staff that were translated into a set of consistent macroeconomic variables using the BoE's main medium-term macroeconomic model. These scenarios embody an assumed monetary policy response by the authorities. The banks were also asked to calculate the first-round effects on their trading book of changes in some key individual variables. In addition, the authorities used aggregate supervisory data to compute the effect of the macroeconomic scenarios on the building societies sector. Finally, the FSAP team independently estimated the effects of several domestic and external shocks on the banks' profits and capital with the help of some vector-autoregression models. Details on the stress test methodologies and results can be found in Appendix I.

¹¹ On average, return on equity (ROE) was around 10 percent for commercial and mortgage banks in 2001 and the first half of 2002. However, the BoE has reported much higher published individual bank ROEs in excess of 20 percent for this period, suggesting some variance in ROEs.

¹² Some weaknesses are evident in the "other U.K. banks" peer group, but this group is not systemically important (its assets are only 2 percent of total bank assets). Nor is it a homogenous group of financial institutions. Consequently indicators for this group are difficult to interpret. That said, non performing loans for this group nearly doubled in 2001 to 15 percent of total loans (and remained high as of June 2002), and these institutions reported losses equivalent to 1.8 percent of total assets. Given the diversity, it appears that there are not systemically important common risk factors among the small banks, while exposures of larger banks to this group are by definition small. Nevertheless, the BoE is developing an analysis of interbank links, which will further examine issues like the latter.

60. **The stress test results indicate that the stability of U.K. banks should not be compromised by the shocks postulated in the stress scenarios.** The results obtained from the different approaches are consistent in that U.K. banks should still be profitable even in the event of relatively large shocks. Potential losses calculated under different methodologies never exceeded their annual profits or represented a large fraction of banks' capital. Moreover, the standard deviations of the results from the bank-run scenarios are also tight, implying that the results are broadly consistent across institutions.

61. **Supplementary information and indicators point to the fact that while new forms of risk continue to arise owing to innovations in the financial system, the credit risk component remains the most relevant one for U.K. banks, including in the event of equity price declines and other market risk sources.**¹³ Indicators of other forms of risk were discussed with U.K. authorities, such as market risk in traded portfolios, interest rate risk in the banking portfolio, and liquidity risk. Institutions are aware of these risks and have specific structures in place to manage them. Potential losses due to these sources of risk appear to be generally well covered by capital.

B. Insurance Industry and Pension Funds

62. **The insurance industry is under considerable stress.** Although such stress is not limited to the U.K., locally it reflects depressed investment returns coupled with the effect of (appropriately) more stringent prudential supervision; tighter regulations surrounding the design and marketing of long-term insurance and savings products; rising uncertainty about general insurance companies' exposure to very low probability and catastrophic ("long tail") risks; and depressed capital resources for a significant number of players. One measure of financial strength, the "free asset" ratios of larger U.K.-resident insurers declined to a median value of around 6 percent for 2001, compared to levels some 1½ to 2 times higher in the preceding three years.¹⁴ An analysis of the life industry by capital strength shows a distinct bimodal distribution, with a large number of (generally smaller) life companies having capital relatively close to minimum required capital levels, and a smaller group maintaining much stronger capital positions. Furthermore, despite a reduction over recent years, U.K. life insurance companies remain heavily exposed to equities,¹⁵ and further losses will have been suffered in recent months.

¹³ For example, around 70 percent of U.K.-owned bank assets are loans to customers or other credit institutions, and only 15 percent are securities. Net interest income accounts for about 55 percent of the pre-tax income of U.K.-owned banks is represented by their net interest income, while 8 percent comes from trading activities, and 30 percent from fees. Value-at-risk estimates are small fractions of capital. Supervisors' scores indicate that credit risk is more relevant than interest rate risk in banking portfolios.

¹⁴ BoE *Financial Stability Review*, December 2002.

¹⁵ At end 2001, over 40 percent of U.K. life insurers assets were in equities.

63. **However, it is also important to note that life insurance companies have been able to pass some of their investment losses on to policyholders** by adjusting terminal benefits due to them and the cancellation penalties applicable to policies that are terminated ahead of schedule. U.K. authorities indicated that these measures helped companies manage their solvency positions when equity prices were falling, although judicial interpretations of the reasonable expectations of policyholders may in some cases limit this (as seen in the recent Equitable case). In addition, a number of life insurers have been raising further capital, either from markets or from their parents. Nevertheless, against this background, the life insurance industry, in particular, could be headed for large-scale consolidation in the coming years.

64. **The general insurance industry does not face issues that are as difficult as those facing the life sector; however it does have its own challenges.** These mainly relate to operating in a world of low investment returns, much fatter and less tractable claims tails than were previously thought to exist, and looming in the near future, a more demanding recognition of liabilities and capital allocation under a risk based prudential regime.¹⁶ These secular trends are all superimposed on an insurance premium pricing cycle that historically has been difficult to manage due to fluctuations in capitalization levels (which determine industry capacity). After a long period characterized by excess capital and strong price competition,¹⁷ the U.K.-based general insurers have been able to accelerate and widen a rise in premium rates especially post-September 11, 2001 (though the trend began in early 2001). London market players and Lloyds members in particular were hit hard by the terrorist attack on New York, but the U.K. underwriters appear on the whole to have coped remarkably well, even though certain segments of the market remain vulnerable.

65. **Overall, the difficulties in the insurance sector, although significant, do not currently appear to be of a systemic nature; but they clearly require very close monitoring.** The authorities are already closely involved in dealing with the situation and, up to now, most of the difficulties have been concentrated in small- to medium-sized long-term insurers. However, some larger companies, including non-life insurers with “long tail” liability exposures, could also be at risk if equity prices were to remain depressed or continue to decline for a prolonged period. The ability for life companies to pass at least some of their losses to policyholders provides an additional buffer, but further new capital may be needed in some cases. At a broader level, the links between insurers and banks have been growing but appear manageable to date: they are less tight than in countries where financial conglomerates offering both banking and insurance products have long been established. In addition, bank loans to insurers, a traditional channel of

¹⁶ Most leading general insurers, however, are already well down this path.

¹⁷ Aggregate U.K. general insurance shareholders’ funds dropped from £21.9 billion in 1995 to £19.0 billion in 2000 in a rather extreme example of the destruction of value that occurs in the downward part of the insurance premium pricing cycle.

66. contagion, represent only a small fraction of U.K.-owned banks' claims.¹⁸ Linkages through the risk transfer markets also appear moderate given the current relatively low activity by U.K. insurers, but like other potential channels for spillovers will need to be watched. General insurers as a group, meanwhile, have been able to increase profits, at least in the short run, since the higher post 9/11 premiums have more than offset any increases in claims. In addition to the quite immediate problems in the insurance sector, there is the strong imperative to overhaul insurance supervision to introduce more risk-sensitive governance and prudential measures, and in particular, risk-based capital combined with appropriately determined long-term and long tail liabilities. The authorities have the task of achieving this supervisory reform expeditiously at the same time as they deal forcefully with the current problems in the industry.

C. Major Financial Markets

Resiliency of exchange-traded markets

67. **The financial exchanges in London play an active role in intermediating funds and securities for both domestic and international investors.** Like other major markets around the world, those in the U.K. have had to cope with a number of global shocks in recent years, including the boom and subsequent bust in share prices for high-technology and telecommunications firms, and the recent slowdown in global economic activity. In addition, U.K. debt and equity markets have had to cope with changes to U.K. pension and accounting rules, which are causing insurance companies and pension funds (the principal investors in U.K. equities) to reduce their holdings of equities in favor of fixed-income securities. Also in the background has been the consolidation of the securities regulators that supervised U.K. financial markets into the FSA, and the move to a risk-based supervision approach. These developments are expected to have significant implications for the future regulation of these markets.

68. **The quality of trading on U.K. financial exchanges is high, and the exchanges function well.** Concerns associated with market fragmentation have not yet arisen to a significant degree in the U.K. compared to some other industrialized countries. In some sectors, OTC markets and alternative trading systems could pose a competitive threat to the exchanges. However, in recent years the LSE and Euronext LIFFE have taken steps to enhance their trading systems and adapt their rules to ensure their markets remain attractive to investors.

Demands placed by global markets on the U.K. financial system

69. **The global financial market activity that takes place in London does not appear to pose significant risks to the stability of U.K. financial markets or to the domestic financial system more generally beyond those that would normally arise from the cross-border activities of U.K. financial institutions.** Although some of the U.K.-owned institutions are significant players in some of these markets, the trading activity is to an important extent

¹⁸ Some 5 percent of the 10 largest banks' Tier 1 capital, plus another 4 percent for undrawn facilities (*Financial Stability Review*, December 2002).

insulated from the domestic financial system, in part because it primarily involves wholesale market transactions between branches of foreign institutions that have little connection to the domestic financial system. U.K.-owned institutions obtain most of their profits from the provision of financial services to the domestic economy rather than from their activities in global markets.

70. **In addition, the nature of this activity is such that the location of trading in London is largely divorced from the final processing and settlement of transactions, except with respect to transactions that go through CHAPS-Euro and LCH.** Although a large amount of back-office trade processing takes place in the U.K., it does not place significant additional demands on the U.K. payment and settlement systems.¹⁹ Two main exceptions are the LCH, which is playing a growing role in serving as the central counterparty to global OTC market transactions, and the RTGS payment system for the euro, which has an important node in London. It is critical that these parts of the U.K. financial infrastructure maintain their efficiency and risk-containment systems to ensure that they can handle the demands placed on them.

71. **The global markets trading activity in the U.K. requires continued surveillance and supervision by the BoE and the FSA, who, together with central banks and supervisors in other major international financial centers, play an especially important role in promoting and fostering the smooth functioning of global financial markets.** Both institutions play an active role in a number of international forums, promoting the development of more resilient institutions and market structures. The concentration of international financial activity in London also provides U.K. authorities with a useful perspective on developments and trends in the global financial markets, which can be invaluable when assessing the potential sources of strain that could affect the U.K. and international financial systems.

The risk of contagion associated with interbank exposures

72. **The money market does a good job in distributing the liquidity supplied by the BoE.** Market participants are generally able to distribute liquidity among one another without recourse to the BoE's facilities. Similarly, the pound sterling foreign exchange market functions well, and has not required official intervention in recent years to promote orderly trading conditions. Both markets are also very liquid, although the increasing "lumpiness" of the order flows could potentially make it difficult for traders to manage their positions in stressful situations. This is not a trend specific to the U.K.; it is also evident in money and foreign exchange markets in other major global trading centers.

73. **Although the large interbank segment of the money market functions well, it warrants close surveillance by the authorities because it could potentially act as a contagion**

¹⁹ Moreover, the authorities and market participants agreed that in the event of operational difficulties in London, it should be possible to reroute trading and trade processing to other financial centers without seriously disrupting the global or U.K. financial systems.

channel in extreme circumstances. As noted previously, unsecured interbank deposits and CDs represent the largest segment of the money market, and most of them are held by less than ten institutions. The risk of contagion is also not helped by the fact that smaller U.K. banks tend to hold the most of their liquidity in the form of unsecured deposits issued by the largest institutions, nor by the two-tier structure of the U.K. payment system. Thus, while highly improbable, the failure of a major bank to honor its unsecured obligations could threaten the health of some other institutions. In light of the risks inherent in these exposures, the authorities are intensifying their surveillance of bilateral unsecured exposures between banks so that they can obtain a better sense of the distribution of these claims in the banking system, and the risk of contagion in the event that an institution is not able to honor its obligations. Consideration could also be given to publishing their findings on a regular basis, albeit in a highly aggregated form, so that banks can take the distribution of exposures in the system into account when they decide on how much unsecured credit they are willing to extend to one another.

74. **While an active interbank market can be a useful market discipline device in that it forces banks to regularly “test their names” in the market, this could likely still take place if the unsecured segment of the market represented a smaller share of the money market.** Consequently, the authorities were encouraged to continue championing measures that encourage netting, where feasible, and more trading between banks on a secured basis. However, there is also a need to ensure that such steps do not go so far as to unduly undermine the positions of unsecured creditors.

D. Payment and Settlement Infrastructure

75. **Major reforms of the U.K. financial infrastructure have been initiated in recent years and the CHAPS and CREST systems are of a very high standard internationally.** So far, the main priority has understandably been to improve the real-time gross settlement (RTGS) system for large-value payments and settlement mechanisms for the principal financial markets.

76. **Nevertheless, some vulnerabilities remain, which need to be addressed.** The tiering between direct settlement members and indirect members and end-users means that close attention needs to be paid to the risk exposures among inner-tier institutions and potential contagion risk. While CHAPS and CREST protect settlement members from intraday exposures, the two-tier structure of the payment system may still result in significant intraday exposures between direct and indirect settling banks, in addition to the overnight or longer exposures noted above. The U.K. authorities were encouraged to continue to give a very high priority to the identification and overall monitoring of these risks. This is all the more warranted in view of the rather common, and perhaps surprisingly explicit view of a number of market participants that the major settlement banks are “too big to fail.” The authorities are also rightly encouraging improvements to BACS, the largest retail payments system.

77. **Foreign exchange settlement continues to take place through correspondent banking relationships, and as in all major industrialized countries, represents a key area in which the management of settlement risk needs to be enhanced.** The introduction of the CLS system in September 2002 is expected to bring a clear improvement in this area. As the CLS system

becomes more actively used, there might be a need for increased attention to availability and liquidity issues in CHAPS, since CLS settlement takes place under a tight time schedule starting in the early morning—a time when a high volume of CREST DVP transactions is also currently settled. However, no bottlenecks have emerged so far.

78. **In the securities settlement area, the clearing and settlement of money market instruments needs to be brought onto a real-time delivery-versus-payment basis in CREST, as is done for other securities.** This will require a legislative change to fully dematerialize these instruments. The government has set in train a consultation process that, subject to Parliament, should deliver the necessary change by mid-2003. CREST is planning to start integrating these instruments into its system through the second half of the year. Thus, it is important that the authorities give a high priority to the required legislative changes currently being discussed.

79. **LCH is conservatively managed and close to best practice in many respects, but has an important weakness with its payment scheme, where it settles its cash payments across accounts held at various commercial banks, rather than using a default-risk free settlement asset.** The resulting intraday risk exposures, whilst short lived and involving a group of well-regulated banks, are of a magnitude that could threaten the integrity of LCH. Given the importance of LCH for the U.K. and global financial markets, the authorities are working to resolve this issue with LCH. In addition, the placement of most of LCH's funds in the money market has been collateralized using a tripartite repo structure, in order to limit unnecessary credit risk exposures. On the legal side, there are uncertainties about certain minor proportions of funds paid in by members to LCH's default fund and some residual uncertainties attaching to the cross-margining link with CME (although this currently handles only small exposures). Work is underway to identify the best method of rectifying these legal uncertainties.

V. MANAGING THE VULNERABILITIES

A. Financial Stability Policy Framework

80. **Although U.K. financial institutions and markets are generally sound and function well, the financial stability policy framework needs to adapt constantly to ongoing innovations in the global markets, and the growing complexity of institutions.** Large institutions are increasingly playing an important role in financial intermediation in the U.K. As noted in the previous chapter, this contributes to financial stability in that the institutions in question have been able to achieve a broader global diversification of portfolio risks, with a reduced risk of these institutions being undermined by individual shocks. Similarly, they are better able to justify the expense associated with adopting leading-edge techniques to manage the risks associated with their activities. In addition, the U.K. authorities are to be commended for the many steps they have taken in recent years to improve the underlying macroeconomic policy framework, and to build a more resilient financial system infrastructure. As a result, the financial system is now almost certainly better positioned to tolerate the failure of significant institutions, as evidenced by its ability to successfully weather the failure of Barings a few years ago. The authorities are now able to focus more on systemic situations when dealing with shocks, rather

than on the size of the institutions affected. Nevertheless, there may still be an issue of “too big to fail” perceptions, that may be exacerbated in the U.K. by the two-tier structure of the banking system. The associated risk of moral hazard is another reason for continuous review and development of the policy framework across all its aspects.

81. **The U.K.’s financial stability policy framework is well designed.** The roles and responsibilities of the key players in the framework (BoE, FSA, and HM Treasury) are clear and well-articulated. This has enabled each institution to focus on its own respective role and to be more accountable for its actions. While the framework has yet to be tested in a genuine crisis, the MoU provides a strong framework for coordination and information sharing amongst the three organizations, both in crisis periods and more normal times.²⁰ In addition, the safety net underpinning the system reinforces market discipline through appropriate co-insurance arrangements. One aspect to be noted at this broad level concerns the specification of the four statutory objectives for the FSA, under the FSMA. Although the FSA has been able to give greater attention to consumer protection and financial crime issues without significantly undermining the attention paid to financial risks in firms and markets, there is the potential for the objectives to conflict at times, at least at the margin; or more precisely, with scarce supervisory resources, they may compete for management attention and supervisory resources. Prioritization of those objectives might change over time, and it could be expected that through the FSA’s risk-based operating framework (see Appendix II for a description), such changes would be discussed fairly explicitly in the FSA’s publications—although this has yet to be fully tested. In any event, this operating framework is a major stride forward in making decisions about supervisory attention and resource allocation more transparent and consistent.

82. **The framework is also highly transparent.** The FSA and the BoE both compare very favorably with international transparency practices, as evidenced by their strong observance of the *financial policies* section of the *Code of Good Practices on Transparency in Monetary and Financial Policies* (Section II). Nevertheless, some further refinements in specific areas could make the transparency even more effective. For the FSA, this reflects the fact that the implementation of its new regulatory framework is still taking shape, and there is some continuing uncertainty in the financial sector as to the precise implications. Thus, it may need to take additional measures to help regulated entities and the general public improve their understanding of the new regulatory framework, and some streamlining of its consultation process would be desirable. For the BoE, it would be desirable to: (i) make available more information on the framework for its financial stability role, including in a crisis situation; and (ii) continue to provide more detailed public reporting on its financial stability and payments system oversight responsibilities, building on the very recent advances in its FSR assessment article, and (iii), at an appropriate time formalize more directly its financial stability and payment and settlement systems oversight functions in legislation.

²⁰ For example, the MoU states explicitly that “all information that is or may be relevant to the discharge of [the] respective responsibilities [of the three organizations] will be shared fully and freely.”

83. **While the surveillance of systemic developments and structural issues and the authorities' efforts to build a more robust financial infrastructure have been of high quality, several challenges remain.** The BoE, in particular, is well-regarded for the quality of its surveillance of systemic developments and structural changes taking place in the domestic and global financial system, and both it and the FSA have taken a number of steps in recent years to improve the system architecture, such as reducing intraday exposures in the payments system and promoting the use of repos in the money market, to name but two examples. Effective surveillance requires continuing cooperation and sharing of data and qualitative information between the BoE and the FSA (as envisaged in paragraph six of the MoU). Going forward, both the BoE and the FSA were encouraged to continue with their efforts to analyze and monitor interbank exposures (as noted above), to further develop and publish a broader range of aggregate statistics on the financial sector, and to consider making more regular use of stress tests in their monitoring of the health of the financial system. These initiatives could help strengthen their base-line surveillance of the financial system as a whole, as well as provide an extra dose of market discipline if ways can be found to publish the results.

84. **The Bank's systemic perspective, together with the FSA's efforts to monitor risks in the U.K. financial system and its risk-based approach to supervision, provide a proactive focus towards emerging vulnerabilities in the financial system and provides a useful anchor for the allocation of the FSA's supervisory resources.** Both agencies are also very active on the international front, working on various committees to champion measures that help to foster a more resilient international financial system. One example in this regard is their contribution to work on how to unwind the activities of LCFIs in an orderly fashion in the event that one or more of them were to experience financial distress.

B. Integrated Supervision

85. **The role and performance of the FSA as the first fully integrated regulator in a major economy has attracted world-wide attention.** The organizational restructuring involved in combining and regrouping up to 11 predecessor agencies has itself been a major, if still incomplete, accomplishment. The changes in the supervisory regime, however, go well beyond the consolidation of multiple separate agencies into a single organization. The FSMA represents a comprehensive update of U.K. financial supervision legislation. It consolidates authority for financial supervision under the FSA, and it gives the FSA broad new statutory authority to carry out its responsibilities. Statutory regulation has displaced most of the self-regulatory arrangements that had been a traditional feature of U.K. financial markets. With its four statutory objectives and seven principles of good regulation (see Appendix II for a listing), the FSMA has also reoriented the U.K. approach to financial regulation. Reducing financial crime and ensuring appropriate consumer protection have been made explicit statutory objectives. Traditional regulatory objectives such as depositor protection or investor protection are now implicit in the broader, more general objectives of maintaining confidence in the financial system or promoting awareness of and understanding of the financial system. The traditional U.K. emphasis on strong governance by regulated parties and a preference for minimally prescriptive regulation has been retained.

86. **To give operational content to its abstract statutory objectives the FSA has developed a distinctive risk based approach to supervision.** The FSA approach sets supervisory priorities based on the risks posed by regulated individuals and firms, and by industry-wide developments, to the achievement of FSA's statutory objectives. Processes are now focused more sharply on meeting the specified (albeit broad) statutory objectives. As a result, the supervisory process in the FSA is giving greater attention to consumer protection and financial crime issues without diluting attention to financial risks in firms and markets. The principles of good regulation in the FSMA underpin the risk-based framework that the FSA has developed to guide its own supervisory efforts, and, inter alia, reinforce the traditional U.K. emphasis on strong governance by regulated parties and a preference for minimally prescriptive regulation. While the risk-to-objectives framework (see Appendix II to this Section) provides an orderly framework for setting broad supervisory priorities, it is implemented at a high level of generality that still allows for considerable judgment and flexibility in, for example, the firms and risks that attract close supervision, and in determining "how much" supervision is enough. The framework makes more explicit the areas where judgment is required, however, and explicit, cost-benefit analyses are required for significant supervisory proposals.

87. **The principle that similar risks should be regulated in the same way, regardless of type of institution, is giving a strong impetus to integrating not only FSA rules but also its organization and processes, although this is still at a preliminary stage.** Implementation of the FSMA has allowed the FSA to introduce a single enforcement regime applicable to all firms and individuals it regulates. The new regime sets out which regulated activities require authorization, and the FSA authorizes firms by giving permissions defining which activities they can carry out. The FSA has developed an authorization process that applies across all sectors, and it includes giving approval to individuals responsible for key designated duties in authorized firms. Development of the authorized-persons regime is also giving the FSA an important tool for implementing its supervisory strategy which looks to firms' directors and management to take responsibility for compliance with rules and regulations. Conduct-of-business rules have been developed that apply across all regulated firms. Prudential requirements across banks, insurance companies, and independent securities firms remain quite distinct, although projects are underway to achieve greater harmonization. Regulation of insurance is undergoing a fundamental review, which may lead to adoption of elements of the risk-based strategies used in the regulation of banks. Reporting requirements are also undergoing a systematic re-evaluation that is likely to lead to more commonality across financial sectors.

88. **The new FSA approach has involved some tensions at the operating level, but no gaps in regulation were detected as a result of these tensions.** The risk-based approach to bank supervision is supporting the development of a more intensive oversight of the financial operations of large integrated financial firms, both domestic and foreign, that are so prominent in the U.K., but at the same time there is more competition for regulatory resources to carry out FSA responsibilities in the areas of financial crime and consumer protection. Specialized firms, particularly in the securities area, expressed concerns that their unique requirements might receive less attention as the integrated approach develops. Insurance firms expressed concern that the staffing and structure of the FSA will lead to bank-like supervision that may be inappropriate for insurance firms. Among financial firms there is some concern that the FSA's

89. statutory framework, its strong statutory powers, and a greater priority to financial crime and consumer protections will push the FSA in the direction of a more rule-based regulatory regime. Staff turnover in the FSA has seen some skills loss in some specialized areas, particularly securities. To help mitigate such unavoidable tensions, the FSA engages in extensive consultation with industry before undertaking new initiatives. Industry contacts expressed strong appreciation for the openness of the FSA in its consultative processes.

C. Adequacy of Supervision

90. **The quality and effectiveness of financial sector supervision in the U.K. is strong in the banking area.** The FSA showed a high degree of observance of the *Basel Core Principles for Effective Banking Supervision* (Section II). Judged by results, the U.K. banking sector is well-capitalized, highly profitable and has shown considerable resilience to both market stress and in stress test simulations. The prudential regime for banks is fully developed, and well explained and documented in the Handbook. An extensive mix of on-site and off-site techniques is used to carry out ongoing supervision, with the intensity of FSA oversight calibrated to risks. Close attention is given to both the qualitative and quantitative aspects of supervision. Capital and large exposure requirements are firmly enforced on both a solo and on a fully consolidated basis. A clear framework is used to oversee risks arising from various lines of business wherever that business is conducted. Consistent with London's role as an international financial center, the FSA has a very well-developed and active program for exchanging information and cooperating with overseas supervisors.²¹

91. **A few additional measures were recommended to reinforce base line monitoring and to more fully exploit the on-site work done in the higher impact firms, and the FSA has already launched a project to examine issues here.**²² The additional measures included: (i) the need for a more complete supervisory validation of systems and controls for "medium-high impact" banks; (ii) a possible need to undertake more on-site work for "low-impact" banks if measures to sharpen disclosure and market disciplines (noted below) are not implemented quickly; (iii) additional efforts to review and validate supervisory returns; and (iv) improved reporting requirements for classified and nonperforming loans.

92. **The supervision of bank liquidity risk management could be improved.** The Sterling Stock Liquidity Ratio used to supervise the liquidity of the major U.K.-owned banks has served an important function in ensuring a level playing field and minimum holdings of sterling stock liquidity in the context of prudential standards and the BoE's official money market operations.

²¹ Appendix III outlines the U.K. implementation of consolidated supervision, including supervisory relationships with respect to offshore financial centers (OFCs).

²² As already noted, supervisory initiatives would rightly need to be subject to explicit cost-benefit analyses. These are published whenever a proposal is to be taken to the implementation stage.

However, it seems to have adversely affected the liquidity management behavior of some banks. In particular, some of them appear to be focusing too much on meeting the supervisory requirement, and are not using the more sophisticated liquidity management practices found elsewhere in the market. The FSA recognizes that the current approach used to supervise bank liquidity risk management practices needs to change, and is consulting with stakeholders on how best to proceed. It was encouraged to consider introducing a common liquidity reporting system for all banks that would collect liquidity data on a global basis, and to take more fully into account the maturity distribution of assets and liabilities in a behavioral sense.

93. **In the case of insurance supervision, U.K. authorities are significantly strengthening supervision in this area, and are shifting resources within the FSA to insurance sector oversight.** This is timely given the significant stress in the industry and the strong incentive for excessive risk taking in the current environment. Given the importance of U.K. insurance companies and markets in the global insurance industry, and the highly sophisticated nature of the U.K. market, the assessment of U.K. regulation in this area was made on the basis of the more stringent enhanced criteria underpinning the *IAIS Insurance Core Principles* (Section II). Even though it would be deemed to observe the prudential core principles using the more commonly used criteria, based on the enhanced criteria, (and at the time of the assessment at least) the FSA's regulatory and prudential regime required an increased degree of hands-on prudential supervision and was not sufficiently proactive. Reflecting in part the absence of formal actuarial, general insurance, and reinsurance involvement in the risk review and assessment process, the current prudential regime may not ensure a sufficiently comprehensive review of the appropriateness of firms' risk management systems, asset allocation limits, and internal controls, in light of the nature and amount of business underwritten.²³ Also, the desk-based analysis of statutory returns may not adequately capture the nature and scale of risks of underlying asset and reinsurance exposures. The authorities were encouraged to consider a further strengthening of insurance supervisory resources and processes within the FSA. In addition, the need for improved transparency of early intervention actions was stressed, along with stronger reporting, disclosure, and governance-related requirements for insurance companies.

94. **The FSA is already making important progress on insurance supervision reform.** It is in the process of rolling out a strengthened approach under its risk-based framework, in line with its own comprehensive review of the prudential regime for insurance (see the "Tiner Report") which was in train at the time of the FSAP assessment. These reforms are expected to remedy most of the shortcomings noted in the assessment of observance of the enhanced version of the IAIS Principles (see Section II).

95. **Securities regulation is strong.** The U.K. observes all of the elements of the *IOSCO Objectives and Principles of Securities Regulation* (Section II). Nevertheless, some technical

²³ Very recently, the FSA has integrated into its supervision team the previous work of the Government Actuary's Department (GAD).

suggestions were provided to enhance the quality of supervision given the importance of the U.K. as a major trading center in global markets. *Inter alia*, care needs to be taken to ensure that competitive pressures between markets and exchanges do not result in developments that undermine market participants' ability to monitor the flow of buy and sell orders going forward.

D. Accounting, Corporate Governance, and Information Disclosure Issues

96. **Though the differences should not be overstated, it seems fair to characterize the U.K. supervision regime as somewhat less prescriptive, and somewhat less intrusive overall, than in some other countries, but with relatively more emphasis on policies to promote market discipline.** Regulatory principles of attention to the responsibilities of owners/managers, and proportionality of regulation (with the attendant requirement for explicit cost-benefit analysis of new regulatory proposals), are noteworthy in this context. Indeed, the logic of the FSA's risk-based framework, and specifically the envisaged flexibility to shift supervisory resources between objectives and risk areas, requires a strong underlying disclosure and governance regime to cushion and minimize the potential costs of the shifts in supervisory focus in the face of unexpected developments. This consideration also has implications for the nature of supervision, which needs to rely on independent assessments of the effectiveness of systems and controls, a strong baseline monitoring of key risks, including through regular coverage of core themes (such as validation of returns, anti-money laundering, and credit risk management), and early intervention arrangements. In sum, continued further efforts to promote market discipline—if necessary, ahead of the completion of international efforts—are necessary to complement and underpin the U.K. supervisory philosophy, as well as being part of the policy response for minimizing perceptions of “too big to fail.”

97. **There are a number of issues arising from U.K. convergence to IAS.** Financial institutions, especially insurance companies, are facing considerable and complex changes to financial reporting which need to be implemented in a short period of time (before 2005). Some 34 standards are being reviewed. While the adoption of IAS offers considerable benefits in the form of comparable accounting across the EU and (in the case of insurance companies) more relevant financial reporting, the process to convergence will be extremely costly and resource intensive for financial institutions, particularly insurance companies. An especially difficult challenge will be the convergence to financial instrument accounting rules (IAS 39). These rules are quite restrictive, and many institutions that use derivatives to hedge economic risks could find themselves reporting more volatile earnings than if they did not hedge. They are looking to the FSA for guidance on how marked to market volatility arising from financial instrument accounting will be treated for regulatory capital purposes.

98. **A new system of non-statutory independent regulation of the accountancy profession's audit activities has recently been established under the auspices of the Accountancy Foundation (AF).** That system of regulation of financial reporting is currently being reviewed by the Government. As part of that review, consideration should be given to bringing together the regulation of financial reporting, currently under the Financial Reporting Council (FRC), and the Accounting Standards Board (ASB), together with that of the profession, under the AF.

99. **The FSA is conscious of the importance of having consumer self-help measures in place to reinforce market disciplines in the provision of financial services, and is taking measures in this direction.** Given the significant reliance placed on disclosure practices in the supervision framework, the authorities should ensure that consumer investment advisor and investment product disclosures are not complex and use plain language, to develop depositor-friendly comparative prudential disclosures for deposit-takers, and to ensure that these requirements are adequately enforced.

100. **There is also a need for market and credit risk disclosure requirements applicable across all sectors of the finance industry, or at least for the large or “high impact” financial institutions.** Many large institutions are already disclosing market risk information using VAR methodologies and credit exposure concentrations. However, the usefulness of these disclosures is undermined because there is no industry-wide measurement standard (e.g., for VAR-holding period, confidence interval). Consideration could be given to mandating market and credit risk disclosure requirements broadly in line with the proposals of the *Multidisciplinary Working Group on Enhanced Disclosures*, starting with the large “high impact” financial institutions. In addition, all institutions should be required to publish financial reports on a six monthly basis that have at least “negative assurances” from auditors (certifying that they have no reason to believe that the reported information is not materially correct), coupled with a continuous disclosure requirement.

101. **Proposals have been made to update governance arrangements in U.K.-regulated institutions.** The DTI’s review of company law published in 2001 noted that U.K. law has fallen behind other jurisdictions that have rewritten their legislation, frequently based on U.K. models. The final report proposed a thorough revision to the U.K. law covering issues such as disclosure to shareholders, fair treatment, and accounting and auditing standards. Implementation of the report’s recommendations is expected to begin in the near future with the publication of a consultation paper.

E. Insolvency Framework

102. **Receiverships and liquidations currently account for the majority of corporate insolvency proceedings in the U.K., and the U.K. system is still ranked as one of the most “creditor-friendly” among major industrialized countries.** Nevertheless, the government’s recent reform initiatives, as embodied in the Insolvency Act 2000 and the last year’s Enterprise Act, make significant strides towards making the U.K. regime more supportive of business rescue while also ensuring protection of creditors’ rights. In this regard, it is commendable that the Insolvency Act’s CVA moratorium provisions became effective in January 2003, and it is

recommended that the authorities continue with efforts to make the corporate insolvency provisions of the Enterprise Act effective as soon as possible.²⁴

103. **Despite the important and commendable reforms already undertaken, a few broad policy areas merit additional attention.** Specific further measures would need to strike an appropriate balance between different considerations, such as whether they would make the system more effective in accomplishing the broader value maximization, risk allocation and financial soundness objectives that underlie orderly and effective insolvency systems. They would also need to be designed to avoid counterproductive results, such as encouraging commercially imprudent behavior by debtors, or creation of disincentives for lenders to provide reasonably priced financing to enterprises. Bearing in mind these issues, consideration should be given to adoption of the following additional reforms: (i) expanding the Insolvency Act 2000's CVA moratorium procedures to cover a wider range of companies, including at least medium-sized businesses, given that the CVA remains the primary insolvency procedure which does not displace a firm's existing management; (ii) examining the scope for inclusion of a moratorium in scheme of arrangement procedures, given the availability of these procedures for complex workout situations; (iii) broadening the criteria for commencement of administration proceedings to include additional circumstances where a debtor is not insolvent or in immediate danger of insolvency; (iv) reducing the creditor voting majorities required for approval of CVAs and schemes of arrangement, as a means of facilitating creditor approval of restructuring plans; (v) adopting reforms to expedite court approval of agreements that have been negotiated out-of-court between a debtor company and a qualified majority of its creditors; and (vi) adopting innovative solutions to facilitate the provision of financing to troubled but viable companies, while preserving the security interests of existing creditors.

104. **The expeditious nature of the U.K. legal system offers some comfort that the FSA's ability to take actions in the event of a financial institution's insolvency should not be unduly constrained by the fact that they are subject to the normal corporate insolvency laws.** Although the FSMA gives the FSA and FSCS a role in financial institution insolvency proceedings, the insolvency laws contain firm requirements governing the roles and duties of the court, and of the administrator or receiver appointed to manage the affairs of a troubled institution. These requirements would have to be observed by the FSA and other governmental agencies (subject of course to the FSA's normal supervision and regulation of any regulated activities that may be carried on by an institution in insolvency proceedings). However, the FSA also has some strong rights that help balance this situation, especially the right to petition the court, a presumption that a receiver or administrator would consult the FSA, and the right to file objections with the court.

²⁴ Because they only apply to new floating charges, however, the Enterprise Act's important provisions to limit the ability of floating charge holders to appoint an administrative receiver will have only limited effect for quite a while.

105. **The option of pre-statutory insolvency actions by the authorities reduces the scope for any delays or difficulties from the various statutory routes, and the system appears to work well in practice.** This does not completely eliminate the issue, however, as the statutory route may in some cases be unavoidable: for example, where pre-statutory efforts are insufficient to resolve an institution (e.g., Barings), or in cases where insolvency proceedings are initiated by any creditor of the institution (creditors are authorized to initiate proceedings where the statutory requirements are met without consulting the FSA). The authorities were encouraged to keep the issue under review to ensure that the balance of powers and duties continues to allow the authorities to do what is necessary from a stability perspective, and with a view to considering the scope and desirability of possible reforms to the system to broaden the ability of the FSA and/or other governmental agencies to restructure and liquidate financial institutions outside of the corporate insolvency system.

F. Safety Nets

106. **If the U.K. regime is to be able to permit poorly-managed financial institutions to fail, its credibility will be highly dependent on appropriately designed safety nets that are well-understood by potential claimants.** The FSCS is well-designed in that it supports the exercise of market discipline through the use of co-insurance risk-sharing when losses exceed prescribed modest thresholds (except in the case of compulsory insurance). Thresholds for co-insurance also help to ensure proportionately greater protection for those lower-income claimants least able to sustain financial losses. However, public awareness of the FSCS is limited and consumers will only directly benefit from the FSCS if they are aware of their rights and privileges under the scheme. This issue has been recognized by the authorities, who are taking steps to address it. In May 2002, the FSA issued a consultation paper, which proposed that regulated entities be required to disclose to their clients relevant information about the compensation scheme, its coverage, and limits. And, the FSCS is working with stakeholders and the media to make its presence better known. A review of the FSCS is upcoming, and one of the aspects that should be considered is whether a more explicit contingency credit line from the Government would be desirable.

G. Oversight and Supervision of Payment and Securities Settlement Systems

107. **The oversight of the CHAPS payment system and CREST securities settlement system is strong.** Although some technical strengthening of some aspects of the supervision of securities settlement systems is desirable, the overall effectiveness of the oversight arrangements is reflected in the fact that these systems are of a very high standard internationally, as evidenced by the U.K.'s high degree of observance of the *CPSS Core Principles for Systemically Important Payment Systems* and the *IOSCO/CPSS Recommendations for Securities Settlement Systems* (Section II). As noted previously, for the BoE, some further refinements over time on the transparency front would be helpful, but in any event oversight should include exploring the risk between the direct and indirect settlers, given the large interbank exposures that partially reflect the tiered payment system. Both the BoE and the FSA being designators under the Settlement Finality Regulations, and it is important that the flow of information and data between the two organizations continues to be smooth on both system- and settlement member-specific issues.

H. Systemic Liquidity Arrangements

108. **The BoE's monetary framework and operating procedures are fundamentally sound, and have contributed to well functioning financial markets.** Monetary policy and the BoE's market operations in money and foreign exchange markets are now conducted in a highly transparent fashion, as evidenced by the BoE's strong degree of observance of the *monetary policy* portion of the *Code of Good Practices on Transparency in Monetary and Financial Policies* (Section II). This helps to minimize uncertainty in markets regarding the Bank's intentions. In addition, the granting of operational independence in 1997 and associated institutional changes at the BoE helped to provide a clear focus to its monetary policy and financial stability activities, which has helped market participants by providing a stronger anchor for inflation expectations. Nevertheless, there is scope for some minor technical improvements at the margin, including: (i) possibly some streamlining of the BoE's daily operations in the market if the daily liquidity forecasting process can be improved; (ii) the desirability of additional risk management mechanisms for the substantially expanded range of high-grade securities that are now eligible collateral for BoE operations; and (iii) down the road, possibly reintroducing some longer-term operations into the mix.

I. Public Debt Management

109. **The management of public debt is not a source of vulnerability for the financial system given the low level of government indebtedness and the conservative approach to managing the risks associated with the debt.** U.K.'s practices are fully consistent with the *IMF/World Bank Guidelines for Public Debt Management*. The transfer of cash management responsibilities from the BoE to the DMO in 2000 went smoothly, and there have been a large number of initiatives to minimize the fragmentation of the debt stock and maintain issuance volumes in a period of modest borrowing requirements. Going forward, consideration could be given to some minor technical innovations, such as introducing some indicators to explicitly articulate the government's preferred cost-risk tradeoff, and automating the bid-capture process used in debt auctions in order to reduce operational risk and improve auction-processing times.

110. **Nevertheless, the gilt market has been distorted by changes to accounting and pension rules.** It is important to note that these distortions are gradually being resolved by market participants themselves as insurance companies and pension funds become more adept at investing in non-gilt securities, and as other borrowers enter the market to take advantage of the high demand for sterling-denominated debt.

J. Financial Crime

111. **The U.K. has a comprehensive legal, institutional and supervisory regime for AML/CFT that is broadly in line with the criteria set forth in the FATF 40+8 Recommendations and the AML/CFT Methodology (Section II).** The only significant gap relates to FATF Special Recommendation VII, as current U.K. law (like the laws of most other countries) does not require the inclusion of originator information on funds transfers and related messages. In May 2002, the authorities issued for public comment a proposal to implement this

112. requirement, with exemptions for certain wire transfers. However, given the subsequent issuance for comments of a proposed FATF Interpretative Note on Special Recommendation VII, the authorities have decided to await the final outcome of the FATF consultation before finalizing any new requirements in this area. More generally, the AML/CFT framework has been made more robust over the last few years, with the adoption of key measures on terrorist financing and non-bank financial institutions (money services businesses—bureaux de change, money remitters, and check cashers), as well as by issuance of the FSA's Money Laundering Sourcebook. Further substantive improvements should emerge once all the relevant AML provisions of the Proceeds of Crime Act 2002 are made effective, and a requirement is adopted to mandate the inclusion of originator information on funds transfers. The authorities were provided with some additional technical recommendations to enhance the strength and effectiveness of the legal framework and supervisory regime for AML/CFT in key areas.

Table 1. U.K. Banks and Insurance Companies (March 2002)

Financial Institutions	Number	Total assets (£bn)
Resident Banks	395	3,488
Out of which		
Foreign Subsidiaries	70	281
Foreign Branches	211	1,880
U.K.-Incorporated Banks (consolidated worldwide, except for foreign subsidiaries)	236	2,472
Out of which		
U.K.-Owned Commercial Banks	35	1,455
U.K.-Owned Mortgage Banks and Building Societies	78	683
Other U.K.-Owned Banks	53	52
Foreign-Owned Banks	70	281
Insurance Companies	782	1,018
Out of which		
Life Insurance Companies	182	942
Non Life Insurance Companies	600	76

Table 2. U.K.-Incorporated Banks—Composition of Balance Sheet Claims

Counterparty	Exposures (% of banks' total claims)		Exposures (% of banks' own funds)	
	June 2001	June 2002	June 2001	June 2002
Foreign	47.1	47.0	394.7	385.1
Developing Economies	15.7	14.2	131.9	116.5
Argentina	0.3	0.1	2.7	0.9
Brazil	0.8	0.4	6.4	3.6
US	13.1	14.5	110.2	118.9
Developed Europe	13.2	13.0	110.9	106.5
Off-Shore Centers	9.5	8.6	79.7	70.2
Cayman Islands	1.2	1.4	9.8	11.2
Domestic	52.9	53.0	443.8	434.0
Households	28.3	29.4	237.1	240.9
Real Estate Loans	3.6	4.3	30.5	35.5
Corporations	9.0	9.3	75.1	76.3
Non Bank Financial Institutions	6.5	7.2	54.3	58.6
Banks	9.2	7.1	77.4	58.1
Memo note:				
Total Claims/Own Funds (£bn)	1652	1761	197	215

Source: Bank of England, BIS, FSA, and staff estimates

Table 3. United Kingdom - Selected Economic Indicators, 1997-2001

Total population (end-2000) 59.5 million

GDP per capita (2001): \$23,783.4

	1997	1998	1999	2000	2001
<i>Demand and supply (percentage changes)</i>					
Real GDP	3.4	3.0	2.1	3.0	2.4
GDP (in billions of pounds sterling)	811.1	859.8	901.3	943.4	980.4
Unemployment Rate	7.0	6.3	6.0	5.5	5.1
<i>Prices and incomes</i>					
GDP deflator (average percent changes)	2.9	3.0	2.3	1.8	..
Consumer prices index	3.1	3.4	1.6	2.9	1.8
Household savings ratio	9.3	6.4	6.4	6.4	6.4
<i>Monetary and credit data (percent change in annual averages)</i>					
Monetary base (M0)	6.3	5.6	11.7	5.5	8.0
Broad money (M4)	5.7	8.4	4.1	8.3	6.7
Domestic credit	5.6	3.6	7.5	12.5	9.2
<i>Interest rates (period averages, in percent)</i>					
Three-month interbank rate (period averages in percent)	6.9	7.4	5.5	6.1	3.9
Ten-year government bonds yield (period averages)	7.4	5.4	5.4	5.4	4.6
<i>Public finances</i>					
General government balance	-0.9	0.2	0.9	2.6	0.4
Public sector balance	-0.7	0.6	1.8	4.3	-0.1
<i>Balance of payments</i>					
Trade balance (In billions of US\$)	-20.2	-36.1	-44.5	-46.1	-53.6
Current account	-2.9	-8.0	-30.9	-27.8	..
Portfolio investment (net)	-41.4	-18.2	141.4	154.6	136.9
<i>External sector (levels, unless otherwise indicated)</i>					
Sterling per US\$ (end of period)	0.6	0.6	0.6	0.7	0.7
Total reserves (billions of US\$)	37.1	37.3	41.8	48.2	..
Reserve cover (months of imports)	..	..	..	..	..
Total external debt	..	..	..	..	..
of which: Public sector net debt (in percent of GDP)	42.8	40.1	37.3	32.0	30.6
of which: Banking sector debt	..	..	..	..	..
Bank of England short-term liabilities (end of period)	..	..	..	..	..
Bank of England short-term foreign currency liabilities (end of period)	..	..	8,034	9,102	10,302
External interest payments to exports (in percent)	..	..	..	..	..
<i>Financial Markets Indicators</i>					
Spread of benchmark bonds (end of period)	..	..	..	..	..
Change in stock market index (percent, end of period)	13.2	17.3	11.9	6.0	-22.9

Sources: Bank of England; and Fund staff calculations.

Table 4: United Kingdom - Financial Soundness Indicators for the UK Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)

BANKING SYSTEM	1997	1998	1999	2000	2001	2002 H1
<i>Capital Adequacy 9/</i>						
Regulatory capital to risk-weighted assets	14.9	13.2	14.0	13.0	13.2	13.4
Foreign Subsidiaries	25.4	17.4	18.6	17.7	20.8	20.2
UK Large Commercial Banks	13.6	12.4	13.6	11.8	12.2	12.5
UK Mortgage Banks	133.2	11.9	11.6	12.1	11.5	...
UK Other Banks	28.7	26.8	27.2	28.6	27.2	26.2
Regulatory Tier 1 capital to risk-weighted assets	10.7	9.7	9.3	8.8	9.0	9.2
Foreign Subsidiaries	19.3	13.2	14.6	13.9	16.2	16.1
UK Large Commercial Banks	9.2	8.7	8.6	7.9	8.2	8.4
UK Mortgage Banks	10.0	8.7	7.3	7.2	6.9	...
UK Other	28.2	24.3	21.9	24.3	24.3	23.8
Capital to assets ratio	7.2	7.2	7.5	7.0	7.1	7.0
Foreign Subsidiaries	10.2	11.2	10.1	9.6	11.1	9.4
UK Large Commercial Banks	6.8	7.0	7.5	6.5	6.6	6.7
UK Mortgage Banks	6.4	6.0	6.0	6.2	6.0	...
UK Other Banks	12.1	9.3	10.4	15.3	16.7	15.8
<i>Asset Quality 9/</i>						
<i>Loans in foreign currency to total loans ratio (%)</i>	41.9	39.0	37.6	42.3	45.2	45.1
<i>of which:</i> Foreign Subsidiaries	85.0	84.7	83.3	87.0	88.5	89.7
UK Large Commercial Banks	18.1	15.1	17.4	20.2	28.2	29.0
UK Mortgage Banks	1.8	1.8	2.7	3.1	7.1	8.2
UK Other Banks	24.8	19.3	12.7	8.8	8.3	7.8
<i>NPLs to total loans</i>	3.7	3.2	3.0	2.5	2.6	2.6
<i>of which:</i> Foreign Subsidiaries	5.0	6.8	6.3	4.9	5.7	6.1
UK Large Commercial Banks	3.5	3.1	2.9	2.6	2.3	2.3
UK Mortgage	3.1	2.2	1.7	1.2	1.2	...
UK Other Banks	10.6	4.9	5.1	7.0	14.9	14.2
<i>NPLs net of provision to capital</i>	27.6	22.9	19.0	16.0	15.1	14.9
<i>of which:</i> Foreign Subsidiaries	26.2	34.4	33.5	30.4	33.9	33.5
UK Large Commercial Banks	24.4	18.9	15.2	14.6	9.6	9.9
UK Mortgage Banks	32.6	22.0	15.7	9.0	10.6	...
UK Other Banks	48.5	31.8	28.4	21.7	39.4	34.8
<i>Large exposures to capital</i>	...	...	...	...	...	...
<i>Off B. Sheet Items to (%) UK-owned banks</i>	25.6	26.8	28.3	29.5	29.9	...
<i>Derivatives (credit equiv) to Assets (%). UK-owned banks</i>	6.0	6.5	5.7	6.0	4.8	...
<i>Spread between highest/lowest interbank rate 4/</i>	0.04	0.03	0.05	0.04	0.06	...

Table 4. (con't): United Kingdom - Financial Soundness Indicators for the U.K. Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002 H1
<i>Composition of loan portfolio (% of total peer-group loans)</i>						
Manufacturing loans	5.7	6.4	6.5	5.6	5.0	4.8
<i>of which:</i> Foreign Subsidiaries and Branches	8.8	11.1	12.7	9.2	8.9	8.3
U.K. Large Commercial Banks	7.0	7.2	6.8	6.2	5.2	5.0
U.K. Mortgage Banks	0.0	0.0	0.2	0.2	1.4	1.4
U.K. Other Banks	6.4	6.4	4.7	3.2	2.9	2.8
Construction loans	1.0	1.1	1.0	1.1	1.2	1.2
<i>of which:</i> Foreign Subsidiaries and Branches	1.1	1.1	1.2	1.0	1.0	1.2
U.K. Large Commercial Banks	1.6	1.7	1.6	1.8	1.7	1.7
U.K. Mortgage Banks	0.0	0.0	0.0	0.1	0.7	0.7
U.K. Other Banks	0.5	0.6	0.5	0.4	0.6	0.6
Wholesale and Retail loans	4.0	4.2	3.9	3.5	3.1	3.1
<i>of which:</i> Foreign Subsidiaries and Branches	5.4	6.0	5.6	4.2	4.0	4.0
U.K. Large Commercial Banks	5.4	5.5	4.9	4.5	4.2	4.1
U.K. Mortgage Banks	0.4	0.5	0.8	0.9	1.0	0.9
U.K. Other Banks	2.1	2.1	1.5	1.2	1.2	1.2
Transport and Communication loans	1.9	1.9	2.1	1.8	2.1	2.2
<i>of which:</i> Foreign Subsidiaries and Branches	3.8	4.0	4.8	3.5	4.1	4.4
U.K. Large Commercial Banks	1.8	1.8	1.8	1.7	1.7	1.9
U.K. Mortgage Banks	0.0	0.0	0.1	0.1	0.7	0.7
U.K. Other Banks	1.9	1.6	1.0	0.8	1.1	1.1
Hotels and Restaurants	1.5	1.4	1.4	1.5	1.6	1.6
<i>of which:</i> Foreign Subsidiaries and Branches	1.5	1.4	1.4	1.4	1.6	1.6
U.K. Large Commercial Banks	2.4	2.4	2.4	2.3	2.1	2.1
U.K. Mortgage Banks	0.0	0.0	0.1	0.1	0.9	0.9
U.K. Other Banks	0.7	0.9	0.5	0.4	0.4	0.3
Commercial Real Estate loans	4.3	4.8	5.1	5.5	6.3	6.4
<i>of which:</i> Foreign Subsidiaries and Branches	5.1	6.2	6.3	5.8	6.4	6.7
U.K. Large Commercial Banks	5.4	5.7	6.1	6.6	6.6	6.6
U.K. Mortgage Banks	1.4	1.7	2.1	2.9	5.9	6.2
U.K. Other Banks	8.4	8.4	5.9	5.0	5.3	3.5
Individual loans	46.0	47.0	47.4	45.5	45.7	45.9
<i>of which:</i> Foreign Subsidiaries and Branches	10.0	11.5	12.8	10.9	11.1	11.4
U.K. Large Commercial Banks	44.3	44.4	43.7	46.4	47.0	46.5
U.K. Mortgage Banks	90.7	89.2	86.0	83.8	73.8	73.4
U.K. Other Banks	24.0	33.6	55.3	66.7	75.5	79.0

Table 4. (con't): United Kingdom - Financial Soundness Indicators for the U.K. Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002 H1
Mortgage loans	37.8	38.1	38.0	36.3	36.1	36.3
<i>of which:</i> Foreign Subsidiaries and Branches	5.1	5.8	6.2	5.0	5.0	5.2
U.K. Large Commercial Banks	30.4	30.3	29.7	33.2	33.9	33.7
U.K. Mortgage Banks	88.4	86.2	82.6	80.1	67.8	67.3
U.K. Other Banks	5.8	10.1	32.7	37.5	39.0	41.5
Insurance and Pension Fund loans	1.5	1.9	1.8	1.9	1.4	..
<i>of which:</i> Foreign Subsidiaries and Branches	2.7	4.3	4.0	4.8	3.5	..
U.K. Large Commercial Banks	1.4	1.3	1.5	0.8	0.9	..
U.K. Mortgage Banks	0.4	0.4	0.4	0.5	0.3	..
U.K. Other Banks	0.4	0.9	2.1	0.9	0.6	..
Financial Intermediation loans	27.0	24.4	23.9	25.6	26.5	26.8
<i>of which:</i> Foreign Subsidiaries and Branches	52.3	45.8	42.6	48.7	50.8	51.3
U.K. Large Commercial Banks	20.7	20.0	21.5	19.8	21.8	23.0
U.K. Mortgage Banks	6.8	7.7	9.6	9.2	11.9	11.8
U.K. Other Banks	51.6	41.5	25.1	17.3	8.1	6.9
<i>Of which:</i> Securities Dealers loans	12.7	9.9	9.9	11.5	11.1	11.2
<i>of which:</i> Foreign Subsidiaries and Branches	35.6	26.9	25.7	30.3	30.4	29.7
U.K. Large Commercial Banks	3.7	4.1	5.8	4.5	5.3	6.7
U.K. Mortgage	0.1	0.6	1.1	1.5	1.9	1.7
U.K. Other Banks	24.3	19.2	8.3	10.0	0.1	0.2
Other loans	7.1	6.9	6.9	8.1	7.0	6.7
<i>of which:</i> Foreign Subsidiaries and Branches	9.3	8.8	8.8	10.4	8.5	8.0
U.K. Large Commercial	10.1	10.0	9.7	9.9	8.7	8.2
U.K. Mortgage Banks	0.2	0.4	0.8	2.1	3.5	3.6
U.K. Other Banks	4.0	4.1	3.4	4.0	4.3	3.9
<i>Geographical distribution of cross-border claims</i>						
<i>(% of total cross border claims)</i>						
Consolidated: Claims on developed Europe 3/						
U.K. Resident Banks	29.7	33.6	39.7	41.0	42.4	42.6
<i>of which:</i> U.K. Owned Large Commercial Banks	28.9	34.2	41.3	41.5	41.1	42.4
U.K. Owned Mortgage Banks	31.4	28.7	31.3	37.9	46.9	42.7
U.K. Owned other Banks	43.6	54.1	60.8	55.9	54.4	55.2
Consolidated: Claims on developing Europe 3/						
U.K. Resident Banks	1.3	1.6	1.3	1.2	1.2	1.1
<i>of which:</i> U.K. Owned Large Commercial Banks	1.6	1.8	1.6	1.4	1.3	1.2
U.K. Owned Mortgage Banks	0.1	0.1	0.5	0.6	0.8	0.7
U.K. Owned other Banks	1.2	6.1	0.7	0.3	0.4	0.2
Consolidated: Claims on Japan 3/						
U.K. Resident Banks	6.6	5.8	4.6	4.2	3.6	2.9
<i>of which:</i> U.K. Owned Large Commercial Banks	7.2	6.9	5.5	5.0	4.1	3.4
U.K. Owned Mortgage Banks	3.8	2.3	1.5	0.8	1.5	1.3
U.K. Owned other Banks	4.5	3.5	3.9	0.7	1.4	1.4

**Table 4 (con't): United Kingdom - Financial Soundness Indicators for the UK Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)**

	1997	1998	1999	2000	2001	2002 H1
Earnings and Profitability						
Before Tax ROA 10/	0.9	0.8	1.0	0.9	0.5	0.6
<i>of which:</i> Foreign Subsidiaries	1.1	0.6	1.1	1.2	0.4	1.0
UK Large Commercial Banks	0.9	0.8	1.0	0.9	0.6	0.7
UK Mortgage Banks	0.8	0.8	0.8	0.7	0.5	...
UK Other Banks	2.4	1.6	2.3	1.0	-1.7	-0.2
Before Tax ROE 10/	15.9	13.1	16.2	13.5	7.7	10.2
<i>of which:</i> Foreign Subsidiaries	13.6	6.4	12.4	13.8	5.0	11.0
UK Large Commercial Banks	17.2	14.5	17.7	14.0	9.2	10.9
UK Mortgage Banks	13.6	13.9	14.4	13.4	9.7	...
UK Other Banks	19.9	15.0	22.0	8.2	-11.0	-0.8
Net interest income to total income	56.7	57.8	55.3	53.6	55.0	53.3
<i>of which:</i> Foreign Subsidiaries	42.8	47.2	44.0	35.9	39.3	36.3
UK Large Commercial Banks	56.5	57.6	56.4	54.6	56.2	54.9
UK Mortgage Banks	74.0	72.2	70.3	68.0	62.4	...
UK Other Banks	28.3	28.4	21.2	27.2	45.1	47.9
Noninterest expenses to total income	59.5	58.4	55.8	57.1	59.4	59.0
<i>of which:</i> Foreign Subsidiaries	64.3	67.7	60.8	61.8	64.9	64.6
UK Large Commercial Banks	61.5	59.6	56.9	57.6	59.1	58.2
UK Mortgage Banks	49.2	48.3	50.2	51.8	52.9	...
UK Other Banks	61.0	62.3	52.9	59.1	89.8	81.3
Personal expenses to noninterest costs	53.2	52.1	52.9	51.9	50.2	43.8
<i>of which:</i> Foreign Subsidiaries	52.4	52.7	53.0	54.2	52.3	50.3
UK Large Commercial Banks	54.4	53.1	54.5	53.3	52.1	42.2
UK Mortgage Banks	46.3	45.9	45.5	43.5	41.4	...
UK Other Banks	60.3	58.4	58.6	58.2	53.9	53.1
Trading income to total income	5.1	4.4	5.9	7.0	6.9	6.7
<i>of which:</i> Foreign Subsidiaries	8.0	3.5	10.0	15.0	10.0	15.2
UK Large Commercial Banks	5.3	5.5	6.5	6.6	7.7	6.3
UK Mortgage Banks	1.3	1.1	1.4	2.7	2.3	...
UK Other Banks	5.7	2.6	2.8	3.6	3.0	2.1
Lending/deposit interest spread 2/						
Deposits						
PNFCs						
<i>of which:</i> Sight	...	...	3.6	4.2	2.6	2.5
Time	...	...	4.9	5.3	3.8	3.7
Households						
<i>of which:</i> Sight	...	...	2.5	3.1	1.7	1.9
Time	...	...	5.1	5.6	4.1	3.9

Table 4. (con't): United Kingdom - Financial Soundness Indicators for the U.K. Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002 H1
<i>Lending</i>						
PNFCs	...	...	7.3	7.6	6.0	5.9
of which: Loans	...	...	7.3	7.6	6.0	5.9
Overdrafts	...	...	7.7	8.2	6.4	6.5
Households	...	...	11.5	11.0	10.0	9.9
of which: Loans	...	...	11.5	11.0	10.0	9.9
Overdrafts	...	...	10.4	10.8	9.9	9.8
Bridging	...	...	8.5	9.2	7.9	8.0
Mortgage	...	...	6.9	7.0	5.6	5.5
Credit card	...	...	16.5	15.6	15.1	14.1
<i>Liquidity</i>						
Tradable assets to total assets	23.7	25.2	25.8	25.9	26.1	26.1
of which: Overseas	27.5	30.3	30.6	30.7	32.3	32.2
U.K. Large Commercial Banks	18.1	17.6	20.0	19.0	20.8	21.5
U.K. Mortgage Banks	20.1	20.4	19.8	21.8	15.8	15.6
U.K. Other Banks	23.4	28.6	28.9	24.1	21.0	20.6
Foreign denominated liabilities to total liabilities	51.6	50.8	50.0	53.0	53.8	54.4
of which: Overseas	75.8	74.9	73.9	75.0	75.8	75.9
U.K. Large Commercial Banks	24.5	21.7	24.8	27.1	30.1	31.9
U.K. Mortgage Banks	16.8	18.5	21.3	24.4	28.6	30.0
U.K. Other Banks	17.1	13.3	11.7	8.4	8.2	9.0
Average bid-ask spread for CDs 4/	0.05	0.08	0.07	0.05	0.03	0.03
Average bid-ask spread for Repo 4/	0.05	0.05	0.06	0.05	0.06	0.06
Average daily turnover ratio in the securities and other markets 5/						
Short sterling	42.1	60.4	31.8	42.2	70.0	76.0
Options	4.7	14.9	7.5	10.1	15.0	14.0
Interbank	6.5	7.4	7.7	10.8	11.0	12.0
Gilt Repo	12.9	15.8	12.9	17.5	20.0	21.0
<i>Sensitivity to Market Risk</i>						
Duration (or average repricing period) of assets	..	..	..	..	..	..
Duration (or average repricing period) of liabilities	..	..	..	..	..	..
Net open positions in FX to capital	..	..	..	..	..	..
Net open positions in equities to capital	..	..	..	..	..	..
2. CORPORATE AND HOUSEHOLD SECTORS						
Total Corporate Debt Annual Growth 1/	11.8	15.9	21.5	16.8	0.6	5.9
Corporate Debt to Equity Ratio	15.01	15.73	15.36	19.39	23.36	24.19
Number of Insolvencies in England and Wales	-6.2	4.7	8.2	0.6	4.7	..
Gross Corporate Operating surplus before interest and taxes	6.0	5.6	5.6	4.7	5.4	5.8
in percent of gross interest payments 2/						
Total Household liabilities rate of growth 4/	6.3	6.5	8.2	8.9	10.0	2.8
Total household Interest payments, in % of h'hold disp. Inc.	8.1	3/ 9.1	7.8	8.5	7.5	7.3
H'hold Fin. liabs, in % of h'hold disp. Inc.	103.3	107.9	108.0	113.3	116.7	120.1
Households Secured debt defaults, in percent of all loans 3/	0.16	0.16	0.12	0.11	0.09	..

Table 4 (con't): United Kingdom - Financial Soundness Indicators for the UK Financial System, 1997-2002 1/
(In percent, unless otherwise indicated)

	1997	1998	1999	2000	2001 H1
3. MARKET-BASED FSIs					
<i>Average probability of default of UK corporate sector based on Moodys' rated issuers</i>					
					4.0
<i>Moodys' ratings for largest UK-owned banks</i>					
	Bank	LT	LT Debt		
	Deposit	Debt	Subor-	Financial	Issuer
	LT	Senior	dated	Strength	Rating
<i>Barclays</i>	Aa1	Aa1	Aa2	A-	Aa1
<i>HSBC Holdings Plc</i>	...	...	A1	...	...
<i>Lloyds (Lloyds TSB)</i>	Aaa	Aaa	Aa1	...	A
<i>Royal Bank of Scotland</i>	Aa1	Aa1	Aa2	A-	...
<i>Abbey National</i>	Aa2	(P)Aa2	Aa3	B+	Aa2
<i>Alliance & Leicester</i>	A1	A1	A2	B	A1
<i>Halifax</i>	Aa2	Aa2	Aa3	B+	Aa2
<i>Standard Chartered Plc</i>	...	...	Baa1	...	...
4. FINANCIAL SOUNDNESS INDICATORS INSURANCE					
	1996	1997	1998	1999	2000
	(in percent unless otherwise indicated)				
Non-Life/General Insurance 6/					
Gross premium written, annual change	22.2	-23.9	-4.6	4.5	4.2
Net premium written, annual change	31.8	-29.0	-2.5	1.6	-3.5
Net premiums earned, annual change	31.3	-30.1	-2.0	1.7	-5.3
Cession ratio	83.1	77.5	79.2	77	71.3
Net investment yield	4.6	5.1	5.0	4.1	5.3
Underwriting Profit / Net Investment Income	-20.4	-49.9	-78.4	-81.5	-74.9
Operating ratio	91.1	89.4	95.1	96.4	93.9
Combined ratio	102.4	109.3	115.3	112.5	113.8
Expense ratio	21.5	31.5	33.2	33.6	33.9
Loss ratio (net)	80.9	77.8	82.1	78.9	80.0
Change in adjusted shareholder funds	11.2	11.8	6.6	-20.0	-18.2
Pre-tax profit ratio	17.7	30.4	42.9	7.7	7.8
Pre-tax profits/Average adjusted shareholder funds	14.4	13.7	9.9	4.8	5.0
Life/Long-Term Insurance 7/					
New business premium growth	33.7	20.4	21.0	17.1	16.7
Total gross premium growth	17.0	17.9	27.0	20.2	25.5
Cession ratio	9.9	15.1	16.2	15.6	12.7
New business expense ratio (gross)	69.3	62.1	56.9	57.3	49.9
Total expense ratio (net)	16.3	15.7	13.9	13.0	10.1
Claims ratio (net)	75.2	79.3	73.3	67.3	71.9
Investment return (yield plus realised gains)	5.3	4.7	4.3	3.8	3.6
Free asset ratio	10.4	10.1	8.3	10.0	6.5
Statutory solvency cover	4.7	4.8	4.1	5.2	3.7
Liquidity ratio	106.4	106.6	104.4	106.5	101.6

Sources: Bank of England, FSA; Moodys and Fund staff calculations; S&P Theys.

1/ Aggregate data, unless otherwise indicated.

2/ 2001 data are as of September.

3/ Consolidated figures are for UK-owned banks only.

4/ 2002 figures are as of end October 2002.

5/ Quarterly data reported as end of period basis, in this case, end June 2002.

6/ Total UK non-life insurance less global branches.

7/ All companies.

8/ As of June 2002.

9/ As of March 2002.

10/ Annualized on the basis for the first 6 months.

U.K. FSAP: Stress Testing Methodology and Results

Methodologies

Stress tests performed by banks

113. **Two types of tests were carried out by the U.K. banks. One set of tests—scenario analysis—was based on shocks selected by the U.K. authorities and IMF staff that were translated into a set of consistent macroeconomic variables using the BoE’s main medium-term econometric model.** The severity of the initial shocks was calibrated to represent a 0.5 percent probability event based on past history. Four adverse shocks were chosen to generate the stress scenarios: (i) 35 percent decline in world and U.K. equity prices (relative to the base case that incorporates a small rise); (ii) a 12 percent decline in U.K. house and commercial property prices (relative to a base case that has some deceleration in house prices from current levels); (iii) a 1½ percentage point unanticipated increase in U.K. average earnings growth; and (iv) a 15 percent initial unanticipated depreciation in the trade-weighted sterling exchange rate. All scenarios were estimated relative to a base case specially constructed for this purpose to give a plausible projection of macroeconomic variables. The base case assumed constant nominal short-term interest rates, starting from actual data available for 2001 Q4. It should be noted that since the scenarios are based on full macroeconomic simulations, they incorporate a monetary policy reaction function (simulated assuming a Taylor rule) that mitigates the effects of the exogenous shocks.

114. **Each bank in the sample was asked to identify the potential impact according to five main risk classes: market risk, interest rate risk, credit risk, insurance risk, and a residual ‘other’ risk.** The U.K.-owned institutions were asked to consider the effects on both their domestic and global operations. The foreign-owned institutions reported the impact solely in relation to business units operating in the U.K. The risk horizon was one year (March 2002-March 2003).

115. **A second set of tests—single factor sensitivity tests—was based on the direct effect of separate single shocks on banks’ traded positions as of December 2001²⁵ under ceteris paribus assumptions.** In addition to the scenario analysis, each of the banks were asked to investigate the impact on market risks in the trading book of the following univariate shocks: (i) a 1 percentage point rise in interest rates; (ii) 3 percentage point rise in interest rates; and (iii) a 10 percent depreciation of the sterling/dollar exchange rate.

²⁵ U.K. banks updated the sensitivity tests based on their positions as of March 2002 and September 2002. The results were qualitatively similar to the December 2001 results.

U.K. authorities stress test for building societies on an aggregate basis

116. **The FSA undertook the stress testing of the building society sector in aggregate as a representative peer group of small institutions.** This complemented the stress test of the largest banks. The stress tests of building societies were based on an assessment of the impact of the four scenarios derived by the Bank of England for the stress tests of banks (described above) on (i) the retail deposit rate; (ii) the mortgage lending rate; (iii) other building societies' income; (iv) management expenses; and (v) provisions. These factors were then used to estimate the building societies' profits and capital as of end-2001.

U.K. authorities' "top down approach" to stress testing

117. **As a complement to the 'bottom-up' calculations based on the responses of the banks, the Bank of England also investigated the impact of the four shocks used in the banks' scenarios tests on U.K. commercial banks' provisions using a single-equation econometric model.** The model was specified in reduced-form and so, it cannot describe the exact causal links involved. But the underlying economic intuition is based on the impact of the macroeconomic shocks on borrowers' financial health feeding through to greater loan defaults, and ultimately probable credit losses for banks. The risk-horizon was two years.

Stress tests undertaken by the IMF mission

118. **IMF staff used two different methodologies for assessing the resilience of U.K.-owned FIs in relation to domestic and external shocks:** (i) a Vector Auto-Regression (VAR) approach to forecast the impact of changes in macroeconomic variables on household and domestic corporate loan losses; and (ii) a credit ratings approach to assess the risk of exposures to foreign counterparties. The chosen shocks were: a shock to interest rates of 530 bps; falls in real estate prices of 11 percent, 30 percent and 40 percent; a GDP fall of 2.3 percent; a fall in employment that corresponds to a rise of close to 3 percentage points in the unemployment rate; an ERI depreciation of 18 percent; and falls in equity prices of 30 percent and 40 percent. The risk-horizon was one year. The shocks were applied to the banks' positions as of June 2002. The size of the shocks represent the worst historical realization of each variable, except in the case of the 30 percent and 40 percent drop in real estate prices that were based on the possible existence of a bubble in U.K. real estate prices.

119. **Staff estimated two different VARs depending on the type of borrower (households or non financial corporations) and then used the estimated coefficients to simulate conditional future household and corporate defaults rates in the event of selected macroeconomic shocks.** Specifically, the variables used in the model are the following: (i) *credit quality* (loan default rate); (ii) *a measure of leverage* (for households, total interest payments to disposable income; for corporations, the debt to market value of equity ratio). (iii) *macroeconomic variables* (for households, unemployment and the real estate price index; for corporations the real estate price index and the nominal exchange rate. (iv) *policy variables*: the nominal lending interest rate. Based on available information, default rate of loans to households was proxied by the default rate of mortgage loans. The

default rate of loans to domestic corporations was proxied by the rate of bank corporate loan write-offs.

120. **The VARs were intended to be parsimonious while at the same time capturing most of the impact of macroeconomic variables on bank clients.** For that reason, the GDP growth was chosen for corporations and the employment rate for households. In the same vein, the equity price was chosen for households for its impact on household wealth while the nominal exchange rate (GBP/DM) was chosen for corporations for its impact on the level of domestic business. The sample period for households was from 1987:01 to 2001:4 and 1987:01 to 2001:02 for corporations. There were two monetary regimes in this period: exchange rate targeting (Deutsche Mark) up to 1992 and since 1992, an inflation targeting framework. A *dummy variable* was included to take account of this change in the policy regime. Two lags were included in the VAR for households and three in the VAR for corporates.

121. **The credit ratings approach for foreign exposures weights total exposure to each country by each country's probability of default, based on its ratings.** For each country three sectors were considered: corporate, banks and sovereign. The probability of default for each country was estimated at the weighted average of the probabilities of default of each sector. The probability of default of each sector, in each country, was estimated as the weighted average of all rated institution within the sector. The first 10 locations, ranked by the losses forecasted by the rating approach were: US, Indonesia, China, Argentina, Netherlands, Hong Kong, Cayman Islands, Liberia, Germany, and Brazil.

Results

122. **Table 1.1 and 1.2 below summarize the results of the stress tests carried out by the banks, focusing on the distribution of outcomes.** Table 1.3 shows the predicted annual rates of households and corporate defaults. Those rates were applied to the outstanding amounts of corporate and household loans in order to obtain the forecasted losses over a one-year horizon reported in Table 2. In all cases, the recovery rate was assumed to be zero. Potential losses due to exposures to households and domestic corporates turn out to be roughly similar.

123. **Table 2 summarizes the sum of aggregate potential losses under each test in £mn and also as a ratio to a common denominator (all U.K.-incorporated banks' own funds) in order to facilitate comparisons.** Potential losses are small in all cases, and robust to how results are reported. The worst potential losses, excluded the scenarios that postulate defaults by foreign counterparties, were recorded for the scenario where there is a 35 percent decline in world equity prices.

Table 1.1. Stress Tests Performed by the Banks—Aggregate Effects (in £mn)

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Sensitivity 1	Sensitivity 2	Sensitivity 3
Major U.K.-owned banks							
Mean	-432	-252	-146	-214	-60	-195	-1
Median	-408	-195	-57	-81	-16	-48	1
St. Dev	305	219	270	359	81	278	9
Foreign- inv. Banks							
Mean	-83	-11	-39	-32	-117	-482	5
Median	-78	-11	-50	-8	-117	-482	5
St. Dev	27	9	28	56	83	N/A	N/A
Overall							
Mean	-292	-192	-110	-141	-76	-243	0
Median	-131	-136	-56	-47	-59	-134	2
St. Dev	290	216	220	285	80	275	8

Table 1.2. Stress Tests Performed by the Banks. Risk Asset Ratio Net of Impact of the Scenarios (December 2001, in percent)

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Major U.K.-owned banks				
Mean	10.84	10.92	11.01	11.03
Median	11.11	11.19	11.35	11.50
St. Dev	1.17	1.20	1.25	1.29

Table 1.3. Forecasted rates of defaults for corporate and household loans

Shock	Forecasted annual rate of default of household loans (%)	Forecasted annual rate of bank corporate write off (%)
5.3 percent point increase in interest rates	0.209	0.518
11 percent decline in property prices	0.252	0.344
30 percent decline in property prices	0.342	0.424
40 percent decline in property prices	0.387	0.466
2.3 percent decline in GDP		0.321
2.8 percent decline in employment	0.260	
30 percent decline in property prices + 2.8 percent decline in employment	0.378	
40 percent decline in property prices + 2.8 percent decline in employment	0.408	
18 percent ERI depreciation		0.221
30 percent decline in equity prices	0.198	
40 percent decline in equity prices	0.214	

Memorandum item:

Loans to households: £518 bn (as of June 2002); Loans to domestic, nonfinancial corporations and nonbank financial corporations: £290 bn (June 2002)

Table 2. Potential Losses Under Each Stress Test

Type of Stress Test (one year-horizon)	Potential Loss (in £mn)	Potential Loss (percent all U.K.-incorporated banks' own funds) 8/
Banks (Scenario 1: 35 percent decline in world & U.K. equity prices)	2,922	1.5
Banks (Scenario 2: 12 percent decline in property prices) 3/	1,538	0.8
Banks (Scenario 3: 1 ½ unanticipated increase in wages) 4/	991	0.5
Banks (Scenario 4: 15 percent depreciation in ERI)	1,414	0.7
Banks - Single factor: 1 percentage point rise in interest rates 5/	535	0.3
Banks - Single factor: 3 percentage point rise in interest rates 6/	1457	0.7
Banks - Single factor: 10 percent depreciation of £/\$ exchange rate 6/	2	0.0
Provisions (Scenario 1: 35 percent decline in world & U.K. equity prices)	1,086	0.6
Provisions (Scenario 2: 12 percent decline in property prices)	300	0.2
Provisions (Scenario 3: 1 ½ unanticipated increase in wages)	244	0.1
Provisions (Scenario 4: 15 percent depreciation in ERI)	192	0.1
VAR – Scenario 1: 5.3 percentage point rise in interest rates	2577	1.2
VAR – Scenario 2: 11 percent decline in property prices	2513	1.2
VAR – Scenario 3: 30 percent decline in property prices	3000	1.4
VAR – Scenario 4: 40 percent decline in property prices	3356	1.6
VAR – Scenario 5 : 2.3 percent decline in GDP	931	0.4
VAR – Scenario 6 : 2.8 percent decline in employment	1347	0.6
VAR – Scenario 7: 30 percent decline in property prices + 2.8% decline in employment 7/	1960	0.9
VAR – Scenario 8: 40 percent decline in property prices + 2.8% decline in employment 7/	2113	1.0
VAR – Scenario 9: 18 percent ERI depreciation	641	0.3
VAR – Scenario 10: 30 percent decline in equity price 7/	1026	0.5
VAR – Scenario 11: 40 percent decline in equity price 7/	1110	0.5
Ratings approach to cross border exposures	7,634	3.9
B.Soc. (Scenario 1: 35 percent decline in world & U.K. equity prices)	-20 1/	0.2 2/
B.Soc. (Scenario 2: 12 percent decline in property prices)	-30 1/	0.3 2/
B.Soc. (Scenario 3: 1 ½ unanticipated increase in wages)	240	2.2 2/
B.Soc. (Scenario 4: 15 percent ERI depreciation)	330	3.0 2/

1/ i.e., a marginal improvement in profits: this is largely due to a behavioral assumption that if investors were more likely to place money on deposit under these scenarios, then this might be accompanied by some relative easing in deposit rates.

2/ percent of building societies' own funds.

3/ two foreign banks did not report their results.

4/ one foreign bank did not report its results

5/ one U.K.-owned bank and two foreign banks did not report their results.

6/ one U.K.-owned bank and three foreign banks did not report their results

7/ This scenario only affects the banks through their exposures to households

8/ "Own funds" comprises Tier 1 + Tier 2 + Tier 3 capital for U.K. incorporated banks.

The FSA's Risk-Based Operating Framework

124. **Risk based supervision as adopted by the FSA follows a distinctive “risk to our objectives” (RTO) approach. In this approach, the objectives at risk are the four statutory objectives assigned to the FSA by FSMA:** The four regulatory objectives identified in the FSMA are *market confidence, public awareness, protection of consumers, and reduction of financial crime*. These objectives are buttressed in FSMA by seven “principles of good regulation,” which cover the following areas: minimizing adverse effects of regulation on competition; encouraging competition among FSA regulated firms; efficient and economic use of resources; being “proportionate,” in supervisory policies (i.e., consistent with perceived costs and benefits); appropriately recognizing the responsibilities of firms’ own management; facilitating innovation; and maintaining the U.K.’s international competitive position.

125. **The RTO approach is a higher level corporate planning framework that should not be confused with conventional formulations of risk based supervision followed in many countries.** The conventional approach focuses on the risk exposures of individual firms, such as credit risk, liquidity risk, market risk, operational risk, litigation risk, etc. The FSA approach, in contrast, considers the risks posed by regulated individuals and firms, and by industry-wide developments, to the achievement of the FSA’s four statutory objectives. Under the RTO approach, the risks of primary concern to the FSA are the risks that developments in firms or markets will undermine market confidence in the financial system, that financial institutions and individuals will be subject to abuse by criminal elements, or that uninformed individuals will be misled by financial operators. RTO serves as the organizing framework for establishing supervisory strategies, guiding the FSA’s work program, allocating supervisory resources, designing regulations, and evaluating the effectiveness of supervisory efforts.

126. **As articulated by the FSA, risks to its objectives arise from within regulated firms or as a result of the wider external environment.** To make the RTO framework operational and to allow it to be applied consistently across all firms, the FSA has developed a classification scheme that links firm risk and environmental risk to the risks to its objectives. The FSA has identified seven high level risk groups linked to one or more of the four statutory objectives. The seven risk groups are: financial failure, misconduct/mismanagement, consumer understanding, incidence of fraud or dishonesty, market quality, incidence of market abuse, and incidence of money laundering. Firm specific risk is divided into two broad categories: business risk and control risk. These categories, in turn, are subdivided into some 40 risk elements. Based on a risk assessment, firms are categorized as High Impact, Medium High Impact, Medium Low Impact, or Low Impact. This categorization, in turn, determines the nature and intensity of the supervision of individual firms by FSA. Firm size is not the exclusive factor in determining where a firm lies on the spectrum between high and low impact but it is a central factor.

127. **The RTO approach provides an orderly and explicit framework for setting supervisory priorities and allocating scarce supervisory resources as well as a**

framework for establishing accountability of the FSA. The four statutory objectives are not all closely related to the broader objective of financial stability—a joint objective to which the FSA, BoE, and HMT are each bound to contribute cooperatively under the financial stability MoU—and the statute provides no principles for evaluating the relative importance of each of them. To the extent that the priorities between objectives shift over time, it can be expected that this would be reflected fairly explicitly, through the RTO framework, in the FSA’s corporate plan, annual report, and other publications. However, this has yet to be fully tested.

128. **Also, the RTO framework still allows room for flexibility and judgment in its application.** For example, the risk analysis that leads to the categorization of individual firms is, unavoidably, highly subjective; nor does the framework itself provide much operational guidance for determining, overall, how much supervision is enough or which risks are most important for which firms. At the firm level, the supervisory strategies adopted by FSA appear to be guided as much by conventional risk assessments (credit, liquidity, interest rate, operational, litigation, etc.) as by the RTO factors. Beyond that, judgments about supervisory policies are shaped by the requirement to undertake explicit cost-benefit analyses for all proposals as well as the broad consultation requirements. In short, the RTO framework, while certainly not providing all the answers itself, does make the operational framework for supervision more open, and open to challenge at several levels.

U.K.—Consolidated Supervision and Offshore Financial Centers

129. **Several U.K. Crown Dependencies and Overseas Territories have active offshore financial centers.** Constitutional arrangements for self-government vary among these jurisdictions but, in general, responsibility for financial supervision has been devolved to local governments. While London does retain ultimate constitutional powers that allow it to influence financial legislation in these jurisdictions, particularly in the Overseas Territories, as a matter of constitutional practice, these powers are used sparingly. While there are close political and financial linkages between these jurisdictions and London, neither FSA nor the Bank of England have any legal responsibility for financial supervision in these jurisdictions.

130. **The FSA does not have a separate policy with respect to offshore jurisdictions.** Rather, the supervisory relationship between the FSA and the various offshore financial centers flows from the FSA's role as a home or host country supervisor. The U.K. branches and subsidiaries of OFC financial firms are subject to FSA supervision. The offshore affiliates of U.K. banking groups fall within the FSA's regime of consolidated supervision.

131. **Under consolidated supervision the FSA looks to the U.K. headquarters of U.K. banking groups to provide all information it requires for the consolidated supervision of the activities of the bank, wherever those activities are carried out.** As a matter of routine, the capital and exposures in offshore jurisdiction are accounted for in the consolidated returns of the group and normal capital requirements and exposure limits apply at the bank and at the group consolidated level. Banks are required to be able to aggregate and monitor significant balances on a worldwide basis. Private banking, trust and asset management, specialized capital market products and insurance are some of the more important business lines that U.K. banking groups carry out in OFCs. These business lines are typically managed on a centralized basis, either in London or another major financial center, and FSA looks primarily to top level functional managers for an evaluation of risks and controls in these business lines. Only infrequently would FSA oversight require on-site visits to the offshore centers for risk assessment purposes. Even so, spot checks are conducted from time to time.

132. **Evaluation of home country supervision is an important factor in FSA supervision of the overseas operations of its banks.** The FSA expects to be able to request and receive supervisory information from overseas supervisors, including offshore regulators. Overseas affiliates of U.K. financial firms are required to adopt the stronger of U.K. or local anti-money laundering regulations. FSA supervision requires U.K. banks to be extra vigilant in dealing with customers in jurisdictions that have weak anti-money laundering regimes, particularly jurisdictions that have been classified by FATF as non-cooperative jurisdictions. The FSA has authority to impose punitive capital requirements on exposures to FATF criticized jurisdictions. More generally, to the extent the FSA is not satisfied that sufficient information on offshore activities is available at a banking group's headquarters or from the OFC regulator, it may take a variety of supervisory actions ranging from requiring deduction of the capital and assets of the offshore affiliate, to requiring the U.K. firm to withdraw from the jurisdiction.

SECTION II. SUMMARY ASSESSMENTS OF OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES:

This section contains summary assessments of adherence to the major international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory frameworks have been adequate to address the potential risks in the financial system. They have also provided a source of priority areas for ongoing legislative revision, and recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process as part of the FSAP by John Abbott (IMF), Jan Rein Prunel (De Nederlandsche Bank, Netherlands) and Laurie Edlund (Office of the Comptroller of the Currency, United States) for the *Basel Core Principles for Effective Banking Supervision*; Alan Cameron (World Bank Consultant, Australia) and David Shillman (Securities and Exchange Commission, United States), with the assistance of Mark Zelmer (IMF), for the *IOSCO Objectives and Principles of Securities Regulation*; Rodney Lester (World Bank) and Carl Hiralal (Office of the Superintendent of Financial Institutions, Canada), with the assistance of Frank Engels (IMF), for the *IAIS Insurance Core Principles*, Tom Kokkola (European Central Bank) and Martin Andersson (Riksbank, Sweden) for the *Core Principles for Systemically Important Payment Systems* and the *IOSCO-CPSS Recommendations for Securities Settlement Systems*; Mark Zelmer and Eric Parrado (IMF), with the sectoral experts, on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*; and John Abbott, Rhoda Weeks-Brown (IMF) and Paolo Costanza (Ufficio Italiano dei Cambi, Italy) on *AML-CFT Standards*.

The U.K. authorities were requested to complete self-assessment questionnaires for the standards and codes and these and other information were made available to the peer group of experts. During the missions, the responses to the questionnaires and self-assessments of compliance with the standards and principles were clarified and checked through subsequent discussion with the authorities and market participants in critical areas.

The U.K. systems of regulation and supervision are in general fully or largely compliant show a high degree of observance with international financial sector standards and codes, although unsurprisingly in such a complex financial system, in each area there are typically a few aspects where further improvements would be desirable, mostly of a relatively technical nature, and largely reflecting the sophisticated nature of the U.K. financial system and London's role as a key international financial center. The quality and effectiveness of supervision is strong in the banking and securities areas, albeit with room for further improvement, in banking in particular, in ensuring sufficiently strong "baseline" supervision including strong internal assessments of systems and controls. For insurance, proposals are currently being developed to significantly strengthen supervision, and these are likely to deal with most of the weaknesses observed in the current framework, relative to the IAIS standards including the demanding additional criteria applicable to an advanced, international insurance center. Oversight of payments and securities settlement is effective, as evidenced by the major infrastructural reforms of recent years; transparency practices are very strong; and the U.K. has a comprehensive regime for AML/CFT, further improved with recent legislation, that is broadly in line with the criteria in the IMF/World methodology, notwithstanding some desirable additional technical improvements.

The U.K. authorities were generally well aware of the areas for further reform and have typically been moving forcefully to address priority issues, especially where measures would be required to achieve full compliance with financial sector standards and codes. They indicated that in many instances the assessments helped foster the internal debate and generate momentum for reform. In some cases, revisions to the legislative framework are currently being prepared that will help to further improve the overall level of observance.

VI. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

General

133. **This section provides summary findings from the assessment of the BCPs.** The assessment is based on a review of documents made available in advance of and during the May 2002 mission, and meetings with representatives of the FSA, home country supervisors in the United States and Germany, bankers, bankers' association representatives, and accountants. The assessment takes into account a comprehensive self-assessment of compliance with the Basel Core Principles that was submitted by the U.K. authorities.

Institutional and macroprudential setting, market structure—overview

134. **The United Kingdom has a highly developed, well-diversified and overall robust financial system.** Banking is a major industry in the U.K. economy in terms of value added and employment, contributing 3.6 percent to GDP and employing over 440,000 people (figures for 2000).

135. **The FSA, being an integrated supervisor, has the sole responsibility for licensing and supervising all financial institutions in the U.K., including banks, building societies, insurance companies and intermediaries, and investment managers and advisors.** The authority and responsibilities of the FSA are clearly set out in the FSMA. The FSMA gives the FSA four statutory objectives: maintaining market confidence, promoting public understanding of financial issues, protecting consumers, and reducing financial crime. A memorandum of understanding concluded between the FSA, HM Treasury and the Bank of England defines the modalities for the three institutions' cooperation in safeguarding financial stability.

136. **At end-September 2001, 395 banks were registered in the U.K.** This number includes 70 U.K. subsidiaries and 211 U.K. branches of foreign firms. Of the total number of branches, 93 were branches in the U.K. of banks incorporated in other member states of the European Economic Area (under the European Banking Consolidation Directive, these banks can establish a branch in the U.K. without having to seek separate authorization from the FSA). Total banking assets amounted to £ 3.5 trillion (approximately three and a half times U.K. GDP), with the four major U.K.-owned banks accounting for almost 30 percent of this.

General preconditions for effective banking supervision

137. **The U.K. banking industry has benefited from a remarkably stable macroeconomic environment and sustained growth over nearly a decade.** Recently, however, imbalances have emerged, particularly in the expansion of credit to consumers and businesses and burgeoning prices for residential real estate. Although these imbalances are, on the whole, not large and likely to be resolved gradually, they do pose risks to the financial system that require monitoring and management.

138. **The U.K. has a well-developed judicial system with a reputation for probity and professionalism, and the accounting and auditing professions are also well developed and are subject to full liability for breach of duty.** The U.K. sets high standards for corporate governance, including public disclosure practices. With regard to the regulated financial sector, market discipline is reinforced by the fact that the U.K. authorities have publicly stated their view that it is neither possible nor desirable to remove all risk of financial failure.

Main findings

139. **Objectives, Autonomy, Powers and Resources (CP 1):** The basic legal framework is contained in the FSMA, which clearly sets out the FSA's role as bank supervisor, defines its regulatory objectives, and provides it with broad rulemaking powers. The FSA also has broad powers under the FSMA to take action against banks that do not comply with legal and regulatory requirements. The FSA's activities are carried out in a transparent manner. The FSA is accountable to Treasury Ministers and, through them, to Parliament. The FSA is funded entirely by the industry, with regulated firms being required to pay fees directly to the FSA. It has the authority to increase fees to fund increasing supervision needs. The FSA and its staff are credible and professional. However, the number of staff deployed in banking supervision appears to be quite small.

140. **Licensing and Structure (CPs 2–5):** FSMA Schedule 2 identifies deposit taking as a regulated activity. The FSMA mandates that all persons carrying out regulated activities are properly authorized. Any person using the term 'bank' or 'banking' in its name would be presumed to be carrying out regulated activities and must therefore be licensed. The FSA sets criteria for the licensing of banks, including information on the applicant's ownership and management structure, capital, business plan and system of controls. FSA has authority to reject applications that do not satisfy its criteria. FSA also assesses the fitness and propriety of management and officers filling key functions in the firm.

141. **Any person proposing to take control (or increase the level of control) over a U.K. bank has to provide the FSA with prior notification.** The FSA may object to a proposal unless it is satisfied that the acquirer is fit and proper and that the interests of the consumer would not be threatened. The FSA may also impose conditions on the acquisition. The FSA also has the power to prohibit a bank from undertaking a major acquisition or investment in cases where the bank would no longer meet the licensing requirements or FSA rules.

142. **Prudential Regulations and Requirements (CPs 6–15):** The FSA's prudential regulations and requirements for banks are generally sound but there are a few aspects that need to be strengthened to meet full compliance with all the BCPs. The minimum capital requirements for all U.K. incorporated banks (not just those that are internationally active) are fully in line with the Basel Capital Accord. In addition to the general capital requirements, for each U.K. incorporated bank an individual required capital ratio is set based on the bank's overall risk profile, anticipating the supervisory review process in the

new Basel Capital Accord (Basel II). The mission welcomed the FSA's initiative to develop a new approach to liquidity monitoring that will be more aligned to banks' own approaches to liquidity management.

143. **The FSA's standards for credit policies and large exposures are consistent with the BCPs.** Although no specific rules have been set for banks' loan and investment policies and practices, since these are considered to be a management responsibility, the FSA requires banks to have credit-granting procedures that identify, monitor and control credit risks. In contrast, clear and precise regulations exist with respect to large exposures, reflecting the relevant EU Directive. The FSA's approach to connected lending offers sufficient safeguards that such lending will be undertaken on an arm's length basis. No specific loan classification or provisioning rules have been set since a judgment-based approach is followed in these fields in the U.K. This approach works well and actual provisioning levels in U.K. banks appear to be adequate. Off-site monitoring of banks by the FSA could be strengthened by introducing a requirement for periodic supervisory reports on asset quality.

144. **Banks are required by FSA rules to take reasonable care to establish and maintain such systems and controls as are appropriate to the nature and scale of their business.** Banks also must have an independent internal audit function which should have appropriate reporting lines and unrestricted access to all relevant information. The FSA can request copies of internal audit reports and minutes of audit committee meetings. The quality of internal audit may be assessed during on-site visits. External auditors test a bank's accounting procedures during their audit of the financial statements. Any material deficiencies they find are reported to the FSA, either by the bank's management or by the external auditors themselves.

145. **The FSA has strong powers and a comprehensive program for supervising banks' anti-money laundering practices.** The Money Laundering Sourcebook of FSA's Handbook spells out banks' obligations to have effective systems and controls to protect against money laundering, to insure proper customer identification, to identify and report suspicious transactions, to maintain records of customer identification and individual transactions, and to insure that staff are properly trained in anti-money laundering matters. Banks are required to appoint a Money Laundering Reporting Officer (MLRO) who must be approved by FSA and who is responsible for the firm's compliance with the AML/CFT regime. Under FSMA the FSA has been given criminal prosecution powers to enforce its money laundering rules and regulations. An industry group, the Joint Money Laundering Steering Group (JMLSG), has prepared Guidance Notes that provide detailed guidance on customer identification, identification and reporting of suspicious transactions, and other matters related to the implementation of the AML/CFT regime. The JMLSG Guidance Notes are advisory rather than mandatory, although the FSA will take the Guidance Notes into account in evaluating compliance with its Rules and Regulations. Under its program of thematic supervision, FSA is undertaking on-site, horizontal reviews of individual bank's compliance with the anti-money laundering regulations. Over the past two years FSA has conducted an intensified outreach program to heighten industry awareness of firms' responsibilities under the U.K. anti-money laundering regime.

146. Methods of Ongoing Supervision (CPs16–20): The FSA utilizes a combination of on-site examinations and desk-based analysis to acquire a thorough understanding of banks' safety and soundness. The regular supervisory staff is supported by specialized risk review teams in a number of areas and, in addition, the FSA may appoint so-called skilled persons (usually auditors from the big accountancy firms) to assist in the supervisory work. The supervisory team responsible for testing the adequacy of banks' controls surrounding market operations appears to be thinly staffed and consideration should be given to expanding it (see CP 12). Banks are required to submit a variety of prudential and statistical returns, where appropriate both on a solo and a consolidated basis. Prudential reporting requirements cover both financial and compliance information, but the FSA does not routinely collect data on classified or non-performing loans. Supervisory information may be validated through the FSA's own on-site work and through the use of external auditors' and skilled persons' reports, but there is no requirement that external auditors periodically examine key supervisory returns such as capital adequacy. The FSA follows a risk based approach to supervision, which has led it to concentrate its supervisory work on the larger institutions. In addition to the industry-wide risk assessment, the FSA uses a firm-specific model to assess risks in individual banks. On-site and off-site work are integrated through the firm-specific risk-assessment model.

147. On-site supervision is most active in banks rated as high impact in the FSA's industry-wide risk assessment. For these banks, there will also be frequent contacts with directors and senior management, as well as other employees. Low impact banks, on the other hand, are largely supervised through off-site baseline monitoring supplemented occasionally by on-site visits and management contacts that are event driven or are in response to risks that have crystallized. To the extent that risk based supervision entails less reliance on direct oversight of lower impact banks and more reliance on baseline monitoring, consideration should be given to more frequent reporting of audited prudential returns and more regular disclosures by all banks. It would also be helpful if reporting requirements were expanded to include data on classified and non-performing loans. In addition, it would be useful to identify more specific criteria that would require banks to notify the FSA of emerging problems at an early stage and to establish off-site monitoring triggers that would prompt the FSA to initiate contact with these banks.

148. The FSA has comprehensive arrangements to enable it to supervise U.K. banking groups on a consolidated basis, both quantitatively and qualitatively, regardless of where their business is carried out. In the FSA framework, consolidated supervision is used to enhance the overall effectiveness of the prudential supervision of a bank by ensuring that risks related to the bank's membership of a group are taken into account. Consolidated supervision does not, however, constitute supervision of undertakings within the group which are not authorized as an FI. To ensure that the U.K. banking activities of a group are adequately capitalized, FSA requires that capital requirements be satisfied on both on a solo and a consolidated basis. Large exposure limits are also enforced on both a solo and a consolidated basis. Management systems and controls are required so that risks arising from the bank's dealing with other parts of the group are properly identified, measured, monitored and controlled. A variety of arrangements are in place for coordinating

and cooperating with other regulators, both at home and overseas, who have responsibility for other legal entities within the group.

149. Accounting Standards (CP 21): An accounting and reporting structure is in place in the U.K. to provide for financial statements on a regular basis. The Companies Act requires banks' annual accounts to be prepared in a way that gives a true and fair view of the results and financial position of the bank. The accounts are subject to public filing requirements. Banks must appoint an external auditor and published accounts have to bear the opinion of the external auditor as to the completeness and accuracy of the financial statements. External auditors have to inform the FSA if they have any material concerns as a result of their work and the FSA has the authority to disqualify external auditors. The FSA requires banks to use generally accepted accounting principles when valuing assets. Banks are required to capture and record accurately, on a timely basis and with the appropriate details every transaction and commitment they enter into. Banks are also required to file a range of regulatory reports with the FSA. Detailed guidance notes have been provided by the FSA to assist in the preparation of these reports. The FSA has powers to enforce the recording requirements and may fine banks for late or inaccurate supervisory returns.

150. Remedial Measures (CP 22): The FSMA provides the FSA with a broad range of supervisory measures to address a bank's failure to meet statutory or regulatory requirements. The FSA can take remedial action with immediate effect, using a supervisory notice. The FSA may cancel a bank's permission and it has the authority to take disciplinary action against a bank or an individual, including fines and public censure. Persons taking on so-called controlled functions have to be approved by the FSA and such approval may be withdrawn if the person is no longer considered fit or proper. The FSA may also place requirements or restrictions on a bank's permission. This power can be used to require a bank to take (or refrain from taking) specified actions. Banks or individuals may refer regulatory decisions to the independent FSM Tribunal, but such referral does not suspend the FSA's decision, with the exception of decisions involving fines or public censure.

151. Cross-Border Banking (CPs 23–25): The FSA supervises internationally active U.K. banks on a globally consolidated basis, both quantitatively and qualitatively. The international dimension places particular emphasis on ensuring that banks have information systems and controls to manage risks in all business units, wherever they are located. The FSA ensures that overseas activities are structured in a way that can be properly supervised and, where it is not satisfied, imposes restrictions or limits activities. The U.K. operations of foreign banks are subject to the same high level standards and principles the FSA applies to U.K. banks and the FSA applies the same risk based supervisory tools to both foreign and domestic banks. Reporting requirements are similar for all banks, taking into account differences applicable to branches of foreign banks and the special legal arrangements for EEA branches established under the EU passport regime. For international firms, the FSA has a regular program of on-site visits to the overseas parents of the branches and subsidiaries of foreign banks operating in the U.K. and to the affiliates of U.K. banks operating overseas.

152. **The FSA has wide authority to share supervisory information with home country supervisors and, as a matter of policy, the FSA encourages home country supervisors to carry out on-site examinations of the U.K. operations of their banks.** The FSA has established an extensive network of formal and informal contacts with overseas banking supervisors to provide for the exchange of information necessary for effective global consolidated supervision. Bilateral memoranda of understanding with numerous supervisors provide for information exchange and on-site examinations of branches and subsidiaries of U.K. banks. The FSA routinely undertakes assessments of the quality of supervision as practiced by other supervisors relevant to the U.K. In particular, it forms its own judgment as to their compliance with the Basel Core Principles. In cases where the FSA feels unable to rely on the home country supervisor its policy is that branches of non-EEA banks should close or the branch should subsidiarize.

153. **The following table summarizes the mission’s recommendations in this area.** The recommendations relating to Principles 15, 16, 18 and 19 are to improve observance of the BCPs; for other cases, the recommendations are relatively technical ones that the mission believes would be desirable, especially given London’s role as a major international financial center.

Table 1. Recommended Action Plan in Relation to Basel Core Principles

Reference Principle	Recommended Action
CP 8 Loan evaluation and provisioning	Introduce periodic reports on asset quality.
CP 12 Market risks	Consider expanding the supervisory staff responsible for testing banks’ market risks controls.
CP 13 Other risks	Develop a new approach to liquidity monitoring that will be more aligned to banks’ own techniques for liquidity management.
CP 15 Money laundering	FSA to monitor annually a sample of anti-money laundering reports from banks that have not been subject to on-site review.
CP 16 On-Site and Off-Site Supervision	See recommended actions under CPs 17, 18 and 19
CP 17 Bank management contact	Identify criteria for banks to notify the FSA of emerging problems at an early stage. Establish off-site monitoring triggers for the FSA to contact banks with emerging problems.
CP 18 Off-site supervision	Introduce regular reporting requirement for data on classified and non-performing loans.
CP 19 Validation of supervisory information	Introduce a requirement for key supervisory returns to be examined at least annually by external auditors. Extend listed banks’ disclosure requirements to non-listed banks.

Authorities’ response

154. **The U.K. authorities consider that the FSAP assessment is valuable and clearly demonstrates the U.K.’s very high degree of compliance with the Basel Core Principles.** They support the broad thrust of the FSAP mission’s findings and recommendations and find them helpful in taking forward some existing strands of work. In particular, they agree with the usefulness of developing a new approach to liquidity monitoring, and changes to their

existing approach are in train. There are a small number of recommendations where they believe the current regime effectively fulfils the IMF's requirements. There are also some recommendations where further consideration will be required to effectively account for the costs of implementing them relative to the benefit. Specific comments from the authorities on the recommendations in the table above, are as follows:

- On *CP 8*, in line with their risk based approach to regulation, and the principle of proportionality, the FSA indicated that it currently operates a selective process to reporting asset quality. I.e. if they have concerns about an institution's asset quality, or the possible deterioration of that asset quality, they may ask the bank to provide regular info on asset quality. Their approach to this issue is being considered under the currently ongoing data needs project, and would be considered in the same context as *CP 18*.
- On *CP 12*, they noted that the FSAP team has rightly recognized their need to focus most of their resources, which are of course finite, on the institutions that have the largest combination of impact and risk.
- On *CP 13*, the authorities agreed with the usefulness of developing a new approach to liquidity monitoring, and changes to their existing approach are in train. They have already consulted on systems and controls requirements and it is planned to introduce these in summer 2004. They will also consult on a framework of quantitative requirements for liquidity risk in summer 2003.
- On *CP 15*, the authorities noted that they already monitor the reports of Money Laundering Reporting Officers and have undertaken a specific study of reports from 75 banks. This program of work will continue.
- On *CPs 16-19*, in the context of a risk based approach, the authorities were of the view that, while valid, some of the recommendations about the supervisory process in relation to these Principles relating to on/off site supervision, management contact and validation of information, could be overly prescriptive and less relevant to low impact banks (which account for only 0.02 percent of deposit liabilities). They felt that, by and large their tools are adequate and it is doubtful whether the value of extra reports on asset quality would outweigh the cost. Nonetheless, they are reviewing their data needs requirements generally and exploring ways of strengthening baseline monitoring, including the quality of data they receive from firms and the timeliness of notifications. (See also comment on *BCP 8*). The recommendations will be considered in this context.

With respect to D firms [low risk / low impact firms], in the authorities' view, their new systems and processes deliver a robust, and appropriate supervisory regime for these low impact firms and they do not wish to overburden this sector with unnecessary or disproportionate regulatory obligations.

Regarding *CP17*, they noted that block one of the FSA handbook sets out senior management responsibilities and the Principles for Businesses. These have the status of rules and apply to all firms. One of these Principles requires firms to disclose appropriately anything that the FSA could reasonably expect to be notified of. The authorities felt that providing detailed criteria and triggers for when firms should contact or notify the FSA is unlikely to make firms more open. They already have a list of basic events that must be notified and moving beyond this minimum could perversely restrict the issues on which a firm feels it has to consider communicating, and also weaken senior management's responsibility to make considered judgments.

On *CP19*, the authorities noted that the FSA checks the plausibility of comparisons and trend analysis on financial returns from banks. Where there are concerns supervisors can request further information

or appoint a skilled person (under S 166 of FSMA) to verify the accuracy of information. Auditors have a statutory duty to report to the FSA. Again, they are reviewing the recommended CP19 requirement under the data needs project.

VII. IAIS INSURANCE CORE PRINCIPLES

General

155. **Insurance is supervised in the U.K. by the Financial Services Authority, under powers granted by the Financial Services and Markets Act 2000.** Given the highly developed nature of the U.K. insurance market, the current lack of stability in certain segments of the market and the large exposure to international financial activities, this assessment has been carried out on the basis of both the essential and additional criteria underpinning each Core Principle. In addition the assessors relied on the override provisions in the Methodology.²⁶ Demanding benchmarks were applied and this will need to be taken into account in any comparison with other industrial countries.

156. **This assessment also reflects the peer group against which we have rated the U.K. (Canada, Australia and North Western Europe); the leading global position of the U.K. insurance sector; and the fact that FSA is still developing its new approach.** The Tiner Project has acknowledged the need to review and upgrade the prudential governance of insurers, and on the basis of what the assessors have observed is likely to place the U.K. in a leadership position in this regard within the next few years.

Institutional and macroprudential setting

157. **The British insurance industry is venerable and large, contributing importantly to U.K. employment and overseas earnings.** With net premium income in 2000 of £174 billion or approximately 10 percent of the world market, it is the third largest after the U.S. and Japan (although considerably smaller than either). It includes the most important cross border non-life insurance markets in Lloyds and the London Market, which together account for 65 percent of approximately US\$20 billion of annual global cross border general insurance premium flows (Source- Sigma No. 6, 2001), and is a significant source of life insurance product for people resident in other EU countries. Insurance penetration²⁷ at

²⁶ The key override provision comes under the heading 'Comprehensiveness' and states that 'the assessment must be conducted in sufficient depth to allow a judgment of whether criteria are fulfilled in practice, not just in concept.'

²⁷ Premiums as a percentage of GDP, a widely accepted basis of comparison—though it is important to note that for the U.K. in particular this measure includes a significant amount of premiums collected from overseas.

15.8 percent is the highest in the world, South Africa excepted. U.K. insurers are also well represented in foreign markets.

158. **U.K. based insurers are, with self-administered pension funds, the most important repositories of individual financial sector wealth.** Of total FY2000 financial assets of households and related non-profits of £3 trillion, more than 50 percent is represented by insurance policyholder-related liabilities (Source National Statistics, Financial Statistics, Table 12.1N). Total investment assets under management at the end of 1999 amounted to slightly over £1 trillion and the life and pensions sectors were easily the major providers of finance to government and private borrowers.

159. **An analysis of the long term (life) insurers by capital strength shows a distinct bimodal distribution,** with a large number of insurers having 100 percent to 300 percent of minimum required statutory solvency and a smaller, but significant group of very well capitalized insurers.²⁸ From a stability and efficiency point of view the main danger is that if investment returns remain depressed, some long term players under stress will engage in risky business and investment strategies and tactics in an attempt to improve their market positions. This has already been observed in a number of other leading industrial markets, and FSA management has advised that they are aware of and monitoring this trend.

160. **The general insurance industry does not face fundamental questions of the type facing the long term sector; however it does have its own challenges.** These relate largely to operating in a world of low investment returns, much fatter and less tractable claims tails than were previously thought to exist and, in the near future, a more demanding recognition of liabilities and capital allocation under a risk based prudential regime.²⁹

161. **Overall the assessors did not identify any immediate systemic risks arising from the insurance sector.** However the linkages between insurance and banking appear to be growing and warrant close monitoring. Broader risks arising from the potential rationing of insurance classes essential to the operation of key sections of the economy also appear to be low, but the assessors were advised that if the general insurance sector suffers additional severe shocks, this could become an issue.

General preconditions for effective insurance supervision

162. **The U.K. easily satisfies the preconditions for a full assessment.** It has a well developed judicial system with a reputation for probity and professionalism. The professions important to the financial sector are also well developed in the U.K. and are subject to full

²⁸ U.K. solvency standards are based on EU standards, which for life offices are typically around half the requirements applying to equivalent institutions under the current U.S. risk based capital regime.

²⁹ Although most leading general insurers are already well down this path.

liability for breach of duty. There is no insurance accounting standard aside from the regulatory reporting requirements, which serve a different role to published accounts. Instead there is a Statement of Reporting Principles (SORP), largely worked out by the insurance sector on a modified regulatory reporting basis, but informed by general company reporting requirements, and “negatively approved” (not objected to) by the Accounting Standards Board (ASB). The assessors were advised that the imposition of IAS in the EU in 2005 will to a large extent supplant the ASB role.

Main findings

163. **The U.K. is developing a very advanced, indeed leading edge, approach to financial sector supervision.** The FSA’s approach for the future appears to be to build on existing strengths, but with more focus on risk level and likely macro impact, and further emphasizing the responsibilities of management’s and boards of entities which come within its remit. To some extent the approach cuts across the Core Principles, which incorporate a range of supervisory styles. Nevertheless, the FSA and its supporting regulatory infrastructure comfortably accommodate most requirements of the IAIS assessment methodology. When the importance and special features of the U.K. market are considered, and appropriately more demanding standards are applied, a number of opportunities for further refinement become apparent. In particular, under the U.K. risk-based approach, not all financial intermediaries will be inspected (unless they are selected for a thematic investigation), and even in the larger institutions, the more routine supervisory visits will generally operate at a high level, although skilled persons may be utilized when required. The assessors judged that there is scope for a more hands-on approach to inspection, using specialist skills where appropriate while still not threatening the risk-based model.

164. **Insurance supervision in the U.K. is in a transition phase, and the assessors strongly agree that greater emphasis will need to be placed on staff training and development as the new risk-based methodology is rolled out.** In addition, the disposition, quantity and quality of actuarial, non-life long tail claims assessment, and reinsurance skills needs to be carefully reviewed with a view to further strengthening.

165. **The U.K. is a world leader in corporate governance; however the assessors recommend that the FSA require firms to strengthen or formally adopt the risk manager function.** In addition, there is a general perception that on site inspections by the supervisor could be more testing. The modalities currently being developed should largely deal with these concerns.

166. **The assessors believe that there is scope for a more explicit statement of solvency requirements.** Regulatory minimum solvency levels are officially set at EU levels or somewhat higher, which tend to be less demanding than risk based capital methodologies. While the assessors acknowledge that more demanding standards apply in practice in the U.K. through the informal rules that have been applied, these ideally should to be codified under the recent Solvency I dispensation allowing stronger variations.

167. While practice with regard to derivatives and reinsurance is conceptually appropriate, the assessors believe there has been a lack of expertise immediately and obviously available to the teams supervising LCFIs. In addition the assessors feel that reinsurance is one area where information requirements could be more searching.

Table I. Recommended Actions to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance supervisor CP 1	<p>The FSA should consider building its core insurance expertise to include individuals with significant experience in reinsurance, actuarial practice, and long tail, non life claims. These resources should be made available to all supervisors who are responsible for supervising insurance firms regardless of where they work within the FSA. Because the addition of these individuals would likely be organized in a matrix set up, the availability of their technical skills to all supervisors should be actively promoted within the FSA.</p>
Corporate Governance and Internal Controls CPs 4-5	<p>The FSA should consider making it mandatory for a Financial Condition Report (FCR) to be signed off by the Board and to be available to the FSA. The Board should take responsibility for the analysis of the FCR and ensure that the level of stress/scenario testing is appropriate to the complexity and size of the organization. The FSA may wish to work closely with the appropriate professional bodies to develop guidance for use by supervised firms when preparing the FCR.</p> <p>At the conclusion of every supervisory cycle, the FSA may wish to meet with the audit committee of high impact firms to review the management letter points. If these meetings were to occur, it would be good practice to meet <i>in-camera</i> with only non-executive members of the audit committee.</p> <p>The increasing pressures on insurance firms require management to pay more attention to risk management practices. In the current environment, most firms, particularly those in MFGD, are increasingly strengthening their risk management practices; however, where this is not true, the FSA should consider encouraging those firms to do so. Possible actions that could be taken by firms include the establishment of a risk management function and a risk committee of the board. This would also largely deal with concerns expressed under CP 6 (Assets).</p>
Prudential Rules CPs 6-10	<p>The determination of policy liabilities in life firms is a highly specialized task and involves the use of considerable judgment by the appointed actuary. Judgment is required even though the appointed actuary is required to calculate the policy reserves within the guidelines set out by the relevant professional body. Judgment is particularly critical for some products as certain valuation assumptions are highly sensitive and slight variations usually result in material differences in reserve balances. Consequently, it would be good practice to require the implementation of a peer review process and the FSA may want to work with the Institute of Actuaries or other relevant professional bodies to implement such a review. Depending on the company-specific situation, a multi-discipline team may be required to do the review.</p> <p>The FSA may wish to consider implementing a thematic review of reinsurance operations across the firms for purposes of ensuring that appropriate controls and systems are in place.</p>

<p>Monitoring, Inspections and Sanctions CPs 12-14</p>	<p>The risk profile of the insurance industry is increasing due to pressure points from several fronts including more volatile underwriting results (non-life); reduced returns on investment activities coupled with expense pressures; and uncertainty about the adequacy of long-tail liabilities.</p> <p>Currently, firms are required to file statutory returns annually. Given the rapidity with which an insurance firm's risk profile can change, a move towards quarterly reporting for higher priority firms would significantly enhance a supervisor's ability to closely monitor his or her assigned firm(s). Firms that fall under the purview of MFGD, particularly listed firms, should provide their MIS reports prior to public release.</p> <p>To accommodate this increased information flow, FSA may need to review its financial reporting data base and systems capability, and require electronic returns from insurers. Furthermore, it is necessary to carry out a review of the nature of the existing data being received as it may no longer be relevant. Consequently, changes to the statutory returns may be required.</p> <p>Public disclosure of relevant information on a timely basis is one element of the three-pillar approach proposed by the Basel Committee for banking supervision but is equally applicable to insurance firms. There is an increasing need for all firms to disclose more relevant information in their published financial reports. For example, there is need for firms to include more information on risk management practices, risk exposures and sources of gains and losses, etc. In this connection, the FSA has an important role to play in encouraging firms to adopt more appropriate disclosure practices.</p> <p>In order to comply with this CP, the FSA will need to increase the resources and skill set of supervisors who are responsible for supervising the insurance industry. Core insurance expertise should be strengthened to include individuals with experience in reinsurance, risk management, actuarial science and long-tail, non-life claims.</p> <p>The FSA has powers under the FSMA to require firms to take remedial action when threats to the solvency of the institutions are noted. Although there are well developed processes within the FSA for dealing with firms when prudential concerns are noted, firms which are placed on a watch list are not formally notified when such action is taken. The FSA may wish to consider notifying firms when, for prudential reasons, they are placed on a watch list.</p>
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Authorities' response

168. The authorities noted that the FSA is carrying out a major program to reform insurance regulation (the Tiner project). This work was in train during the IMF's mission and has now progressed further. The reforms are having a significant and far-reaching impact on the FSA's approach to insurance regulation and on the industry. The program of reform was triggered by a number of factors. First, the insurance industry is operating in a significantly more challenging environment. This has underlined the importance of ensuring that insurance firms have sound management structures and adequate financial resources. Second, the creation of the FSA as a single regulator has highlighted significant differences between the regulation of insurance and of other sectors, not evidently justified by sectoral

specifics. Third, an independent report commissioned by the FSA into the FSA's regulation of Equitable Life made several recommendations about the regulation of the sector.

166. **The reform program was established in September 2001 and the FSA set out the work that has been completed, or is underway, in a progress report published in October 2002.** The reform program is focused on strengthening the prudential regime, including corporate governance, ensuring that insurance firms take proper account of the nature, diversity and scale of risks they face. It also aims at delivering a more proactive and challenging risk-based approach to regulating insurance, including significantly more on-site work.

167. **As a result of the changes from the Tiner project insurance firms are facing a fundamental change in the way they are regulated, including a more proactive and challenging regulatory relationship.** In line with the FSA's risk-based approach, some firms will have started to notice the increased contact with supervisors at senior management and working levels. This reflects the explicit responsibility the FSA places on management for ensuring that systems and controls are adequate and that they are treating their customers fairly. The FSA uses a range of tools including on site work and reports by external auditors, actuaries and other professionals to test the controls that management have put in place.

168. **The FSA has already begun to address the need for more insurance specialists.** Over the last year the FSA has recruited in total 35 new insurance supervisors, the majority from insurance firms. These new recruits have brought with them a wide range of skills. In addition the Risk Review Department set up an insurance risk review team at the beginning of the year which includes secondees with strong technical skills and knowledge of the insurance market.

169. **The FSA has already made good progress in addressing some of the points raised by the IMF.** In particular, it has given guidance on improving risk management in insurance firms (see Consultation Paper 140 and feedback statement). This is also being addressed in the work to prepare an integrated prudential sourcebook. The FSA has developed proposals on the role of actuaries in life assurance companies on which it has already undertaken an initial consultation with the industry and other interested parties. More detailed proposals were published for consultation on 24 January 2003. The FSA has also published proposals to strengthen the regulation of insurance firms in the area of financial engineering, and has developed proposals on regulatory reporting, which specifically address the type of reporting required from insurance companies under risk-based supervision. These proposals also consider the issues about frequency of reporting by firms more generally.

170. **The authorities welcomed the IMF's recognition of the importance of the Tiner project in strengthening insurance regulation and in meeting much of the IMF's proposed action plan.** They had the following specific comments on the assessors' recommendations:

- On *CP1*, they agreed that having a range of expert skills in the FSA is important. The FSA's risk review team includes insurance specialists, as well as specialists in credit risk, operational risk and traded risk. This is a valuable resource for the FSA, which it intends to maximise. The FSA's actuarial and other specialist skills are already available to all those responsible for insurance firms.
- On *CP4*, the authorities noted that the requirement for the Board of an insurance firm to receive and review financial information that provides a true reflection of the health of the business under a number of different scenarios, is clearly recognised. The FSA will place increasing emphasis on appropriate stress and scenario testing within insurance firms. The precise nature of any future requirements in this area, and any link to reporting by insurance firms to the FSA, are under consideration.

There is presently no clearly defined financial condition report for non-life insurers and the FSA would like the life one to be more clearly focussed. Since the FCR includes an analysis of the financial impact of possible future scenarios, a report of this nature will be needed to support firms' individual capital requirements, on which the FSA will be consulting shortly. At present the FCR does not give rise to a capital requirement as such. On that basis it would be premature to replace the existing resilience test.

It is not standard practice for FSA supervisors to see the Board or Audit Committee after a visit, but the FSA does write to the main Board to present the conclusions of its risk assessment. If there were significant issues arising that it was best to address through a meeting then the FSA would certainly pursue this option.

If the FSA wanted to see non-executive directors separately, it would probably involve them all rather than those represented in a particular committee. The FSA would only consider focusing on a select group of directors where it felt there were real problems that it was necessary to deal with through this route.

- On *CP 5*, the FSA has made clear through the Tiner Reports on the future regulation of insurance (November 2001, progress report of October 2002) the importance it attaches to the need for firms to strengthen their risk management practices. This has been given further substance by the Guidance on Systems and controls published in a Policy statement issued in December 2002, which sets out for firms the FSA's expectations that they will have proper risk management functions appropriate to the size and nature of their business. The FSA's supervisors cover this area as an integral aspect of the FSA's risk assessment framework. In addition the whole emphasis of the prudential source book is on the need for proper risk management practices. The Board should be responsible for the appropriate governance for risk management functions. Risk assessment letters and risk mitigation programmes are already copied to the auditors as standard practice.
- On *CP7*, the authorities indicated that the FSA is proposing changes to the role of actuaries in the governance of life insurers. It published a consultation paper on these matters (*CP167*) in January 2003. The intention is that the policy reserves will be calculated by an actuary. The actuary will advise the board on the methods, bases and results of the calculations. The FSA will also require an independent review of the calculation of policy reserves by the auditor. The auditor will be required to take actuarial advice independent of the regulated firm's actuary in forming the audit opinion. The FSA is working with the professional bodies to achieve appropriate guidance to professionals working in this area.

For non-life liabilities, the FSA will keep under review whether to introduce actuarial overview of the provisions as part of its review of insurance regulation. The FSA is preparing rules and guidance on stress and scenario testing and on individual capital adequacy standards as part of its work on the integrated prudential sourcebook. The FSA is also developing proposals for better regulatory

reporting, which will take into consideration the appropriate format for reporting to the FSA risks to non-life insurers.

- On *CP 10*, since the IMF visit the FSA has published a consultation paper with proposals to strengthen controls on financial engineering in insurance companies, which tackles reinsurance and other issues. The possibility of a wider thematic review of reinsurance arrangements will be considered alongside other priorities for such reviews.
- On *CP 12*, the authorities fully recognized that insurance firms are operating in an increasingly challenging environment. Against this background, the FSA is examining how it can reform regulatory reporting to ensure that it receives the key information it requires for supervisory purposes while keeping the burden on industry to the minimum necessary. Issues such as public disclosure versus private reporting, quantity versus quality of information submitted, and capturing more forward-looking information are all being looked at.

Specifically in the insurance area, the FSA published a Discussion Paper on a new approach to regulatory reporting as part of the Tiner project. After analysing the feedback on this, the FSA proposes to launch a consultation paper in mid-2003. Any proposals on the timeliness and frequency of information submitted by insurance firms will be dealt with then. The FSA recognises that deciding on what, if any, information is required more frequently than annually, and what firms any additional reporting requirements should apply to, is a critical issue. Account will also have to be taken of international developments in planning changes in this area. The proposal that listed firms should provide any reports to the market to the FSA prior to public release will be considered.

The FSA is enhancing its IT capabilities to facilitate anticipated changes, and is in the early stages of developing electronic reporting. Initially it is looking at areas such as Authorisation and Listing where there are potential efficiencies from the use of technology, but this will be expanded into new areas as appropriate.

The FSA is participating actively in international discussions within the IAIS and Joint Forum on the need for enhanced public disclosure of key financial information. The role of public disclosure of relevant information is integral to the approach the FSA intends to take in its own development work. In the forthcoming negotiations on a new EU insurance solvency regime the U.K. will press for the adoption of a three-pillar approach similar to that being proposed by the Basel Committee for the banking sector.

- For *CP 13*, the authorities indicated that on-site inspection needs to be considered in the context of the FSA's overall risk-based approach to insurance supervision. The FSA does not undertake on-site inspections of all insurance firms, but follows instead a risk-based approach. During 2002, the FSA began to assess insurance firms using the risk-based framework it has developed. The FSA intends to have a close and continuing relationship with high impact firms (judged by reference to the FSA's statutory objectives). Prudential supervision in relation to these firms, and those judged medium impact, will be more pro-active and less reliant on desk-based analysis of financial returns. At the other end of the spectrum, low impact firms will not be subject to specific risk assessments, but supervised mainly through an analysis of the data routinely submitted to the FSA. On-site work in relation to these firms will (exceptionally) be undertaken in response to any risks identified from the data submitted, together with visits to a sample of firms as part of sector-wide reviews.

Over the last year the FSA has recruited in total 35 new insurance supervisors, the majority from insurance firms. These new recruits have brought with them a wide range of skills. In addition the Risk Review Department set up an insurance risk review team at the beginning of the year which includes secondees with strong technical skills and knowledge of the insurance market. This team is being used actively as part of the risk assessment process. The FSA has also begun to commission skilled persons

reports from independent professional experts on specific aspects of a firm's operation, systems or controls.

- On CP14, the authorities did not believe the recommendation was appropriate. Where a firm is placed on the FSA watchlist the firm will already be well aware of the issues of concern to the FSA, on solvency or other matters, and remedial work will be underway. The FSA does not believe that telling firms that they are on the watchlist is appropriate, since it is essentially an internal tool.

VIII. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

171. **This section provides summary findings from the assessment of implementation of the IOSCO Objectives and Principles of Securities Regulation.** It should be noted at the outset that the U.K. demonstrates a high degree of observance with the IOSCO Principles. However, some suggestions are made in the context of the ongoing process of refining and developing the U.K. securities regulatory structure. The principal regulator of securities markets and participants in the United Kingdom is the Financial Services Authority (FSA). The main information sources in making the assessment were: self-assessments by the FSA; its Annual Reports, handbook and website; the Financial Services and Markets Act 2000 (FSMA); interviews with market participants, industry groups, financial journalists; the FSA's Consumer and Practitioner Panels, and others; and lengthy discussions with senior staff of the FSA.

Institutional and Macro Prudential Setting

172. **The FSA was established by the U.K. Government in May 1997, and commenced operation in June 1998.** London of course is one of the world's major financial centers, and has the largest share of many international financial markets, including foreign equity trading. Reasons for this prominence include the openness and efficiency of its markets, the concentration of skills and expertise in one place, and the liquidity which is already there. There appear to be no significant barriers to entry or exit from markets or products. London's success in attracting overseas business can be attributed in part to the perception that the U.K. has a "proportionate" approach to regulation.

Summary assessment

173. **Regulator (Principles 1-5): The FSA is an integrated regulator with wide responsibilities across the financial sector.** Its statutory objectives and the associated principles of good regulation are to some extent in tension with each other, requiring the FSA to exercise judgment in how it interprets its role. However, it can be argued that an integrated regulator like the FSA can address these tensions at least as effectively, if not more so, than separate sectoral or functional regulators.

174. **The FSA is established as a private company, financed by levies on the industry, with responsibility for its own budget, but the FSA board is appointed and may be**

removed by the Treasury. The FSA exercises statutory powers under the FSMA. The FSMA includes requirements to make an annual report to the Treasury, hold an annual open meeting, establish an independent investigator of complaints, consult consumers and practitioners through representative panels, and consult publicly on regulatory rules and guidance.

175. The exchange of letters between the FSA and the Government in December 2001, shows that the FSA is intended to, and will be permitted to, operate independently. The direction powers do not affect the FSA's operational independence, and of course, enhance its accountability. While the chairman and other board members of the FSA are liable to be removed by the government without cause having to be shown, such action, which would be governed by Nolan Rules, would undoubtedly have political consequences, and would in addition be subject to a limited form of judicial review.

176. The FSA has a budget in the vicinity of £220 million in the 2002/2003 fiscal year. The FSA has a permanent staff of approximately 2200, and can appoint skilled persons to supplement its staff. The FSA experienced significant staff turnover when it commenced operations, although turnover levels have abated recently, perhaps in response to market conditions. While some turnover is to be expected, and indeed is welcomed, there is a concern of loss of expertise. Turnover has been particularly high in the securities sector, leading many in the industry to express concern as to the FSA's ability to conduct effective supervision in this area. Further, the FSA has spoken frequently about the need to minimize the cost of regulation, as reflected in its fees charged to industry, but its fees are already, on its own calculations, low in international terms.

177. Although there is a high degree of observance of the Principles, at this early stage, it remains to be seen whether the FSA's 'risk-based' approach to supervision will result in the consistent and transparent application of its regulatory processes in practice.

178. Self-Regulatory Organizations (Principles 6 and 7): While there is a high degree of observance of these Principles, it is also true that the U.K.'s new regulatory structure makes only very limited use of SROs—with respect to the operation of the securities exchanges and clearing houses, the FSA itself regulates all market intermediaries, with direct responsibility for, among other things, prudential supervision and conduct of business regulation. This places additional pressure on the FSA to attract and retain skilled staff in sufficient number to supervise market intermediaries effectively.

179. Enforcement (Principles 8-10): The FSMA gives the FSA powers to investigate possible contravention of FSA rules. Matters to be pursued are identified using the 'risk-based' assessment framework adopted by the FSA, although at this early stage the effectiveness of this approach has yet to be fully tested in practice.

180. The wide enforcement powers of the FSA ensure that these Principles are highly observed, but they will need to be tested at an early opportunity. The civil offence provisions are novel. The floating burden of proof (somewhere less than beyond reasonable

doubt, but more than on the balance of probabilities) may mean that the perceived advantages of the so-called 'civil offence' are not fully realized in practice. The credibility of a securities regulatory regime depends on the credibility of the threat of enforcement action, and it remains to be seen how civil offence proceedings will be regarded by the community.

181. **Cooperation (Principles 11-13):** The FSA has broad authority to share both public and non-public information with domestic and foreign counterparts, and has a good record of providing such assistance to many regulators around the world. When assessing whether or not to provide assistance to overseas regulations outside the European Community, the FSMA permits the FSA to take into account the U.K.'s own interest in the matter: this might be thought inconsistent with the priority a major international financial centre like the U.K. ought to place on securing effective enforcement across national borders.

182. **The FSA has nearly 160 Memoranda of Understanding (MoUs) with regulatory counterparts overseas.** The MoUs are being reviewed to reflect the many changes in the law and the role of the FSA in the intervening period. MoUs are usually practical devices rather than substantive legal instruments, and any delay in revising them is more likely to lead to delay or inconvenience, than to obstruction, and do not cast any doubt on the Principles being regarded as fully implemented.

183. **Issuers (Principles 14-16):** There is also a high degree of observance of these Principles. Issuers of securities who wish to be admitted to the listed securities markets operated by the LSE must first be admitted to the Official List as maintained by the UKLA (a division of the FSA). The UKLA reviews and approves all prospectuses, and can intervene to stop the circulation of false or misleading information.

184. **The obligations with respect to the publication of annual and other periodic reports of financial results are contained in the Listing Rules and/or the Companies Act.** The time periods for the release of preliminary final results and for the circulation of annual financial reports are too long, and the Department of Trade and Industry plans to shorten the statutory period significantly. A review of the UKLA listing requirements will also look at these issues, at least in part because a proposed EU Directive on Regular Reporting will require periods of 90 days for annual reports and 60 days for half yearly and quarterly reports.

185. **The Listing Rules provide that a company must ensure equality of treatment for all shareholders within a class.** The City Code on Takeovers and Mergers, as administered by the Takeovers Panel, applies to all takeovers of public companies in the U.K., and is based on the principle of fair and equitable treatment of all shareholders within a class. The Code and Panel are seen as effective contributors to the quality of the markets in London, by virtue of the speed, flexibility and certainty they bring to takeovers, despite their informality.

186. **U.K. accounting and auditing standards are of a high and internationally acceptable quality.** While there presently are a number of differences between U.K. accounting standards and International Accounting Standards, the U.K. will require listed

companies, from January 2005, to prepare their group financial statements using international standards.

187. Collective Investment Schemes (Principles 17-20): The U.K. investment fund industry is among the largest and most successful in the world, and it is therefore not surprising that there is a high degree of observance of these Principles. The FSA authorizes investment management firms (as well as trustees and depositories) generally, and grants permissions to market and operate collective investment schemes (CISs). Finally, whether the FSA's 'risk-based' approach (to the extent applied to CISs) results in effective regulation, particularly with respect to smaller CISs, has yet to be tested in practice.

188. An investor must be provided with a Key Features Document, which sets out all material information the investor needs to make a sound purchase decision. The requirement is to produce material in a user-friendly format, and there is a requirement for fair and clear communication with customers, but there is no explicit requirement for 'plain English,' or for research to be conducted to ensure that the material is in fact in a form which is readily comprehensible. Also, there is no continuous disclosure requirement as such for CISs.

189. Market Intermediaries (Principles 21-24): FSA rules require all market intermediaries, other than professional firms and service companies, to meet specified initial and ongoing capital requirements. Professional firms and service companies simply are required to be able to meet their liabilities as they become due. The FSA is to be commended for its efforts to develop a liquidity standard for market intermediaries.

190. Under the FSA's 'risk-based' approach to supervision, approximately 80 percent of market intermediaries are not subject to regular examinations and are required to submit only annual financial reports to the FSA. Visits, and closer attention generally, to these firms comes about when there are complaints from customers, or reports from whistleblowers, or in the context of thematic or random samples. The effectiveness of this approach, and ability nevertheless to ensure compliance with ongoing capital and other important prudential requirements, has yet to be determined, but observance of these Principles is considered high.

191. Secondary Market (Principles 25-30): Securities exchanges are subject to a well-developed regime for regulatory authorization by the FSA, and oversight by the FSA and the exchanges themselves. Although the regulatory scheme for alternative trading systems currently is under review, at present the FSA applies the authorization and oversight regime applicable to 'authorized persons' to these systems. While this structure has the potential for regulatory gaps, it does not appear to be a significant cause for concern, and observance of the relevant Principles is again considered high.

192. The FSA and its predecessor have encouraged improved transparency in U.K. securities markets as an important contributor to market efficiency and investor protection, but detailed guidance is not provided. While the transparency of the U.K.

securities exchanges generally appears good, particularly for the most liquid securities, care should be taken to ensure that competitive pressures do not undermine the visibility of trading interest in the future.

193. **The FSMA provides for a broadening and strengthening of the U.K. regime against market abuse.** Insider dealing and market manipulation are criminal offences. In particular, the FSMA gives the FSA powers to operate a 'financial penalties' regime alongside the continuing criminal regime. The FSA is responsible for monitoring unfair trading practices in the OTC markets.

194. **The SROs appear to have developed appropriate procedures to monitor and address large exposures, default risk, and market disruption.** With respect to large exposures, market authorities should establish trigger levels for identifying large exposures that are appropriate to their markets, and continuously monitor the size of positions on those markets, so that they can assess the risks posed by them to a market or clearing firm. The FSA may wish to consider whether, in practice, the U.K. markets effectively achieve this goal.

195. The assessment of clearing and settlement services is dealt with in the assessment of these systems against the IOSCO/CPSS Recommendations for Securities Settlement Systems.

Recommended Actions and Authorities' Response to the Assessment

196. **The U.K. observance of all of the IOSCO objectives and principles, is high, and there are therefore no recommendations to improve observance.** However, some technical recommendations are outlined below which could be considered to further improve the U.K.'s regulation of securities markets.

- When policy in the area of co-operation in international enforcement is next under review, consideration might be given as to whether the requirement in the FSMA to take account of the U.K.'s own interest when assessing whether or not to provide assistance to foreign regulators, is consistent with the priority a major international financial centre like the U.K. ought to place on securing effective enforcement across national borders.
- Consideration could be given (if and when permitted under EU law) as to whether it is economic or efficient for the law to require all prospectuses to be reviewed by the UKLA; the FSA's 'risk-based' assessment methodology could also be appropriate in this context.
- In the area of collective investments, matters where refinements might be considered include introducing a specific requirement for transactions with affiliated parties to be disclosed to investors and the FSA; introducing a requirement that delegates receiving delegations of functions such as portfolio management, investment advisory and other core functions be bound not only by contract with the operator, as at present, but by law or delegated legislation, to comply with the same regulatory standards imposed on the operator itself; requiring delegation arrangements for custody to also be notified in annual reports at least; introducing continuous disclosure requirements for CISs.
- Finally, the FSA presently is conducting an internal review of transparency matters, and may wish to ensure that competitive pressures do not undermine the visibility of trading interest in the future.

Authorities' response

197. **The authorities welcomed the positive assessment of the U.K.'s observance of the IOSCO principles and noted that the U.K. has fully implemented all 30 principles.** They also noted that the FSAP team has been able to make some technical recommendations which they regard as helpful in providing constructive input to their thinking and they are considering how best to take them forward. They feel that the technical recommendations are constructive and provide useful support for ongoing FSA work to further strengthen the U.K. securities regime. Specific comments on the technical recommendations outlined above are as follows:

- *Co-operation in international enforcement.* The authorities feel that in practice the recommendation concerning co-operation on international enforcement may be overstated, given both their record of effective co-operation and the requirements in FSMA to co-operate and to look beyond U.K. interests.
- *Review of all prospectuses by the UKLA.* The authorities consider the recommendation to apply their risk-based approach to their approval of documents to be useful. They are seeking to develop a more risk-based approach to this work, although they would emphasise that they must still meet their obligations under European Directives that require approval of documents.
- *Collective investments - disclosure of transactions with affiliated parties and requirement of delegation arrangements* The authorities noted that the U.K. has a very comprehensive and detailed regime for the regulation of Collective Investment Schemes (CIS) and in some areas they feel that their regime already provides sufficient protections equivalent to those suggested by the recommendations. On the recommendations on the use of delegates, and for continuous disclosure by CIS, they believe these measures are already undertaken within their regime. They are, however, reviewing their current requirements for continuing disclosure. On transactions with affiliated parties, the FSA is satisfied that the present requirements for information about such transactions to be passed to the FSA are consistent with their risk based approach to supervision and a proportionate regulatory regime. Nonetheless, they are also considering further refinements to their CIS regime through an ongoing current review and they noted that, in this respect, the FSAP recommendations more generally provide support for work already ongoing.
- *Encouraging RIEs to improve price transparency.* The authorities recognise the importance of sustaining improvements in an increasingly competitive environment. To this end they have been working to underpin high levels of transparency in a more fragmented marketplace, while also paying due attention to the need not to damage liquidity.

IX. CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

198. **This section reviews the degree of compliance with the relevant international standards of the NewCHAPS system, with its two sub-schemes, CHAPS sterling and CHAPS euro.**³⁰ The assessment was conducted on the basis of a formal self-assessment of the NewCHAPS system's observance of the Core Principles conducted by the Bank of England, together with detailed answers to an IMF questionnaire and a number of other

³⁰ CHAPS is an acronym for Clearing House Automated Payment System.

documents relevant to the assessment. In addition, extensive discussions were held with officials from the Bank, supplemented by discussions with officials from the CHAPS Company as well as with the Association for Payment Clearing Services (APACS), six NewCHAPS members and two non-member institutions.

Institutional Setting

199. **The majority of interbank transfers of funds in the U.K. are processed through the following systems, all of which operate under the umbrella of APACS:**

- As part of NewCHAPS, the CHAPS Sterling and CHAPS euro systems settle payments on a Real-Time Gross Settlement (RTGS) basis. They are primarily designed for high-value payments, although there is no lower (or upper) limit on the value of individual payments. NewCHAPS was introduced in August 2001, bringing the pre-existing CHAPS Sterling and CHAPS Euro systems onto the same, SWIFT-based, technical platform and facilitating the move to “full DVP” in the CREST securities settlement system. NewCHAPS is among the largest settlement systems in the world in both value and volume terms, settling sterling transactions with an average daily value of over £200 billion and euro transactions with an average of more than another £100 billion.
- BACS³¹ is an Automated Clearing House (ACH), which processes large volumes of relatively low-value (retail) payments, including direct debits, direct credits, standing orders, and other non-urgent automated credit transfers. Given its retail nature, it is not considered to be of “systemic importance”, although clearly its failure could nevertheless cause significant economic disruption at a broader level.
- Finally, paper debit and credit payment items are cleared through two parallel systems run by the Cheque & Credit Clearing Company (C&CCC).

200. **CHAPS Clearing Company Limited (CHAPSCo) is the governing body for the CHAPS Sterling and Euro systems, which currently have 21 participants—20 of which are members of CHAPS euro and 13 of CHAPS Sterling.** CHAPSCo is responsible for the provision and maintenance of the messaging network conveying payment information between CHAPS members and to and from the BoE over the SWIFT network. The BoE is responsible for the provision and maintenance of the central scheduling and settlement accounting environment for the intra-day settlement of CHAPS payments (and other transactions between members outside the CHAPS operating day); intraday payment flow monitoring; provision and maintenance of the Enquiry Link network through which members can query and manage payment flows; and finally for the provision of intraday liquidity to CHAPS members through an intraday repo facility.

³¹ A formal assessment has not been undertaken for BACS, whose payment flows in value terms are dwarfed by those through NewCHAPS.

201. **The BoE also has responsibility for oversight of payment systems, as well as having a joint interest in the oversight of securities settlement systems, alongside the FSA which is the direct supervisor for these systems.** The BoE's role in the latter area stems from both the "embedded payments system" aspects of such systems, as well as a broader financial stability interest.

Main Findings

202. **In sum, the arrangements in the U.K. relating to NewCHAPS and the BoE's payments oversight role are in close accord with the CPSS Core Principles for Systemically Important Payments Systems.** In the initial phase of this assessment, actions were recommended to improve observance of two principles, both having to do with the relationship between CHAPSCo and APACS, but changes have subsequently been implemented which addressed these issues. Those points aside, there are some other areas of the assessment where further refinements at the margin could usefully be made, as noted in the following paragraphs.

Legal Foundation (CP I).

203. **The legal underpinning of NewCHAPS is well-founded, based on the laws of England and Wales, including the general English legal principle of freedom of contract; each NewCHAPS member agrees that the courts of England and Wales are to have exclusive jurisdiction to settle any dispute in connection with NewCHAPS rules.** The EU Directive on Settlement Finality in Payment and Securities Settlement Systems is implemented in the U.K. through the Financial Markets and Insolvency (Settlement Finality) Regulations 1999. These regulations provide that specific provisions of English insolvency law and the general law of insolvency do not apply to the settlement of transfer orders effected through a designated payment system and any action taken under the rules of such a system with respect to such orders. They also protect the provision of any "collateral security" for obligations incurred in connection with participation in a designated system.

Understanding and management of risks (CPs II-III).

204. **The rules, procedures and associated manuals related to NewCHAPS reflect the fact that CHAPS Sterling and CHAPS Euro are RTGS systems, so that no netting takes place, transactions are settled throughout the business day, and each settled transfer is final.** Under these systems, credit risk between direct settling members is therefore eliminated. In addition, a range of controls and procedures aim to minimize liquidity risk, including throughput guidelines (sterling only), "circles processing" to minimize the risk of gridlock, and facilitation of liquidity transfer by System Control in sterling contingency situations. The documentation also covers the timing of settlement of the various ancillary payment systems, as well as the BoE's repo facility for providing intra-day liquidity.

Settlement (CPs IV-VI)

205. **NewCHAPS provides prompt final settlement, in central bank money, of individual transactions on a real-time gross basis in both CHAPS Sterling and CHAPS Euro.** Transfers forwarded for settlement that cannot be settled are queued until the sending bank has sufficient funds, and are then processed first by priority, then by value (lower before higher), then by input time. Members are able to set and adjust priorities and “filters” to better manage their own payment flows; if no priority is set by the sending member the system will allocate a “default priority.”

Security and operational reliability, and contingency arrangements (CP VII)

206. **NewCHAPS is a very robust and well functioning system overall, with detailed business continuity and contingency arrangements that go further than some other systems.** The latter also include a “bypass mode,” which may be activated in the very unlikely event that both the main and backup systems for RTGS failed, involving a return to end-of-day multilateral net settlement to continue to provide for the timely transmission of payments. While the existence of such an arrangement is itself positive, it would be highly desirable that the rules thereof be elaborated more fully in documentation (which is in hand). In the last year or two, the system has had some longer outages and due attention should thus be paid to the assurance of continued high availability of the system. Although there have been a number of cut-off extensions within the sterling service, members feel existing disciplinary measures work well and will keep these to a minimum. Various levels of controls and audit of security and reliability arrangements are in place, ranging from member self-certification on availability and code-of-conduct compliance, to CHAPS internal audit, a form of oversight / audit through APACS, and an annual review by external auditors of the CHAPS control framework.

Efficiency and practicality of the system (CP VIII)

207. **NewCHAPS is practical and efficient for larger value and time critical payments, with a targeted maximum transmission time of one minute between sending and receiving members’ processing systems.** As to TARGET processing, the maximum processing time for euro payments is 30 minutes. Indirect CHAPS members are able to receive online advice of payment receipt, and to initiate CHAPS payments. CHAPS charges are kept to a non-profit minimum consistent with recovery of operating costs, and are allocated essentially on a pro-rata basis (subject to some thresholds for low-volume members). The BoE’s RTGS fees aim to recover attributable running costs including allocated overheads, and some investment costs other than where a case can be made that there is a wider benefit to the financial sector and economy (e.g., recovery of non-hardware-related development costs has not been sought, reflecting the wider benefits of risk reduction through the use of RTGS): the consistency of the fees charged for the two RTGS services is a subject for scrutiny. SWIFT charges are in addition to the above.

Criteria for participation (CP IX)

208. **Access criteria are objective and publicly available.** Criteria for access to BoE settlement accounts (recently clarified) are objective and fair and are not limited to credit institutions—any member of a payment system for which the Bank is prepared to provide settlement, may in principle have an account.

Governance of the payment system (CP X)

209. **The governance arrangements of the system are effective and promote accountability, although they are not as transparent to non-members as they might be.** CHAPSCo is the organization responsible for NewCHAPS but does not itself publish any report on its own or the systems activity (APACS, however, publishes payments statistics).

Central Bank Responsibilities in applying the CPs

210. **The BoE has publicly discussed its role and objectives in payments system oversight in some detail, emphasizing its responsibility to promote overall financial stability.** It also stresses the central role of the Core Principles for Systemically Important Payment Systems as the basis for ensuring that payments systems control risk appropriately. A recent update on payments oversight issues appeared in the BoE's FSR (June 2002). This report, or a similar vehicle, should usefully evolve into a regular annual account of developments related to the BoE's oversight role. When an appropriate opportunity arises, it would also be desirable to lay out the BoE's payments oversight and broader financial stability responsibilities more directly and explicitly in its legislation (see also BoE transparency assessment).

Authorities' response

211. The FSAP visit was a valuable opportunity to have the management of risk within the U.K.'s main payment systems reviewed by the external experts, and the authorities welcomed the constructive approach taken by the IMF team throughout the mission. The thorough review process illustrated the strengths of the U.K. system, but also provide useful insights into a number of areas where work was needed if CHAPS is to remain at the forefront internationally.

X. IMF CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES

A. Transparency of Monetary and Financial Policy at the Bank of England

General

212. **This section provides summary findings from the assessment of the transparency of the Bank of England's (BoE's) monetary policy and financial stability activities,**

including payments system oversight, against the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The report was prepared by the IMF in the context of an assessment of the U.K.'s financial system in February-July 2002 as part of its Financial Sector Assessment Program (FSAP). The assessment was based on an updated self-assessment prepared by the BoE in January 2002; a review of documents maintained on its website; and discussions with BoE, FSA, and HMT staff, members of the BoE's MPC, and a wide range of informed external observers of the BoE, including financial market participants, private-sector economists, journalists, and members of the academic community. The U.K. authorities fully cooperated with the assessment, and all required information and documents were provided.

Institutional and Market Structure—Overview

213. **In October 1992, the U.K. adopted inflation targeting as its framework for monetary policy** and in 1997, the BoE acquired operational independence in the pursuit of that end. The task of the BoE's Monetary Policy Committee (MPC) is to set the Bank's official lending rate (two-week repo rate), on the basis of a majority vote, to achieve the inflation target it has been given—currently 2½ percent for RPIX inflation. The BoE implements monetary policy by lending to its counterparties in the sterling money market at interest rates tied to the official repo rate chosen by the MPC. Settlement banks are also able to obtain intraday credit from the BoE on a collateralized basis to facilitate the smooth functioning of the real-time gross settlement (RTGS) payment system.

214. **The BoE's role with respect to financial stability issues is broadly defined in the Memorandum of Understanding (MoU) between the BoE, the FSA, and HMT.** Under the MoU, the BoE is responsible for the overall stability of the financial system as a whole, and has specific responsibility for overseeing the functioning of payment systems. In exceptional circumstances, it would be expected to undertake official support operations, having informed HMT (under MoU arrangements). It is also responsible for promoting the efficiency and effectiveness of the financial sector, with particular regard to its international competitiveness.

Main findings: summary

215. **U.K. monetary policy is grounded in an inflation targeting framework that is one of the most transparent in the world.** The strong performance of the current framework is illustrated by the fact that inflation expectations seem to be well anchored by the inflation target, the degree of uncertainty in markets regarding future policy actions has declined over time, and the BoE scores well in public opinion polls (although the latter may reflect the current low level of interest rates and the overall strong performance of the U.K. economy). Indeed, the BoE observes most of the elements of the monetary policy portion of the Transparency Code.

216. **The transparency of the BoE's financial stability functions is, to a large extent, also at the forefront internationally.** For example, the BoE was among the first central

banks to publish financial stability assessments, which is done biannually in the Financial Stability Review (FSR). The BoE observes most of the elements of the financial policy portion of the Transparency Code. There are some other issues where there is still room for further refinement both with regard to the clarity of roles and public communication, but these are at the margin.

Principle Section 1: Clarity of Roles, Responsibilities, and Objectives (Monetary Policy)

217. **Major improvements to the clarity of monetary policy objectives and the governance structure surrounding monetary policy were provided in the *Bank of England Act 1998*.** In particular, the introduction of a point-target for inflation and the delegation by the Chancellor of the Exchequer of interest rate settings to the MPC were welcomed by external observers. Nonetheless, a couple of them questioned whether the recently-observed tendency of inflation to run just below the target (both in practice and in the Bank's projections) introduced an element of uncertainty to the objectives of monetary policy. The MPC addressed this issue directly in the minutes of its February 2002 meeting.

Principle Section 2: Open Process for Formulating and Reporting Monetary Policy Decisions

218. **The framework for monetary policy and the modalities used to conduct monetary policy are outlined and discussed in the BoE's publications and on its website.** Similarly, the details surrounding the composition, structure and functions of the MPC are clearly documented and publicly disclosed through various channels. Changes in interest rate settings are announced immediately after the MPC meetings, which normally take place monthly. The schedule for these meetings is publicized prior to the start of the year. The minutes of the MPC meetings, which contain the votes of individual members and a nonattributed summary of the discussion, are released within 13 days of the meeting, even though by law they need only be released within six weeks of the meeting. In addition, there is a quarterly Inflation Report that discusses monetary policy objectives, and the prospects for achieving them. The BoE also works collaboratively with financial market participants to champion measures to promote well-functioning markets and solicit their views on changes to monetary operating procedures. And, data reporting forms and regulations are available on its web site together with accompanying definitions.

219. **The BoE was generally praised for its efforts to highlight the uncertainty in monetary policy through the use of probabilistic fan-charts and its attempts to discuss its economic outlook in a probabilistic sense without focusing on point-estimates.** That said, there appears to be some external uncertainty as to what the fan-charts represent: the uncertainty inherent in the consensus forecast of the MPC versus an illustration of the range of views of MPC members. The BoE has sought to clarify this issue in several Inflation Report boxes, and by a regular table in the Report that summarizes MPC members' different economic assumptions.

Principle Section 3: Public Availability of Information on Monetary Policy

220. **The BoE has an extensive public relations program to build public awareness of monetary policy and the MPC's mandate.** In addition, members of the MPC make a large number of public presentations over the course of a year, and are frequently interviewed by members of the media, both in London and around the U.K.

221. **The prescribed timeliness for data publication is 14 days in the IMF's SDDS, while the BoE publishes the data after 21 working days.** The requirements of the SDDS are met by making use of a 'flexibility' option because the data disseminated are an integral part of the U.K. monetary statistics; these data are published as a complete package at the earliest opportunity. In the case of information on emergency financial support operations, the BoE does not provide enough information to enable outsiders to fully discern, after an appropriate delay, the effects of these operations on its revenues and expenses for the year(s) in question.

Principle Section 4: Accountability and Assurances of Integrity by the Central Bank

222. **Senior officials of the Bank appear in public before the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee.** The BoE is obliged to submit to the Chancellor of the Exchequer an *Annual Report* on its activities in that year, which is laid before Parliament by the Chancellor of the Exchequer.

223. **Data on the BoE's balance sheet and income/expenditure are publicly disclosed on a regular basis.** The accounts are audited by an external auditor. The audit is conducted in accordance with Companies Act requirements and auditing standards issued by the U.K. Auditing Practices Board, except where this would be inconsistent with the BoE's functions.

224. **Internal governance procedures are described in the Annual Report.** The Court is responsible for managing the Bank's affairs, other than the formulation of monetary policy, which is the function of the MPC. Under the Court, the senior policy-making body is the Governor's Committee, comprising the Governors and Executive Directors. The internal management of the BoE is the responsibility of an internal Management Committee.

225. **The BoE has internal rules on personal financial dealings set by Court, which are designed to address the issue of possible, actual or perceived financial conflict of interest or misuse of confidential information.** These are not published, but oral briefings are provided in response to external requests.

226. **Staff have statutory immunity in respect of banking supervisory acts or omissions before June 1998 when supervision was transferred to the Financial Services Authority.** They also enjoy statutory immunity under the Settlement Finality Regulations 1999. The BoE has indemnified members of its Court of Directors against personal civil liability arising from the carrying out of their functions. These immunities are publicly disclosed.

Principle Section 5: Clarity of Roles, Responsibilities, and Objectives (Financial Policies)

227. **There is currently no direct specification, in law or regulation, of payment and settlement systems oversight or a broader financial stability responsibility as key roles of the BoE, with the exception that it is the designator of payment systems under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.** However, there are a number of less direct references that clearly imply or presume these responsibilities for the Bank. Instead, the framework for the BoE's role with regard to payment systems oversight is given in the MoU, while the broad framework for its financial stability work is laid down in the MoU and its *Annual Report*.

228. **Overall, these responsibilities are publicly disclosed and discussed in a way that compares very well with good practice internationally.** This is done mainly through the Annual Report and the FSR. The latter is widely regarded as a leading example of central bank publications on financial stability developments and analysis. It has also published separately its framework for payment systems oversight and its policy with regards to settlement accounts. External observers confirmed the view that the BoE is clear and transparent with respect to its payment systems oversight and financial stability functions.

229. **The possibility of the Bank acting in support operations in order to resolve a financial crisis situation is explicitly recognized in both the MoU and the Annual Report.** What that means in practice, however, has not been explored further in readily available documentation—the most recent elaboration is contained in a 1993 Governor's speech, which outlines the general framework and principles for the BoE's role as a provider of emergency liquidity assistance.

Principles Section 6: Open Process for Formulating and Reporting of Financial Policies

230. **The Bank outlines its financial policy objectives in the Annual Report.** This includes the overall objectives, the priorities for the coming year and a description of what progress have been made. This report also includes the non-executive members of the BoE's Court's evaluation of how well this has been done.

231. **Internally, there is a Financial Stability Committee (FSC), which meets on a monthly basis.** The FSC reviews major current policy issues and the staff's assessment of actual and potential risks to stability. The discussions in the FSC also help to establish the Bank's position on questions which are under consideration in U.K. (e.g. at the level of the FSSC) or internationally. FSC discussions are open to a wide range of staff, which is acknowledged as a positive way of involving staff in the policy process. However, more sensitive issues may be discussed outside the FSC, in a narrower group.

232. **The BoE's reporting requirements for statistical returns, and copies of the returns, are available on its website.** Changes to reporting requirements are communicated via statistical notices, which are sent to each reporting institution and posted on the website. These requirements, and more comprehensive information about the Bank's approach to collection and dissemination, are embodied in the "*Code of practice for Bank of England*

statistics”; available in hard copy and on the website. Links to all the references above, along with other information about Monetary and Financial Statistics, are available on the website.

Principle Section 7: Public Availability of Information on Financial Policies

233. **The BoE’s main report on macroprudential developments is the article in the FSR on the Financial Stability Conjuncture and Outlook, which surveys incipient risks to the financial system, and its capacity to absorb any such shocks.** This surveillance work is also reflected in regular articles in the *Quarterly Bulletin*. The BoE also publishes material on structural developments relevant to financial stability, for example on new financial instruments or patterns of exposures, on payments system developments, and on regulatory changes—domestically or internationally—likely to affect the system as a whole. This publication program is supported by an active and extensive speaking program by senior officials.

234. **Aggregate financial data are disseminated using a variety of media and delivery channels: a monthly publication of key data series “*Monetary and Financial Statistics*” and an annual “*Statistical Abstract*” are available in hard copy and also on the BoE’s website.** Press releases are issued in paper form and posted on the website, as new data become available. Most series are available via Datastream; in addition, Bloomberg, Knight Ridder and Reuters carry selected series. The results of the BoE’s money market operations are released on wire services; and through various publications. an aggregate monthly summary in Bankstats; and a quarterly summary in the *Quarterly Bulletin*. A highly aggregated balance sheet, the ‘Bank Return’, is published weekly.

Principle Section 8: Accountability and Assurances of Integrity by Financial Agencies

235. **Consistent with Principles Sections 3 and 4, there is a high degree of observance of all the elements of this principle, except those dealing with the disclosure of information on expenses and profit and the publication of conflict of interest guidelines, which are broadly observed.**

Table 1. Recommended Plan of Actions to Improve Observance of IMF’s MFP Transparency Code Practices—Bank of England

Reference Practice	Recommended Action
Principle Section 3.1	When feasible, shorten the publication period of the U.K. monetary statistics from 21 days to 14 days.
Principles Sections 3.2.3, 4.3, 7.3.1, and 8.3	When disclosing lender-of-last-resort support provided to distressed financial institutions operation, consider providing enough information to enable external observers to fully discern the effects of these operations on the Bank’s revenues and expenses for the year(s) in question.
Principles Sections 4.4 and 8.4	Although the conflict of interest guidelines are contained in a number of documents and the Bank has a policy of orally explaining them upon request, it should consider publishing a summary of them, and make it clear how members of the public can obtain further information (or the underlying documents) if they so wish.

236. **In addition to the above, further refinements were recommended in a few areas where the MFP Transparency Code Practices were already considered to be observed.** Such refinements would further bolster the BoE’s already strong commitment to financial policy transparency at the margin. Specifically:

- When an appropriate opportunity arises, it would be desirable to lay out more directly and formally in statute the Bank’s financial stability and payments/settlement system responsibilities.
- Some further, readily accessible, elaboration would be desirable on the general principles for emergency liquidity assistance, and on the Bank’s role more generally in financial crisis situations.
- A clearer recognition of the scope of the Bank’s financial stability interest in securities settlement systems would be desirable in the Bank’s relevant publications.
- The June 2002 FSR box on payments system oversight should evolve into a regular (annual) account of the Bank’s activities in payments system oversight. From time to time, such an account could usefully include some more elaboration on particular oversight issues or arrangements. For example, while the June 2002 box reiterated the Bank’s operational role as a member in its own right of some systems, a future box could elaborate on the relationship between the Bank’s oversight and operational roles.

Authorities’ response

237. **The authorities welcomed the recognition that the Bank of England’s monetary and financial policy frameworks are some of the most transparent in the world.** Their specific responses on the main recommendations above are as follows.

- On *Principle 3.1*, the authorities indicated that shortening the publication period of U.K. monetary statistics could only be achieved by imposing significant additional costs on some of the contributors to the data. They noted that, with the exception of the Analytical Accounts of the Central Bank, the U.K. monetary statistics fully meet the requirements of the SDDS in respect of timeliness of publication. Narrow money data are published on the third working day after the final Wednesday of the reference month and Broad money and credit data are published after 14 working days. It is the sectoral breakdowns of broad money and credit, and the consolidated balance sheet of monetary financial institutions, that are not published until after 21 working days. Publication of the sectoral breakdowns takes place 4 working days after the last data become available, and could only be accelerated by imposing unjustifiably high costs on contributors. The requirements of the SDDS are met by the use of a 'flexibility' option in respect of the timeliness of publication of the Analytical Accounts of the Central Bank.
- In relation to *Principles 3.2.3, 4.3, 7.3.1 and 8.3*, the authorities noted that in exceptional circumstances, as part of its central banking functions, the Bank may act as "lender of last resort" to financial institutions in difficulty so as to prevent a loss of confidence spreading through the financial system as a whole. All lender of last resort support operations are disclosed and that disclosure happens in a timely manner. There will be a presumption in favour of disclosing support in the Bank of England's first annual report following the support operation. If disclosure at that time would be damaging to financial stability or the support operation itself, then disclosure would be postponed and the issue re-considered after a further year and, if necessary, in subsequent years until disclosure took place. In disclosing information, those factors which meant that an earlier disclosure would have been unsafe will be explained. Note 1 of the Bank's Annual Accounts explains the Bank's policy in this area in more detail.
- On *Principles 4.4 and 8.4*, the authorities noted that the Court of the Bank has set rules on personal financial dealing which are designed to address the issue of possible financial conflict of interest or misuse of confidential information. MPC members and executive directors are required to disclose the stock of their financial assets, and some liabilities, to the Personnel Director (or in the case of the Governors to the Chairman of the Committee of Non-Executive Directors). MPC members are strongly advised wherever practicable to place their investments at arms length under fully discretionary management. Where this is not practicable they must seek prior agreement before every transaction. Briefings on these rules have been provided in response to external requests up to now. In November, 2002, the Bank sent a detailed summary of the rules as they apply to MPC members to the Treasury Committee of the House of Commons, on the assumption that the Treasury Committee will in due course publish them as evidence. Once that happens, the Bank will place a copy of the summary on its web site.

B. Transparency of Financial Policies (FSA)

General

238. **This section provides summary findings from the assessment of the consistency of the U.K.'s Financial Services Authority's (FSA's) supervisory practices with the financial policies portion of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment was made in the context of a Financial Sector Assessment Program (FSAP) mission to the U.K. from May 8-24, 2002. The assessment was mainly based on a self-assessment prepared by the FSA in April 2002; a review of relevant documents maintained on its website; and discussions with FSA staff and informed external**

239. observers of U.K. financial policies. The latter included financial institution officials, members of the FSA's consumer and practitioner panels; trade association representatives; and journalists. Input was also provided by colleagues who conducted the assessment of U.K. banking, insurance, and securities market supervisory practices against various international standards and codes. The U.K. authorities fully cooperated with the assessment, and all required information and documents were provided.

Institutional and Market Structure—Overview

240. **On December 1, 2001 the FSA became the single statutory regulator for the majority of financial services in the U.K., replacing the previous sectoral regulators.** The FSA's responsibilities are both wider and deeper than those of the predecessor bodies. Wider, in that they embrace additional firms, including those previously regulated by their professional bodies; and deeper, in that they extend the powers of the FSA in relation to regulated firms—for example, to promote standards of market conduct through a Code and to enforce firms' compliance with requirements to have anti-money laundering controls.

241. **The FSA exercises statutory powers under the *Financial Services and Markets Act 2000 (FSMA)*.** This provides a broad legal framework for financial regulation in the U.K. and equips the FSA with a single set of powers and responsibilities, supported by a range of accountability mechanisms. The FSA is an independent non-governmental body in that it has been structured as a limited company financed by direct levies on the financial services industry. It is accountable to Treasury Ministers, and through them, to Parliament. The FSA's governing body is the Board, consisting of a Chairman, three executive directors, and 12 non-executive directors, all appointed by HM Treasury.

Main findings: summary

242. **For the FSA, there is a high degree of observance for all of the elements of the financial policies section of the Code.** The current framework is to be commended, and the FSA in particular, for making the regulatory process more transparent and accountable than the previous regime. Its roles, responsibilities, and objectives are clearly defined in the FSMA, and explained through various channels, including public speeches, conferences, and publications available on the its FSA's website. The policy formulation and reporting process is transparent and involves regular consultation with consumers and industry. Extensive information on the relevant policies is available in FSA publications, the level of accountability is high; and the degree of assurance of integrity is appropriate.

Principle Section 5: Clarity of Roles, Responsibilities, and Objectives

243. **The FSA's roles, responsibilities, and objectives are clearly defined in the FSMA and explained through various media, including publications, its website, and public speeches.** The relationship between the FSA, HM Treasury, and the Bank of England is outlined in a Memorandum of Understanding (MoU) between these institutions.

244. **There continues to be some uncertainty in the financial community about the process used by the FSA to manage the various objectives assigned to it.** To some extent this reflects the limited experience with the new regulatory approach, and to its credit, the FSA has endeavored through various publications, meetings with stakeholders, seminars, and workshops to explain its risk-based approach to supervision, and how its risk assessments drive the priorities assigned to its work on each of these objectives. Nonetheless, the continuing uncertainty suggests the need for further efforts to help regulated institutions and the general public improve their understanding of the new regulatory framework.

Principle Section 6: Open Process for Formulating and Reporting of Financial Policies

245. **The framework for regulatory and supervisory policies and the risk-based approach used to conduct FSA's practices are outlined and discussed in FSA's publications and on its website.** Similarly, the details surrounding the composition, structure, and functions of the FSA are clearly documented and publicly disclosed through various channels. The policy formulation and reporting process is transparent and involves regular consultations with consumers and practitioners. In addition, The FSA reports publicly in a number of other ways on how it is pursuing its overall policy objectives.

246. **While a transparent regulatory and supervisory framework has been introduced with appropriate accountability mechanisms, there is still some uncertainty in the financial community about how the FSA's policies will be implemented in practice.** The FSA has sought to deal with this matter in a number of publications and conferences that outlined its risk-based approach to regulation. However, it should bear in mind that regulated firms are eager to see how it applies judgment and tailors supervision to individual circumstances, rather than adopting a mechanical rules-based approach to supervision.

247. **In addition, while financial institutions generally praised the FSA's efforts to closely consult stakeholders when formulating policies for regulating institutions, a couple noted that the consultation process can be rather onerous and costly for them.** To some extent this is unavoidable, since many consultations are to be expected when a new approach to regulation is introduced. Moreover, FSA officials noted they continue to obtain good feedback from stakeholders despite the large number of consultations in recent years.

248. **The FSA is encouraged to continuously look for ways to streamline the consultation process, so that stakeholders' views can be collected and incorporated in a cost-effective and efficient fashion.** To their credit, it should be noted that FSA officials are sensitive to this issue, and are awaiting feedback from the Practitioner Panel's annual survey, which includes questions that address this issue.

Principle Section 7: Public Availability of Information on Financial Policies

249. **Information on the relevant policies is extensively available in FSA's publications.** It also publishes a range of other publications that report on major developments, such as reports detailing the outcome of work on various regulatory themes,

and a new publication called *Financial Risk Outlook*, which summarizes significant developments in the broader environment within which the FSA operates.

250. **The FSA has an extensive consumer education program to promote public understanding of the financial system and secure the appropriate degree of protection for consumers.** In addition, senior FSA officials make a large number of public presentations over the course of a year, and are frequently interviewed by members of the media. However, there are some operational issues in which the FSA could further improve the transparency of its practices. For instance, consumers' awareness of their rights under the Financial Services Compensation Scheme (FSCS), which acts as a financial safety net for consumers that have claims against failed financial institutions, is poor. To its credit, the FSA recognizes this issue and issued a consultation paper in May 2002, which included proposed changes to business rules that would require firms to disclose relevant information about the compensation scheme, its coverage, and limits. Moreover, the FSCS is working with the FSA, stakeholders, and journalists to make its presence better known. Its website has recently been enhanced, and in recent months it has produced a range of booklets and other information for consumers that have been reviewed by the Plain Language Commission.

Principle Section 8: Accountability and Assurances of Integrity by Financial Agencies

251. **The level of accountability is high, and the degree of assurance of integrity appropriate.** The FSA regularly provides evidence to parliamentary committees on the conduct of financial policies, policy objectives, and performance in pursuing FSA's objectives.

252. Although, the degree of observance is high for all of the elements of the Transparency Code, the following technical suggestions are provided to further improve the transparency of its activities.

- Some continuing uncertainty in the financial community about the process used by the FSA to manage the various objectives assigned to it suggests the a need for further efforts to help regulated institutions and the general public improve their understanding of the new regulatory framework.
- Continue to look for ways to streamline the consultation process so that stakeholders' views can be collected and incorporated in a cost-effective fashion.

Authorities' response

253. **The authorities welcomed this positive assessment and noted that the FSA observes all of the elements of the financial policies section of the Code.** They also welcomed the FSAP team's comments about the transparency of our policy process, the provision of information and the FSA's high level of accountability. They accepted that under Sections 5 and 6 there may remain some uncertainty about how the FSA manages its

various objectives and how it will implement its policies in practice. They noted that this is inevitable under a new regulatory regime, with a new regulator operating under a new statutory basis, but considered that any uncertainty will lessen over time as market participants learn more from the FSA's explanations, supervision and actions. They noted that, indeed, the industry's understanding of how they use their powers and pursue their objectives has considerably increased since the IMF visits in May 2002. The IMF mission made their assessment six months after FSMA came into force. The situation has developed and moved on and they have been operating with their new powers for over a year. Many of the uncertainties raised with the IMF assessors will have been answered.

XI. IOSCO-CPSS RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS

General

254. **This assessment of observance by the United Kingdom of the CPSS-IOSCO Recommendations for Securities Settlement Systems focuses on the overall process of securities clearing and settlement in the U.K., with a substantial emphasis on the settlement systems operated by CRESTCo.** A recommendation-by-recommendation assessment was made for the system covering bonds and equities, the CREST system. A more limited, but still recommendation-by-recommendation assessment was made of the settlement system for money market instruments, the Central Money Markets Office system (CMO). At the time of the assessment, work was underway to prepare for the migration of money market instruments (MMIs) from CMO to CREST. The suggested timetable was to complete this migration during 2003. The London Clearing House (LCH), which undertakes the central counterparty clearinghouse role in the U.K., is the focus of Recommendation 4, but is not covered in detail in this assessment.

255. **The assessment follows the CPSS-IOSCO Assessment methodology for Recommendations for Securities Settlement Systems (RSSS) that was published in November 2002.** The assessment relied on answers to the key questions of the RSSS. The information used in the assessment included relevant laws, rules and procedures governing the systems, and a questionnaire completed by CRESTCo in cooperation with the Financial Services Authority (FSA). Discussions were held with the Bank of England (BoE), the FSA, CRESTCo, LCH, London Stock Exchange, LIFFE, and a number of bank representatives as well as brokers. Information on websites of the FSA, CRESTCo and LCH was also extensively analyzed.

Securities settlement systems infrastructure

256. **CRESTCo operates two securities settlement systems—CREST and CMO.** The CREST system is used for gilts and equities, and the CMO system is used for money market instruments (including T-bills, Bank Bills and CDs). CREST acts as the central securities depository (CSD) for U.K. securities, of which the vast majority are dematerialized: since November 2001, a transfer of securities in the book-entry system of CREST has constituted

the legal transfer of title, with CREST records being the register for dematerialized securities under U.K. law.³² For the remaining securities held in paper form, and for those constituted under some other laws (e.g., Irish), the applicable external registrars have to separately register changes of ownership according to the changes effected in the CREST settlement. For the CMO system, the Bank of England acts as depository for immobilized securities.

257. Trading of securities in the U.K. is mainly done on a bilateral basis between market participants. The exception is equities, which can also be traded, for example, on the London Stock Exchange's electronic order book (SETS, the Stock Exchange Electronic Trading Service). Equity transactions traded electronically are cleared by London Clearing House (LCH), acting as central counterparty (CCP), before settlement in CREST.

258. In November 2001, real-time gross settlement was introduced between CREST settlement banks, across accounts at the BoE. This replaced the previous end-of-day multilateral net settlement of interbank obligations arising from securities transactions, thus eliminating the substantial intraday exposures between settlement banks previously existing, and instituting securities settlement in central bank money.

259. CREST's average daily transaction volume (for gilts and equities) in November 2002 was about 275,000 with an average daily value of £200 bn. CMO's daily settlement averages £7 bn, with less than around 1000 transactions.

260. On 4 July, 2002, Euroclear and CRESTCo announced plans to merge. Following approval of the merger by both groups of shareholders during August and the decision on 16 September of the U.K. government not to refer the merger to the competition authorities, the merger was completed on 23 September, 2002. In practice there have not been any significant changes in CREST operations yet, and the assessment is therefore done on the CREST system as an individual system.

Main findings: The CREST system

261. The overall assessment is that the CREST system itself is reliable and effective in providing delivery versus payment settlement on a real time gross basis. The CREST system started its operations in 1996, but it was not until November 2001 that the transfer of title in CREST's book-entry system became the legal transfer of title to securities constituted under U.K. law. At the same time, full DVP in central bank money was introduced. In a few remaining areas, mostly outside the scope of CRESTCo and CREST itself, some further improvements would be desirable—these should not be too difficult to achieve overall and in many cases are in process already. Table 1 summarizes the recommendations.

³² CREST is not a depository, however, in the narrow sense of keeping documents of title in its vaults.

262. In the area of *pre-settlement risk*, CREST has together with exchanges been able to improve the performance with regard to confirmation, matching and settlement performance over the last year or so, and this work needs to be continued to ensure further performance improvement.

263. Given the importance of *LCH* for the U.K. and the international financial market, high priority should be given to replacing the payments scheme with one based on settlement across the books of the BoE, for settlements in sterling and Euro. In addition, the placement of funds in the money market should be converted from the current unsecured basis to a collateralized basis, in order to limit unnecessary credit risk exposure of LCH. Losses from these particular risk exposures can not be covered by the default arrangements in place. Initiatives to address both these weaknesses were underway during the period of the FSAP exercise and when completed will significantly remove much of this risk. It is also important that U.K. authorities give a very high priority to ensuring that the legal uncertainties are rectified, especially with respect to the default fund.

264. As regards *settlement risk*, most actively traded securities are dematerialized. However, MMIs are not. There are plans to introduce that in 2003, (legal amendments as well as operational and market practices changes are necessary and are under way) after which observance with this recommendation will be achieved.

265. On *regulation and oversight*, there is currently no specific framework for cooperation with relevant authorities outside the U.K. The supervisory process for the organizations involved is evolving towards more differentiation amongst supervised institutions, having regard in particular to the different sorts of risks in CREST and LCH. It is important for this adoption to continue (e.g., in respect of different capital requirements for these institutions, a matter under consideration at the time of the assessment).

Table 1. Recommended Actions to Improve Observance of CPSS-IOSCO Recommendations for Securities Settlement Systems

Reference principle	Recommended action
Pre-settlement risk	Continue the work to improve performance in order to achieve full observance with this recommendation, i.e. to reach the 98 percent level for trades being matched on T-0.
Central counterparty	Continue the initiatives related to LCH payment arrangements so as to establish settlement in central bank money and collateralization of money market placements; also, ensure remaining legal uncertainties are addressed.
Settlement risks	Complete planned introduction of dematerialization of MMIs, including requisite legal and other amendments.
Regulation and oversight	Continue to develop and adapt the supervisory regime in this area, especially as to appropriate differentiation between CREST and LCH in light of the different risks they face.

266. **In addition to the above, some further technical improvements or refinements would be desirable in some other areas where observance is already high.** These include:

- *Settlement of USD transaction.* Although these are presently of low total value, it should be noted that there is an interbank credit risk stemming from the securities settlement mechanism, and principal risk is not fully eliminated. CRESTCo together with the U.K. authorities should evaluate alternative payment schemes that can reduce this exposure, if settlement values were to significantly increase. If no such mechanism is found, it is important that supervisors are aware of this risk exposure and can discuss it with banks in their risk assessments.
- There appears to be a need to *better communicate the safeguards and the legal support for the custodial activity* to market participants, some of whom have expressed concern in this area.

Main findings: The CMO system

267. **A more limited, but still recommendation-by-recommendation assessment was made of the settlement system for MMIs, the CMO.** The CMO system settles trades in MMIs, including treasury bills, bank bills, and CDs, and handles both sterling and Euro settlements. The CMO system has one major shortcoming, in that settlement is not on a full delivery versus payment basis. The securities leg of a transaction is settled gross on a real time basis and is irrevocable upon settlement. However, the payment leg of the transaction settles on a net basis at the end of day, in the settlement banks' accounts with the Bank of England. In contrast to the assured payments used for USD in the CREST system, banks are not obliged to make payments on behalf of their customers. Therefore, all participants in the money market are faced with a full principal risk from the settlement of the securities leg of the transaction intraday, until payments have been settled at the end of the day.

268. **At the time of the assessment, work was underway to prepare for the migration of MMIs from CMO to CREST.** The suggested timetable was to complete this migration during 2003. Legislative changes are needed to change the status of MMIs, which presently are bearer instruments and therefore not fungible, to make the integration into CREST possible. No other changes are planned, nor recommended, for the CMO system. The mission fully endorses the planned migration into CREST, and hopes that this process, including the necessary legislative changes will take place as scheduled. In the meantime, it is important that as long as the CMO system remains, the U.K. authorities take account of this risk exposure in their work on financial stability and supervision of institutions.

Authorities' response

269. **The authorities indicated that the assessment has been a valuable and effective review of the observance by U.K. SSSs of the CPSS/IOSCO recommendations.** They noted, however, a number of areas where they feel that some issues, while identified by the FSAP team and themselves as risks, can be effectively monitored (rather than removed) due

to their relatively low impact (and especially when measured against the costs of remedial action). It is important to acknowledge the cost/benefit issues inherent in tackling low-impact and non-material risks. This is relevant regarding the recommendation for the very low value of US\$ settlement in Crest. The authorities, Crest and APACS have, since the assessment, discussed this issue and will continue to monitor the size of US\$ flows, but feel that the values are currently too small to justify a significant and costly solution.

270. **The authorities were able to report progress on a number of areas highlighted by the IMF.** The recommendation relating to central counterparty arrangements notes that priority should be given to replacing LCH's payment scheme with one based primarily on settlement across the books of the Bank of England: detailed discussions are currently underway between the Bank and LCH. Furthermore, LCH has started to deposit its cash margin on a secured basis. The authorities and LCH are in discussion regarding how to provide further legal certainty to the small proportion of the default fund where there is currently some uncertainty regarding its treatment in the event of a member insolvency. Since the assessment was carried out, substantial progress has been made towards the implementation of money market instrument dematerialization. Most significantly, HM Treasury published a consultation paper on 13 September 2002 that incorporated detailed proposed changes to the relevant legislation (the Uncertificated Securities Regulations 2001). Comments were asked for by 6 December, with the aim of achieving the necessary Parliamentary approval by end H1 2003, so that dematerialized money market instruments can start being issued and settled in CREST from mid-2003 and CMO can be closed at end-2003. This high priority work will address the points raised in relation to Recommendation 6 of the Crest assessment (dematerialization of MMIs) and most of the recommended actions in the CMO assessment will become redundant.

271. **Finally the authorities noted the IMF's observations on the supervisory regime in the U.K. and the application of the sourcebook to CREST and LCH.** They are satisfied that the FSA's current approach provides sufficient flexibility to be able to deal effectively and efficiently with the issues that arise at those institutions. They believe that this view is also shared by the institutions themselves. The FSA have taken the opportunity to compare their approach and regime to those of other European regulators as a result of the various initiatives and mergers being pursued by our exchanges and clearing houses and are satisfied that the FSA's approach compares very favorably in such circumstances.

XII. STANDARDS FOR ANTI-MONEY LAUNDERING AND COUNTERING TERRORIST FINANCING

272. **This Report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations for Combating the Financing of Terrorism* (FATF 40+8 Recommendations) was prepared by a team of Fund staff, an expert under the supervision of Fund staff, and an expert**

not under the supervision of Fund staff who was selected by the authorities to assess matters concerning AML/CFT law enforcement.³³ The report summarizes the level of observance of the FATF 40+8 Recommendations and provides recommendations to enhance observance. The views expressed in this report are those of the assessment team and do not necessarily reflect the views of the U.K. authorities or of the Fund Executive Board.

A. Information and Methodology Used for the Assessment

272. **This assessment is based on a review of U.K. AML/CFT legislation and regulations, as well as supervisory materials issued by the Financial Services Authority (FSA) with respect to prudentially-regulated financial institutions (FIs), and by Her Majesty's Customs and Excise (HMCE) with respect to "money service businesses" (MSBs, which includes bureaux de change, money transmitters and check cashers).** The assessment team held discussions with officials and technical experts from a number of U.K. government departments and agencies, as well as with FI representatives and private sector AML experts. The assessment is based on the information available at the time it was completed on December 20, 2002.

B. Main Findings

273. **The U.K. has a strong and comprehensive legal, institutional and supervisory regime for AML/CFT.** The system has been made more robust over the last few years, inter alia, as a result of passage in July 2002 of the Proceeds of Crime Act 2002 (PCA), whose key AML provisions will come into effect in February 2003; adoption of new legislation on terrorist financing; and issuance of regulations providing a framework for the registration and limited supervision of MSBs. The U.K. complies well with most of the FATF 40+8 Recommendations, other than Special Recommendation VII concerning the inclusion of originator information on wire transfers. There is, however, room for further improvement and enhancement in some key areas covered under the FATF Recommendations and the Methodology that is used to assess observance of those Recommendations.

³³ The assessment was conducted by Rhoda Weeks-Brown (LEG), John Abbott (MAE), Paolo Constanza (Ufficio Italiano dei Cambi, Italy), and Ted Greenberg (U.S. Justice Department), the independent anti-money laundering expert (IAE) on the team. Throughout this report, portions of the assessment attributable to the IAE are shown in italicized text. The areas dealt with by the IAE are not within the Fund's assessment responsibility.

Criminal Justice Measures and International Cooperation

(a) *Criminalization of ML and FT:*

274. **The U.K. criminalizes ML in a manner consistent with the Vienna and Palermo Conventions (the latter despite the fact that the U.K. is still in the process of ratifying the Palermo Convention).** When it becomes effective, the PCA will update, unify and expand the applicable ML offenses, inter alia, by broadening the criminal intent requirement for certain crimes, removing the distinctions between drug and non-drug ML, and consolidating into one statute the dispersed provisions of U.K. law governing the criminalization of ML. Separately, there are regulations (ML Regulations) that impose criminal liability on FIs, MSBs and a broad range of other financial services providers for failure to maintain appropriate internal AML controls (although some aspects of the ML definition in the ML Regulations need to be updated to reflect the currently applicable ML and FT laws). The U.K. has criminalized FT on the basis of the 1999 UN International Convention for the Suppression of the Financing of Terrorism. Adequate and dissuasive sanctions are available for persons that commit ML or FT offences or fail to adopt AML controls as required under the ML Regulations.

(b) *Confiscation of Proceeds of Crime or Property used to Finance Terrorism:*

275. **Legal Provisions and Protections—U.K. law provides broad authority for the competent authorities to confiscate property related to ML and FT, including laundered property or proceeds from, instrumentalities used in or instrumentalities intended for use in the commission of ML/FT offences.** Regulations issued pursuant to applicable UN Security Council Resolutions provide parallel authority for Her Majesty's Treasury (HMT) to freeze accounts of suspected terrorists under certain circumstances. There are also provisional measures such as freezing (restraint) of crime-related property, as well as measures to facilitate the identification and tracing of property that is subject to confiscation. U.K. law contains adequate provisions to protect the rights of bonafide third parties in connection with the exercise of these powers by the authorities. The PCA will enhance these provisions, inter alia, by (i) allowing for the issuance of restraint orders at any time during an ML investigation (rather than only after initiation of the criminal proceeding); (ii) expanding the circumstances under which monetary instruments can be frozen in connection with a criminal investigation; (iii) greatly expanding civil recovery powers; (iv) improving the procedures governing confiscation of the proceeds of crime; and (v) creating a new Assets Recovery Agency (ARA) with functions focused on increasing criminal confiscation, implementing the PCA's new civil recovery powers, and taxing the proceeds of crime.

276. **Law Enforcement Considerations—Confiscation appears not to have been a priority of the U.K. Crown Prosecution Service (CPS), which also lacks resources to handle confiscation matters. Cases are generally considered for enforcement only when there is low likelihood they will be seriously contested or complicated. There is no government property management system so the confiscation of perishable items like air and water craft is not pursued. (As noted above, however, the new ARA is being established to exercise broad**

confiscation and civil recovery powers.) The U.K. has listed over 100 organizations and over 200 individuals under the terms of the applicable UN Security Council Resolutions on FT. Prior to the fall of Kabul, the U.K. froze a total of £70 million relating to the Taliban, Osama Bin Laden and Al-Qaeda.

277. **Outside a core group in HMCE and the National Criminal Intelligence Service (NCIS, the U.K.'s FIU), it appears that there has historically been no comprehensive training program that addresses ML or FT in the law enforcement agencies or the FSA.** However, it is anticipated that proposed training plans (some of which are designed to ensure effective implementation of the PCA) will rectify this situation and provide the U.K. with a greater number of experienced officers to investigate and prosecute ML and FT. Further, the U.K. Government is setting up a National Center for Excellence in Financial Investigation. The Center will be part of the new ARA and its role will be to train financial investigators in the Police, HMCE and other government bodies; and to accredit them to perform various functions provided for in the PCA.

(c) *The FIU and Processes for Receiving, Analyzing, and Disseminating Intelligence: Functions and Authority*

278. **NCIS' Economic Crimes Branch serves as the U.K.'s FIU, with broad functions relating to all ML predicate offences.** Specific statutory functions include gathering, storing and analyzing information in order to provide criminal intelligence domestically and abroad; and acting in support of domestic and foreign law enforcement agencies in carrying out their criminal intelligence activities. On the international level, NCIS also coordinates law enforcement input into the U.K.'s FATF delegation and acts as the secretariat of the Egmont Group. Current law does not mandate the filing of suspicious transactions reports with NCIS, but this would be changed for all financial services providers when the relevant provisions of the PCA take effect. Current law also does not mandate use of a uniform form for reporting of suspicious transactions, but this too is expected to change once the relevant PCA provisions come into effect.

279. **Law Enforcement Considerations—NCIS must add staff or refocus its staff priorities to finish the STR analysis in less than the average three months it now takes.** Further, although 31,251 STRs were filed in 2001, the authorities were not able to supply any statistics to the IAE on the extent to which STRs had been helpful in general criminal investigations. The authorities also were not able to provide the IAE with the total number of ML or FT investigations, or in any fashion correlate to STRs the numbers that they did have.

(d) *Law Enforcement and Prosecution Authorities, Powers and Duties*

280. **A wide range of law enforcement and prosecution agencies have responsibility for the investigation and prosecution of ML and FT, and the applicable laws give the authorities broad powers to compel the production of records maintained by FIs, MSBs and other entities.** When the PCA enters into effect, certain more robust information gathering methods (customer information orders and account monitoring orders) would

become available in all criminal investigations, rather than only FT and other terrorism investigations as is currently the case.

281. ***There are issues of concern in key areas, including:*** (i) *it is not clear that there are sufficient resources to investigate money laundering;* (ii) *there is no single law enforcement entity that covers all aspects of money laundering in the U.K.;* (iii) *there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence;* (iv) *the Crown Prosecution Service does not prosecute any matters other than narcotic ML;* (v) *the FSA needs to begin to intensively train its examiners and prosecution staff on investigation and prosecution of violations of the ML Regulations;* and (vi) *beyond the work done by NCIS on typologies, there does not appear to be any effort to identify on a national basis the U.K.'s vulnerabilities to ML and FT. Further, with the exception of the work done by HMCE at developing a strategy to address drug ML, there is no national strategy to attack ML or FT (although the IAE understands that such a strategy is in preparation).*

282. ***When fully implemented the new legal tools available to the U.K. authorities will make it harder for money launderers to move their money and are essential components of an overall strategy to combat ML.*** *However, a national ML strategy, drawing on the work of all relevant agencies, needs to be articulated. An important precursor to establishing a strategy and priorities is the need for NCIS' work in preparing trend analysis and vulnerability reviews to guide the policy makers. All law enforcement, regulatory agencies and the intelligence community should also participate in developing the strategy based upon their own trend and vulnerability analysis.*

283. ***The FSA has the unique authority to initiate criminal prosecutions for breach of the ML Regulations. However the ability to effectively use this important tool will be hampered by FSA's reliance on a risk-based approach for determining which financial institutions should be subjected to on-site ML-related examinations.*** *The IAE understands that there were only 18 "skilled person" visits focusing specifically on AML issues in 2000 and the first half of 2001. The IAE believes that the number of on-site visits needs to substantially increase in order to allow ascertainment of whether the risk-based approaches of financial institutions are working and to identify whether there is a need for an increase in the use of remedial actions as well as the use of criminal prosecution.*

(e) *International Cooperation*

284. ***Laws and Procedures***—The U.K. has both laws and informal arrangements and procedures that facilitate comprehensive cooperation in AML/CFT matters, including various statutes setting forth procedures for mutual legal assistance (MLA), over 33 bilateral agreements covering drug-related crimes, 13 bilateral agreements covering all crimes, and designation of large numbers of countries for assistance under the Vienna Convention (162 countries) and the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crimes (41 countries). Most U.K. MLA is conducted through informal processes rather than through the formal routes embodied in the criminal statutes

and international treaties. However, the general (non-U.K. specific) experience in this area suggests that MLA is sometimes not consistently provided under informal processes, which points to the need to strengthen effectiveness of the formal MLA procedures. Separately, the U.K. has multilateral and bilateral arrangements for extradition, as well as statutory procedures for one-off extradition arrangements (the latter of which are reported to be cumbersome in practice). The assessors understand that a bill to improve the procedures for extradition has been submitted to Parliament. The U.K. maintains comprehensive arrangements for sharing information in the context of international cooperation.

285. *Statistics and Other Implementation Issues—The U.K. has a comprehensive system in place to provide MLA, the U.K. Government attaches great importance to assisting judicial and prosecuting authorities in other countries in combating national and international crime, and the arrangements for MLA appear to operate effectively in practice. More generally, the extensive efforts undertaken by HMT in supporting the FATF and the regional style FATFs have been essential to their success in changing and enhancing the effectiveness with which the world addresses ML and now FT.*

B. Preventive Measures for FIs

(a) Prudentially-Regulated Sectors

286. **The FSA functions as an integrated regulator of all prudentially-regulated sectors in the U.K.** As such, its AML/CFT supervisory authority extends over the banking, securities and insurance sectors (except for general insurance), as well as over some activities of professional practitioners that require FSA authorization. More generally, prevention of financial crime is one of the four statutory objectives of the FSA under the Financial Services and Markets Act 2000 (FSMA).

287. **The legal requirements governing AML/CFT preventive measures for FIs are found in the ML Regulations, which provide criminal sanctions for AML systems and controls violations; as well as in an FSA ML Sourcebook, which is intended to add a regulatory (as opposed to criminal) focus on AML systems and controls and operates parallel to the ML Regulations.** The ML Regulations and FSA Sourcebook both contain very broadly specified requirements and objectives in key areas such as customer due diligence, suspicious transactions reporting, record keeping and overall systems and controls. More precise details concerning these requirements are addressed in supplementary guidelines issued by the FIs themselves.

288. **Comprehensive Guidance Notes towards this end have been issued by a Joint Money Laundering Steering Group (JMLSG) made up of the major trade associations representing financial services firms in the U.K.** The Guidance notes are an important aspect of the AML/CFT institutional arrangements and are intended to provide an indication of what is expected of financial sector firms. The standards embodied in the Guidance Notes conform well with the sector-specific criteria for banking, insurance and securities that are identified in the Methodology. The authorities report that, in practice, most FIs (especially

banks) follow the Guidance Notes fairly strictly. The Guidance Notes are not mandatory, however, and firms have discretion to adopt procedures other than those specified in the Guidance Notes. Given their non-mandatory nature, the Guidance Notes are not part of the AML/CFT preventive framework that is required by law. The FSA encourages observance of the Guidance Notes, and ensures compliance with its AML/CFT regime, through its regular supervisory processes. These include “fit and proper” evaluations for authorized persons, off-site reviews of internal reports, on-site monitoring of systems and controls, targeted theme supervision across a sampling of firms, and risk mitigation programs applied at individual firms. The FSA’s comprehensive enforcement authority, which ranges from the power to impose civil money penalties to the power to bring criminal prosecutions for violations of the ML Regulations, is a further important strength of the AML/CFT supervisory regime, as are the sustained efforts of the authorities to increase awareness of AML/CFT issues in the prudentially- regulated sector.

289. **Key weaknesses in the supervisory regime include: general insurance companies are not subject to the ML/FT preventive requirements applicable to other FIs; FSA compliance checking of small, low-impact securities firms is inadequate to verify that these firms are performing required customer identification procedures, while at the same time other financial services providers are allowed to rely on customer identification performed by these firms.** Even for those parts of the insurance sector subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts perfunctory; and confidentiality rules limit the ability of FIs to obtain information from attorneys and accountants, which raises concerns especially for attorneys and accountants not subject to FSA supervision. Key recommendations for improving the supervisory regime include: (i) the FSA should adopt some procedures for verifying compliance with AML/CFT requirements by small, low-impact securities firms; (ii) compliance by general insurance companies with AML/CFT preventive measures (see below) should be supervised by the FSA; (iii) FSA compliance checking of the other aspects of the insurance sector should be intensified; and (iv) FIs should be cautioned against doing business with attorneys and accountants that are unable to provide information about the customers for whom they are opening accounts, especially in cases where the attorney and accountant is not subject to the ML Regulations in respect of the business undertaken on behalf of those clients.

290. There is also scope for enhancing the legal framework applicable to FIs:

291. **With respect to the legal requirements for customer identification:** (i) FIs should be required to include accurate and meaningful originator information on funds transfers and related messages; (ii) legal constraints should be relaxed on the ability of attorneys and accountants to identify their clients to FIs when acting on behalf of those clients; (iii) general insurance companies should be brought within the scope of the ML Regulations and FSA Sourcebook; and (iv) consideration should be given to limiting the circumstances in which FIs can temporarily accept funds from applicants before satisfactory evidence of identity is obtained, and to defining more precisely the FSA Sourcebook’s “financial exclusion” exception to customer identification requirements. In addition, given the important

exceptions to the customer due diligence requirements, consideration should be given to ensuring that FIs keep records of the basis on which a particular customer or transaction was considered to be exempt from the otherwise applicable requirements.

292. **With respect to the regime for reporting of suspicious transactions, Part 7 of the PCA should be made effective as soon as possible, given its significant enhancements (expansion of the criminal intent requirement for FI reporting of suspicious transactions, requiring that all STRs of regulated entities be filed with NCIS, and providing for use of a uniform, system-wide STR form).** Consideration should also be given to providing NCIS with the power to get supporting documents (rather than only general information) from FIs that file STRs with it. With respect to the legal requirements for ongoing monitoring of accounts and transactions: consideration should be given to imposing clear affirmative legal obligations on FIs to pay special attention to: (i) all complex, unusual large transactions, or unusual patterns of transactions that have no apparent or visible economic or lawful purpose; (ii) all business relations and transactions with persons in jurisdictions that do not have adequate systems in place to prevent or deter ML or FT; and (iii) all wire transfers that do not contain complete originator information.

(b) *Other Non-Prudentially-Regulated Sectors (Money Service Businesses)*

293. **MSBs have been subject to the ML Regulations since their initial passage, but there was previously no regulatory agency in charge of supervising MSBs' observance of the Regulations.** Effective November 2001, HMCE has responsibility to implement a "light touch" supervisory regime for MSBs. Although an important first step towards making the AML/CFT regime more effective for firms other than FIs, the regime is primarily geared towards registration of MSBs and increasing awareness of their obligations under the ML Regulations and AML/CFT laws. HMCE has begun a program of spot-check "assurance visits" that are primarily intended to ensure that procedural (documentation, posting, etc.) requirements are being observed.

294. **The considerations summarized above with respect to the ML Regulations apply equally to MSBs.** The following is additionally recommended to address MSB-specific factors: (i) consideration should be given to applying a "fit and proper" to MSB management and key shareholders, and to requiring MSBs to adopt employee screening procedures; (ii) HMCE should be authorized to deny or cancel the registration of an MSB in a broader range of circumstances than simply failure to provide information; (iii) the ML Regulations should be revised to provide for *civil* penalties for MSBs' failure to observe the Regulations' systems and controls requirements; (iv) the self-financing scheme for HMCE's supervision of MSBs should be kept under review to determine if it can reasonably be expected to produce enough resources to enable HMCE to carry out effective AML/CFT oversight of MSBs; and (v) industry groups representing MSBs should be encouraged to prepare relevant and comprehensive AML/CFT guidance for their members as quickly as possible.

Summary assessment against the FATF Recommendations

295. **The U.K. complies well with most of the FATF 40+8 Recommendations.** The only gap relates to Special Recommendation VII, as current U.K. laws and regulations do not require inclusion of originator information on funds transfers and related messages. In May 2002, the government issued for public comment a proposal to implement this requirement, with exemptions for certain wire transfers. However, given the subsequent issuance for comments of the proposed FATF Interpretative Note on Special Recommendation VII, the authorities have decided to await the final outcome of the FATF consultation before finalizing any new requirements in this area. Table 1 summarizes recommended actions in areas related to the FATF 40+8 Recommendations, while Table 2 contains other recommendations to further enhance the AML/CFT regime.

Table 1. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
40 Recommendations for AML	
Scope of the criminal offense of money laundering (FATF 4-6)	Correct definitions of ML under the ML Regulations to cross-reference current laws and delete obsolete references.
Provisional measures and confiscation (FATF 7)	Make effective as soon as possible the PCA provisions governing confiscation, seizure, assets recovery and civil recovery.
General role of financial system in combating ML (FATF 8-9)	Give consideration to adoption of a “fit and proper” test for MSBs.
Customer identification and record-keeping rules (FATF 10-13)	Implement the customer identification and record-keeping recommendations outlined above.
Increased diligence of FIs (FATF 14-19)	<p>Make effective as soon as possible the PCA 2002 provisions governing suspicious transactions reporting.</p> <p>Implement recommendations outlined above regarding suspicious transactions reporting and ongoing monitoring of accounts and transactions.</p>
Implementation & role of regulatory and other administrative authorities (FATF 26-29)	<p>Give consideration to adoption of the MSB-related recommendations outlined above</p> <p>Give consideration to designating competent authorities to ensure effective implementation of the ML Regulations for covered entities other than FIs and MSBs.</p>
Other forms of cooperation – Basis & means of cooperation in confiscation, mutual assistance, and extradition (FATF 33-35)	Adopt legislation to enhance statutory extradition procedures.
8 Special recommendations on terrorist financing	
VII. Wire transfers	Adopt legal requirements for FIs and MSBs: (i) to include originator information on wire transfers and related messages, and (ii) to conduct enhanced scrutiny of transfers that do not contain complete originator information.

Table 2. Other Recommended Actions

Reference	Recommended Action
Law Enforcement and Prosecution	<i>Give consideration to creating a national law enforcement organization with the dual mission of investigating criminal acts and foreign counter-intelligence.</i>
	<i>Give consideration to passing legislation that makes wiretap evidence admissible in judicial proceedings.</i>
	<i>NCIS or other competent authorities should undertake a U.K. trend analysis and vulnerability study of how and where money—especially cash—is laundered in the U.K., in order to focus priorities and successfully use the new PCA and Assets Recovery Agency powers successfully.</i>
	<i>Further train prosecutors and judges on ML and asset confiscation laws.</i>

Authorities' response

296. **The U.K. authorities welcomed the assessment that the U.K. complies well with the FATF 40+8 Recommendations, with the exception of Special Recommendation VII concerning the inclusion of originator information on wire transfers.** As the assessment acknowledges, the U.K. plans to legislate to implement this Recommendation when the FATF has issued an Interpretative Note clarifying some important details arising from this Recommendation.

297. **The authorities noted that many of the suggestions in the FSAP for further improvements would be implemented when the Proceeds of Crime Act is brought fully into effect in the early part of 2003.** The Assets Recovery Agency, which will commence operations on 24 February 2003, will focus on increasing criminal confiscation proceeds, implementing the new civil recovery powers, and improving training through the establishment of a new Centre of Excellence. A review of the arrangements for dealing with suspicious transaction reports was underway and the government intended to publish a national Money Laundering Strategy in 2003.

298. **The authorities said that they would consider the rest of the FSAP recommendations, some of which would require new legislation, against their general policy of applying AML/CFT controls on a risk basis, with the tightest controls and greatest resources focused on the areas with the greatest vulnerability.** Proposals for new measures would be assessed using cost-benefit principles. The authorities are not convinced

that some of the recommendations contained in the FSAP could be justified applying risk-based principles. However, they stressed that all aspects of the system are kept under review and changes will be made to it in the light of emerging evidence about vulnerability to money laundering and terrorist financing.

The authorities had the following specific comments on the recommendations:

- On *scope of the criminal offence of ML*, the definitions of money laundering under the 1993 Money Laundering Regulations will be updated when the Regulations are revised in June 2003, to implement the 2nd EU Money Laundering Directive. The U.K. authorities note that the current technical deficiencies in the definition have no practical effect on the ability to detect and prosecute money laundering.
- On *provisional measures and confiscation*, the referenced provisions will be made effective in the early months of 2003.
- On *general role of financial system in combating ML*, consideration will be given to the proposal here, but the U.K. authorities are not convinced, at present, that this would be proportionate to the money laundering risk in this sector.
- On *customer identification and record-keeping rules*, consideration will be given to all the suggestions. The basis will be whether they can be justified on cost-benefit principles given the extent of the vulnerability in these areas. Several of these proposals have been examined before and rejected because they have not been regarded as proportionate to the risk e.g. the risk of money laundering through general insurance business is generally acknowledged to be low. However, all these issues are kept under review.
- On *increased diligence of FIs*, the PCA 2002 provisions governing suspicious transaction reporting will be implemented on 24 February 2003. Consideration will be given to the suggestions on suspicious transaction reporting and monitoring of accounts and transactions, applying the risk-based criteria discussed above.
- On *implementation & role of regulatory and other administrative authorities*, the recommendations will be considered, applying the risk-based criteria discussed above.
- On *other forms of cooperation*, legislation is currently before Parliament to do this.
- On *wire transfers*, the U.K. will legislate to do this when the FATF Interpretative Note clarifying some details has been adopted by the FATF.
- On *law enforcement and prosecution*, the proposal for a national law enforcement organization raises issues that go well beyond the investigation of and collection of intelligence about money laundering. It would also require new legislation and fundamental changes in policing and intelligence collection. The assessors' comments are a valuable contribution to that wider discussion. With respect to wire-tapping legislation, there are good arguments for and against this suggestion which has been considered in the past and is kept under review. With respect to the proposed trend analysis and vulnerability study, NCIS is planning to conduct further analysis along those lines with contributions from partner agencies. On training of prosecutors and judges, such training programs are currently being arranged following the passage of the PCA 2002 and the new legislative provisions in these areas.