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UNITED KINGDOM

THE FUTURE OF REGULATION AND SUPERVISION

TECHNICAL NOTE

JULY 2011

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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Glossary

BoE	Bank of England
BCBS	Basle Committee on Banking Supervision
BCP	Basle Core Principles
CPP	Core Prudential Program
EFSB	European Financial Stability Board
ELA	Emergency liquidity assistance
ESMA	European Securities and Markets Authority
ESAs	European Supervisory Authorities
FCA	Financial Conduct Authority
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FPC	Financial Policy Committee
HMT	Her Majesty's Treasury
IOSCO	International Organization of Securities Commissions
IAIS	International Association of Insurance Supervisors
LTV	Loan to value ratio
MOU	Memorandum of understanding
PRA	Prudential Regulatory Authority
SEP	Supervisory Enhancement Program
SIFIs	Systemically important financial institutions
SRR	Special Resolution Regime

Executive Summary

The authorities have a comprehensive, considered strategy for a new structure of accountabilities and authorities to enhance prudential regulation and supervision, and for melding macro prudential (systemic) considerations with micro prudential regulation and supervision. They are aware of the risks, uncertainties, and issues in that strategy and have broad plans to address these. The proposals clarify accountabilities and mandates considerably from those in place currently, put forward a well-developed framework for coordination and cooperation, and go farther than in many other jurisdictions to determine how to meld macro- and micro prudential regulation and supervision. The notion in the proposals that failures of firms do not necessarily mean that the regulatory system has failed is very important. The mission was impressed by the high quality of resources being devoted by all the authorities to developing a coherent policy framework and sorting out implementation issues. There is a well-developed change management process in place at the Financial Services Authority (FSA), which is broadly on track. It includes appropriate project management disciplines.

The authorities assess the risks in the plan as medium-high, and the mission agrees; quality of implementation will be essential for success. A good part of the success of the strategy will depend on bringing together the different cultures of micro- and macro-prudential regulation and supervision in the Bank of England (BoE) and the Prudential Regulatory Authority (PRA). Both are important and both can benefit from the insights of the other. As well, bringing more market intelligence to prudential supervision and better assessing systemic aspects of market regulation and supervision are highly desirable, but will pose challenges. The authorities are aware of the need for continued attention from senior leadership to promote and model the desired interactions, cooperative behavior, division of responsibilities in practice, and constructive challenge. Proactive use of approaches, such as inter-agency work teams on specific issues and inter-agency secondments, could help in achieving success.

Important details of the proposed U.K. "triple peak" structure are specific to U.K. circumstances. The proposals flow out of U.K. experiences during the crisis, the regulatory and coordination structure the United Kingdom was starting from, and the structure of the U.K. financial system. Other countries will need to consider their own circumstances in meeting the goals for enhanced regulation and supervision endorsed by the G-20 and the Financial Stability Board (FSB), and may well adopt different specific approaches.

The new Financial Conduct Authority (FCA), with its broad remit, is subject to some of the lack of clarity present in the current mandate of the FSA. Ways should be found (such as greater clarity in how the remit of the various parts of the FCA are expressed or the internal senior management structure within the FCA) to ensure that market regulation and supervision, and prudential supervision of FCA firms, do not become diluted.

While the proposals have built in a variety of cooperation and coordination mechanisms, the experience in certain other countries suggests the need for a forum for formal and/or informal relationship building, cooperation, and coordination. These relationships will be necessary for effective operation of the framework, especially in a crisis. A clear locus for all regulatory agencies to interact might also assist the United Kingdom in interacting effectively with the new European Financial Stability Board (EFSB) and with the European Supervisory Authorities (ESAs).

The authorities have appropriately reduced significantly, or eliminated, the references in the mandates of the various prudential bodies to competition and competitiveness. As the package proceeds to adoption they should resist calls for reintroducing such concepts with the potential lack of clarity in the mandate they bring.

In the near term, an interim articulation of the macro prudential risk framework and policy assessment process will be useful. It may be desirable for the BoE, with support from the PRA and FCA, to set out that framework even before it is final, on the understanding that it will evolve with operation and with international progress on analyzing macro prudential issues and tools. Working to set realistic expectations of what macro prudential regulation can achieve is also very important to credibility.

There may be practical challenges in implementing the new governance arrangements to achieve the desired results. It will be important that practice during the interim period demonstrate to all concerned how these arrangements are supposed to work.

The authorities are developing a revised risk assessment and supervisory model for banking, building on existing and proposed FSA frameworks with the addition of key elements such as systemic importance and interconnections to risk assessments and assessing resolvability. In many ways, it is a continuation of the more- intensive approach that is already being implemented for major banks by the FSA. The Financial Sector Assessment Program (FSAP) noted the additional considerable work needed to implement elements of the existing framework for very-high-impact banks and the need (which the authorities recognize) to extend it to other high-impact banks and insurers.

The FSAP also recommended that detailed in-depth supervisory review work to confirm FSA assessments of the inherent risk and quality of risk management and risk governance be more frequent (see also Basel Core Principles ((BCP) assessment); other enhancements are also suggested. There is room to better focus supervisory activity on major areas of potential risk and risk-management deficiencies, to better integrate specialist and supervisory work, to simplify and enhance the usefulness of the ARROW risk model, and to de-layer and better integrate the various supervisory processes to free up more time for focused supervisory work, which could also result in further enhancement in the clarity of messages to bank senior management and boards. Moving to a single-purpose prudential organization in the PRA provides an opportunity for more senior management engagement on prudential issues on an ongoing basis.

The authorities need to ensure they are not seeking false precision in these new systemic add-ons. The frequency of doing full assessments of these systemic modules in the steady state mode (as well as the frequency of recent initiatives, such as cross-system stress tests conducted by the authorities) should be considered. Knowledge and information on network impacts, while well worth pursuing, is not easy to assemble or analyze, and there is a very important international dimension being considered by other bodies. So the authorities need to be realistic about the time frame for major enhancements.

The new approach to macro prudential analysis, resolvability, and the new Special Resolution Regime (SRR)—as well as the possibility of requiring material capital buffers—does not reduce the need for intensified supervision (as started by the FSA) that focuses on effectiveness of risk management and governance, as well as on capital and liquidity. That focus on "not yet problem" banks is important to increase the chance of catching early indicators of material future problems that might otherwise test the capital, liquidity, and resolution regime.

The proposals also include a proactive intervention framework, which the mission supports. It is flexible and promotes early action to reduce the likelihood of material problems developing. It also deals with action steps in advance of the time for recovery or resolution, including coordination actions by the various authorities that need to be involved. It would be desirable for legislation to include a reference to proactive early intervention in relevant mandates to support the supervisory culture desired.

The mission discussed resource requirement issues as part of the FSAP. The authorities should define the desired supervisory operating model, decide how much more enhanced in-depth supervisory reviews are needed to gain adequate assurance, determine how the macro-overlay will work, decide on the desired frequency of cross-system stress testing, determine the economies from supervisory process improvement, and focus and form better IT and analysis of more granular data from banks. This will allow for a better assessment of resource requirements. While the mission is not in a position to do a detailed analysis of resource requirements and possible efficiencies, its strong sense is that the timely completion of already-planned enhancements of regulation and supervision, the new initiatives from macro prudential overlay, other new initiatives such as assessing resolvability, and other recommendations from the standards assessments, such as more frequent, proactive detailed supervisory reviews, will necessitate the enhancement in the resources (some combination of enhanced skills and more persons) beyond that already planned. It is also essential that the new macro overlay not draw away resources from the needed enhancements in micro prudential supervision, which have been identified but not yet fully implemented.

I. INTRODUCTION[1]

1. **While the U.K. financial system was impacted in the crisis by factors that affected many countries, the U.K. government also concluded that there were significant failings in the U.K. regulatory and supervisory framework.** In particular, the White paper of July 2010 (A New Approach to Financial Regulation: Judgment, Focus, and Stability) concluded that the previous 'tripartite system,' involving the BoE, HM Treasury (HMT), and the FSA failed to: identify problems building up in the system; take steps to mitigate them before they led to significant instability; and deal adequately with the crisis when it broke, especially in the latter half of 2007. More recently, the supervisory framework and supervisory intensity is being enhanced (following the Turner Report) and authorities report that cooperation and coordination in resolving banks is working well. The FSAP mission concurred.

2. **In response to identified weaknesses, the U.K. government decided to overhaul the domestic institutional framework for regulation and supervision.** Accordingly, the existing tripartite regulatory regime will be dismantled; the FSA will cease to exist in its current form; and a "three peak" structure will be put in place by end-2012; specifically:

- *A new prudential regulator, the Prudential Regulation Authority (PRA),* a subsidiary of the BoE, will carry out the prudential regulation of financial firms, including banks, investment banks, building societies, and insurance companies;
- *An independent Financial Policy Committee (FPC) will be established at the BoE,* with responsibility for regulation of stability of the financial system as a whole;
- *A new Financial Conduct Authority (FCA) will regulate the conduct* of authorized financial firms providing services to consumers. It will also be responsible for ensuring the good conduct of business in U.K. retail and wholesale financial services, market regulation, and prudential regulation of smaller entities.

3. **The authorities place high importance on these changes for maintaining financial stability going forward**. This will include giving the FPC powers over certain prudential tools that are specific, subject to U.K. national discretion under EU directives, and focused on system-wide rather than firm-specific characteristics. The current plan proposed for consultation include the countercyclical capital buffer under Basel III, the overall

[1] This note was prepared by Nicholas Le Pan, technical consultant to the IMF and former Superintendent of Financial Institutions in Canada and Göran Lind, Adviser to the Board at the Swedish Riksbank. Mr. Le Pan and Mr. Lind also participated in BCP assessment meetings and crisis management meetings, and review of BCP assessment documentation relevant to considering the new arrangements, held meetings with senior decision makers involved in the proposals, implementation teams, and outside commentators. While this note is prepared by technical consultants to the mission, it has benefitted from comments from the whole mission team.

leverage limits, and variable risk weights for a class of assets, margin or haircut requirements, and possible cyclical changes in minimum liquidity ratios. The FPC will also be able to require the PRA (and the FCA) to undertake systemic stress tests or conduct them itself. The FPC will also have the important responsibility of making public recommendations to HMT for adjustments in the regulatory perimeter and in the FPC toolkit, so that systemically important institutions are appropriately regulated and the toolkit can be adjusted as needed with experience.

4. The proposals were not finalized at the time of the mission, but are expected to be fully in place starting in 2013. Following the comments received on the initial HMT paper, there has been ongoing discussion among the authorities to specify the proposals. A further consultation paper containing more detail, and elements of the draft legislation, was released in February 2011. Legislation will be finalized and presented to parliament later in 2011. Amendments may occur in that process. The target is passage of legislation in 2012, in time to permit formal impleme**ntation at the beginning of 2013.**

5. **In the meantime, the FSA and BoE are gearing up as much as possible for a trial run implementation of the proposals, consistent with current law. For example, the FSA has started to implement internally two interim organizations mirroring the expected spl**it of its functions into prudential and market conduct regulation and supervision. The implementation within the FSA was not fully in place at the time of the mission. An interim FPC has also been set up, including the appointment of external members, though it had not commenced operating at the time of the mission.

6. **Some of the initiatives link closely to specific elements of the Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), and International Organization of Securities Commissions (IOSCO) standards assessments, which are also being conducted as part of the FSAP and could affect future assessments.** How the restructuring is done could affect future compliance with international standards.

7. **The HMT proposals also begin to implement some of the more forward-looking parts of the FSB agenda.** In particular, they implement macro-prudential regulation, a contributory systemic stability role for micro prudential and conduct regulators, and issues relating to systemically important financial institutions (SIFIs) such as recovery and resolution plans.

8. **While the proposals affect both prudential and market conduct regulation in the United Kingdom, the focus of this technical note is on the prudential and systemic regulatory aspects of the proposals.** A separate FSAP technical note considers the crisis management arrangements.

9. **This note does not evaluate the decision to rearrange the regulatory and supervisory responsibilities broadly along the lines indicated.** Nor does it analyze the

U.K.-specific causes of the crisis. The comments in this note are based on relevant criteria in the BCBS, IOSCO, and IAIS core principles, the experience in other countries that the FSAP team is aware of, the observations of how the system is operating now, and emerging criteria for effective regulation and supervision from the FSB.

10. **This note considers the proposed regulatory arrangements, focusing on the stability and prudential aspects, and taking into account the current international standards, practice and analyzing success factors and possible impediments and risks. It is not a comprehensive assessment.** In certain areas, it makes observations/recommendations to the authorities of matters they may wish to consider. In developing observations, the team has considered at a high level: the extent to which authorities are aware of various issues and have reasonable plans to address them; the extent to which the new proposals are likely to facilitate improvements or create impediments in meeting their objectives; whether there is evidence that success factors are in place; and, the extent to which there are mitigants planned or in place for the various risks in the proposals.

The authorities have concluded that some aspects of the U.K. regulatory and supervisory system failed. However there are also material parts that did not fail, are working well or are leading edge, or are being remediated, and need to be preserved in the new arrangements. These include a well-developed focus on stress testing, leading practice in setting individual bank capital and liquidity guidance, and the enhanced supervision approach under the Core Prudential Program (including greater use of risk specialists, more detailed reviews, and enhanced focus on business models, risk management, and governance) that is under development and being implemented over the next few years. Supervisors the mission met demonstrated a good understanding of the banks they supervise, including their culture and how regulators can effect change in the institution, if necessary. This is essential to an effective supervisory program. Other aspects that should be preserved are highlighted in the material that follows.

II. CONSIDERATIONS

11. **The specific goals of the new arrangements are to:**

- Create a dedicated focus on macro prudential analysis and action with responsibilities and tools aligned.
- Introduce a new more-judgment-based approach to regulation/supervision of individual firms capable of challenging business models, identifying risks and taking action to preserve stability
- Eliminate gaps in which responsibilities are unclear.

- Establish a dedicated specialized and focused body with clear objectives and functions for conduct of business/market integrity regulation and supervision (including its own culture distinct from other U.K. bodies).

12. **The authorities assessed the risk in implementation of these proposals to be medium-high**. This is partly due to the long and uncertain timing, coupled with uncertainty about how key elements will work in practice. As well, leadership for effective implementation and change management are also facing other demands coming from remedial programs already started, and from the domestic U.K. and international regulatory policy agenda. Given recent resignations of some senior, experienced staff, there are uncertainties about what the full leadership team will be, though progress was continuing to name individuals to key positions, especially within the shadow PRA.

A. Mandates

13. **The government proposes to clarify the mandates of the various authorities.** Standards assessments for this FSAP found the current prudential mandates to be less than clear. So the mission supports the basic thrust to clarify them. The PRA's statutory objective to focus on promoting system stability and safety and soundness, including minimizing the impact when firms fail, is very different to that of the FSA and a new supervisory approach will be introduced to deliver on the objective.

14. **Clarity of mandates for the various organizations involved in financial stability is essential to achieve desired objectives.** Mandates from legislation are not changed often and are a signal of the behaviors and outcomes expected. Clear mandates link to internal and external performance measures and accountability. In the United Kingdom the legislated mandates (called the regulatory objectives) play a more important role in performance than in other countries. In particular, certain specific actions that the FSA can take under the legislation require a determination of whether individual firm's actions are or are not contrary to the regulatory objectives. This will be similar for the PRA and FCA going forward.

15. **The FSA mandate did not explicitly mention prudential supervision and this is much more clearly set out in the proposed mandate of the PRA.** The mission concurs with the authorities' assessment that lack of clarity in mandates and expectations was a contributing factor to the regulatory failure leading up to the crisis. The lack of clarity in certain specific aspects of the existing mandates allowed the 'light touch' ethos to grow, though the FSA did not generally use that term. The mission supports the proposed mandate changes. However, there are some features of the proposals that need consideration, as set out below, in order to maximize the likelihood of success in achieving the desired result.

16. **Legislated mandates in other jurisdictions have been important in having parliament recognize what authorities cannot be expected to achieve.** In particular,

failures of financial institutions do not automatically by themselves mean that the regulatory or supervisory system has failed. Experience elsewhere suggests that this bears repeated emphasis by regulators and policy makers if it is to have a chance of becoming better understood.

Bank of England and Financial Policy Committee Mandate

17. **The BoE's existing financial stability mandate is to be amended to state that "an objective of the Bank is to protect and enhance the stability of the financial system of the United Kingdom."** Legislation will make clear that, in pursuing this objective, the BoE shall aim to work with HMT, the PRA (which is part of the BoE group), and the FCA. The FPC will be a committee of the court of the bank with a mandate to contribute to the achievement of the financial stability objective of the bank. Its legislative responsibility is to relate primarily to identification of systemic risk, monitoring of and taking action to reduce or remove systemic risks, with a view to protecting and enhancing the resilience of the U.K. financial system. For this purpose, systemic risks include those attributable to structural features of the financial markets (including the payments infrastructure) or the distribution of risk within the financial sector, and unsustainable levels of leverage, debt or credit growth. In addition to tools such as specific warnings, regular publication of financial stability reports and making recommendations or directions to the PRA and FCA, secondary legislation will detail specific tools available to the FPC, such as invoking the Basel III counter-cyclical capital buffer, changing risk weights, and changing leverage limits.

18. **The government has considered how to balance the financial stability objective with the need to consider other factors such as contribution of the financial sector to economic growth.** It has appropriately rejected various possibilities, such as requiring the BoE or the FPC to balance several primary objectives, or have regard to specific factors such as lending to support economic growth. Rather, the proposal is that the legislation make clear that the financial stability mandate "does not require or authorize the FPC to exercise its functions in a way that would, in its opinion, be likely to have a significantly adverse effect on the ability of the financial sector to contribute to growth over the medium or long term." This approach also has the advantage of recognizing that financial stability and sustained economic growth are not necessarily opposed.

19. **The proposed approach has the benefit of not trying to be overly-precise about the role of the FPC or the BoE, and thus raise expectations that cannot reasonably be expected to be fulfilled.** This cautiousness is appropriate, given that what macro prudential regulation can achieve is an unknown at this stage of its development in the United Kingdom and elsewhere. For the credibility of the regime, which is important to preserve and promote, the temptation to over-promise should be avoided. As further experience and thinking evolves in the United Kingdom and internationally as to how macro prudential tools operate, it will be open to the BoE or the authorities jointly (including through the possible public remit letter from the Chancellor to the BoE) to issue periodic statements about how they plan

to operate the financial stability mandate in practice. This approach allows flexibility and further detail to be provided, which may be important for conditioning market expectations and for accountability.

20. **In setting out the decision-making authorities, the proposal is clear that decisions on prudential or conduct rules and individual supervisory decisions are the responsibility of the PRA or FCA respectively, not the FPC**. It is also proposed that the FPC not be involved with individual decisions the BoE may make with respect to emergency liquidity assistance (ELA) or use of resolution tools. As a practical matter, that also means that the FPC will not be the lead on crisis management. The proposals rightly recognize that, given the concentrated nature of the U.K. financial system, macro prudential decisions may affect a handful of firms (and conversely micro prudential decisions relative to a few firms might have macro prudential consequences). This will put a premium on effective cooperation mechanisms among the authorities.

21. **One of the goals of the FPC is rightly to deal with more structural (rather than cyclical) macro prudential tools.** An example (had it existed at the time) would have been spearheading the drive that started a few years ago to move certain derivative products onto exchanges. Another might be adjustments in the capital requirements for high-LTV lending. Here, the trade-offs are likely to be with other socio-economic policy goals, and with issues of cost competitiveness of institutions and markets. An effective consultation process with those charged with economic policy more generally, and with industry, for structural changes that have longer lead times would be a way to manage legitimate policy trade-offs in this structural space. Of course, in cases where effectiveness requires very quick implementation of the FPC recommendation waiver of normal consultation requirements is possible.

22. **The FPC will have powers of recommendation or direction with respect to the PRA and the FCA. In the case of recommendations, the other authority will have to comply or explain in writing to the FPC why it has not done so.** The FPC also has powers to make recommendations to HMT on changes to the regulatory perimeter, the dividing line between the PRA and the FCA, and the FPC's toolkit. As well, the PRA will have the authority to veto FCA decisions that it considers are likely to lead to disorderly failure of a firm or wider financial instability, and the PRA must notify parliament of use of this power and set them out in the annual report. It is expected that this power would be rarely, if ever, used, and that the FCA and PRA would normally be able to coordinate their actions to meet their respective mandates.

23. **There are a variety of responsibility and accountability issues, and unintended consequences, including intruding on others' remits, inherent in the directive power that the FPC will have over the PRA and the FCA.** The government is aware of these. It proposes that the macro prudential toolkit be specific and focused on system-wide aspects rather than on individual firms. Naturally, however, individual directions may materially affect individual firms. It is possible that some of these directions could be counter to

immediate prudential goals for those firms. The FPC will consult with the other bodies before issuing a direction, including in the meetings of the FPC.

24. **Macro prudential policy and monetary policy may interact.** (In the long run, their goals do not conflict, but in the short run there may be situations of trade-off). Decisions on one ought not to be mixed in with the other or accountability will be blurred. So the separation of the FPC from the MPC is understandable. However, there may be a need for the FPC and MPC to be aware of each other's thinking. The consultation paper proposes that the governor chair both, and that careful staging of meetings occur, with the MPC likely the body that 'acts last,' taking account of the other's actions. Occasional joint informal contact could be desirable to exchange views (not for decision making) and should not be precluded.

25. **It is normally assumed that the flows go one way—information from the PRA/FCA to the FPC and decisions/recommendations from the FPC back to the PRA and FCA; that may not always be the case.** The PRA and FCA should be encouraged to believe that they can raise macro prudential or systemic issues that they believe are important, and ask the FPC to support certain system-wide actions that they plan to take. That could assist the PRA and the FCA in getting wider support for important financial stability initiatives. That also means the PRA, for example, needs to maintain sufficient financial stability staff to participate effectively with the BoE and support the FPC. While a key systemic input from the PRA into the deliberations of the FPC will come from line supervisors, this is likely to benefit from the involvement of a limited number of PRA financial stability staff, who can liaise between micro and macro prudential matters.

PRA Mandate

26. **For the PRA, the government proposes its primary strategic objective will be "to contribute to the promotion of the stability of the U.K. financial system" and its operational objective will be "promoting the safety and soundness of PRA authorized firms."** The legislation is intended to also make clear that this includes minimizing any adverse effects that the failure of the firm could be expected to have on the U.K. financial system. It is proposed that, as currently, the PRA will have a number of factors it must consider in carrying out its mandate (the "have regards"). But important changes in the 'have regards' are proposed, as discussed below, that will aid in ensuring that the mandate is materially clearer than currently.

27. **The mission supports the two major thrusts of the changes.** The first is to make clear the PRA's focus on prudential regulation and supervision, and the second is to explicitly recognize the possibility of failure of firms and the PRA's contribution to minimizing the disruption of that occurring, without failure of firms being considered per se evidence that the PRA had failed.

28. **There appears to be no reference to proactive, timely intervention currently being proposed for the legislated mandate.** The FSB suggests such a reference is desirable

and the authorities should consider adding it. The changes that are in the process of being introduced within the FSA and the BoE in response to the crisis are bringing that attitude more to bear, and they should be carried over and supported in the new structure. The mission understands that the authorities intend to implement some form of prompt intervention regime, which would properly be set out in rules or procedures or policy statements about how the authorities will use their powers.

29. **However, experience in other jurisdictions indicates that early intervention to deal with actual or potential material safety and soundness issues, before they cause irreparable harm, requires more than a prompt intervention regime, particularly for larger banks.** It requires a mindset and culture of supervision and regulation. Effectiveness will sometimes require action at a time when conditions appear to be robust, but underlying risks are building up and some players are going beyond prudent behavior and will often strenuously resist intervention in their affairs. Having high-level parliamentary recognition of early intervention can be important to regulatory and supervisory credibility.

30. **The initial HMT consultation paper asked for views on the desirability of keeping the 'have regards" for the PRA related to the impact of regulation on innovation or competitiveness of the U.K. financial services sector.** Such references are rare in legislative mandates of prudential regulators. The mission concurs with the government view that there is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to acceptance of the "light touch" orthodoxy (though the FSA did not regularly use that shorthand), further supported by the view that financial innovation should be encouraged at all costs. The mission understands that some in the industry are supportive of keeping such references.

31. **Keeping competitiveness factors in the legislation for prudential regulators, or similar wording as some have proposed, would be a material source of lack of clarity as to what the prudential regulator was supposed to do.** It would also be unclear how the balance should be set in individual operational issues between the overarching objective and the 'have regards.' This might hamper effective and speedy intervention. So, the mission strongly supports removing those from the legislation as now proposed. An effective governance and consultation process, including inter-agency discussion as necessary, is an example of alternative ways of dealing with the legitimate concerns about how trade-offs will be made.

32. **Having regulatory principles that the PRA must have regard for, such as economical and efficient use of resources and proportionality, are understandable.** For the reputation of the authorities, it will be important that proportionality not be interpreted in a way that results in inadequate detailed supervision of smaller firms or firms that are not considered systemic.

33. **It will also be important that the PRA maintain adequate enforcement capability**, either through relying on the FCA enforcement capability, or (more desirably) developing its own reduced permanent enforcement capability, which can then draw on outside resources to supplement as necessary from the market or from the FCA. It is not envisaged that the PRA will need or want to use formal enforcement powers very often.

FCA Mandate

34. **The government's intention is to give added prominence and focus to conduct regulation building on and extending the FSA's recent, more proactive, approach.** The proposed FCA's objective is to protect and enhance confidence in the U.K. financial system. Its operational objectives are proposed to be facilitating efficiency and choice in the market for financial services, securing an appropriate degree of protection for consumers, and protecting and enhancing the integrity of the U.K. financial system. As an extension of the enhanced FSA approach, the FCA is intended to be more willing to intervene in the early stages of a product lifecycle to deliver improved outcomes for consumers. It is in this sense that the FCA is designed to be a 'consumer champion' (without becoming an advocate for consumers)—a balance that may prove challenging in practice. The FCA will be able to, and is expected to, take action to promote competition in pursuing its objectives.

35. **It is intended that the FCA has strong markets regulation and enforcement functions.** Consideration should be given to the explicit mention of markets regulation matters, such as transparency and integrity of markets, in the FCA statutory objectives, making sure that there is a senior executive clearly responsible for markets regulation and supervision, and that there is markets regulation expertise on the FCA Board. The markets regulation and enforcement functions will largely be carried over in their entirety from the FSA. It is intended that the FSA's credible deterrence approach and enhanced use of specialist resources will be continued in the FCA. The FCA will have the U.K. seat on the European Securities and Markets Authority (ESMA). It is essential that the wholesale market integrity mandate be well executed and properly resourced. The IOSCO standards assessment broadly concluded that was the case currently, though there are some areas for improvement. The role of 'consumer champion' may easily be misinterpreted for these markets. There is a risk generally that market regulation will be regarded as the "poor cousin" in the new arrangements. That could repeat the issue that arose with the FSA, where a generally-worded mandate contributed to some functions getting less than desired attention. Consideration should also be given to making sure that the FCA is clearly involved in market infrastructure regulation (which will be led by the BoE), with respect to market integrity matters, with sufficient statutory basis to ensure its workability.

36. **At the time of the mission, thinking was understandably at an early stage on how the proposed involvement of the FCA in competition matters and the FCA prudential supervisory model would operate.** Given the mandate of the FCA, there is the potential for different prudential cultures and supervisory processes to evolve from that in the PRA. If

differences are material this may lead to various undesirable outcomes. For firms that are close to the dividing line between the FCA and PRA it will be important to guard against possible market distortions and impacts on firm behavior.

B. Governance and Accountability Framework

37. **Extensive thought has gone into the design of governance arrangements, but effective implementation and operation will be essential to success.** The FPC is to be a sub-committee of the BoE's existing court, chaired by the governor. It will have independent members (but they will not be in the majority) as well as senior BoE staff and the heads of the PRA and FCA. The PRA will continue to be governed by a board, chaired by the governor, with membership from the BoE, and with a majority of independent members. It will be accountable to ministers and parliament for the use of its statutory authorities, which is not intended to be affected by its status within the BoE group. However, the strategic plan and remuneration policy, as well as remuneration of executive members will be set by the Court. The FCA will be governed by an independent board, similar to the current FSA arrangements, with a majority of independent members.

38. **In addition to the governor, cross-appointments are also to be used more than might be found in other jurisdictions, but these are not likely a substitute for effective cooperation mechanisms.** The CEO of the PRA will also be a deputy governor of the BoE and a member of the FPC. The CEO of the FCA will also be on the FPC. The deputy governor for financial stability at the BoE will continue as a member of the PRA Board. The heads of the PRA and FCA will be on each other's boards. While this may promote greater understanding of other's mandates, it may put individual members in difficult circumstances vis à vis certain decisions. The proposed solution of not having the CEOs exercise voting authority on firm-specific decisions appears reasonable to help preserve independence:

- These arrangements may also raise questions on the degree of independence and separate accountability of the PRA. It is likely that future standards assessments of these issues will depend heavily on actual practice in judging whether there is operational independence.

- As well, as noted below, participation on other authorities' boards will occur in a formal setting, and often with independent members. This may therefore not be a substitute for a locus where formal and informal cooperation and coordination among the authorities can be encouraged, and differences dealt with effectively.

39. **The PRA is to continue to be run (as is the BoE) on sound governance principles and with "appropriate" independence and with oversight by the Court of the BoE. It is intended that the PRA be operationally independent in its supervisory decisions.** This means that all PRA decisions should be taken by the board or under board-delegated authority and should be only in pursuit of PRA objectives. At the same time, the desire is for

closer cooperation between the macro and micro prudential work and close cooperation in the event that serious problems arise. There may be a challenge to make this operational in practice in a model in which the PRA is a 'semi-autonomous' subsidiary of the BoE, and in which the senior BoE and PRA staff (including the governor) has several formal roles. Indeed, part of the success of this model will be to allow much closer coordination in dealing with financial stability issues, including in a crisis. This, by itself, need not lead to independence and accountability problems provided the roles, contributions, and accountabilities of the various parties are clear, understood and respected. Individuals will have to be mindful of the capacity in which they are acting. That will depend on practice. There will be a wide range of issues in which macro-prudential and micro-prudential interests are aligned. But there may be occasional, and important situations in which they are not.

40. **The government has indicated that PRA Board members (including non-executives) will take significant roles in critical firm-specific decisions, in addition to setting rules, which they do currently.** This could have implications for the composition of the PRA Board (e.g., in avoiding conflicts) and how it operates. It may be desirable to consider informally in advance how persons with multiple roles would be expected to act in those various roles, especially in cases of difference in priorities between the various bodies on which they sit. The Nominations Committee of the Court will advise on executive appointments. Appointments to the PRA Board will be made by the BoE with the approval of HMT. HMT will name the CEOs of the PRA and FCA. The proposed relation between the court and the PRA Board will be further elaborated by the PRA and the BoE.

41. **The approach to budgets and remuneration of the PRA may prove problematic for independence, clarity of accountability and appropriate PRA governance.** The role of the PRA board and executives in supervisory decisions should be clear. It has been proposed that the budget and remuneration of the PRA be set by the court of the BoE, on the recommendation of the PRA. This is to ensure the most efficient use of the wider Bank Group's resources. While this is a normal function of a parent company's board with respect to a subsidiary, the situation with regulatory agencies is not fully analogous, given international standards about the agency with supervisory accountability having adequate resources and sound governance. It is also not fully analogous in that the subsidiary (in this case the PRA) has a specific mandate independent from the parent (the BoE). For example, the Court now contains a majority of non-executive directors, some of whom appear to be current financial industry participants. This sets up the possibility of real or perceived conflict and independence issues (which might also be an issue in future FSAP standards assessments). This is covered in the existing BoE Act, which requires members of the Court to recuse themselves in case of conflict. As well, if the PRA Board was to be limited in its determination of budgets and remuneration of PRA executives, it is not clear how a key element of governance will work in practice for the non-executive directors. They will continue to be involved in approving PRA rule changes as the Board now does for the FSA. The proposals mean they may be more involved than in the past in assessing the

effectiveness of individual PRA decisions, and some (or all) may be actively involved in actual supervisory decision making (perhaps in an advisory capacity). These arrangements may prove difficult in practice. It will be important that there is clarity in the roles of non-executive directors and that does not result in their assuming the roles of the executives in PRA supervisory decision making.

42. **Allocating senior executives' time effectively will be important.** It is understandable why the Governor is to chair the FPC, MPC, and the PRA Board, and why Board cross-appointments are part of the structure. Indeed, that would help to establish the legitimacy of the PRA within the BoE group. However, it will be essential to ensure that the Governor and other senior executives have sufficient time for all these duties on a regular basis.

43. **If coordination is not working, it would be the responsibility of the regulators to work it out. HMT, as overall "owner" of the new framework, should take responsibility for monitoring how the new arrangements are operating in practice and deal with any material issues that arise.** That need not require major resources, but should involve a few senior people maintaining close links with the various authorities and with the industry.

44. **Accountability arrangements include material public reporting.** Financial stability publications will continue as will other existing public reporting (such as strategic/business plans and priorities statements). Directions of the FPC will be reported to HMT and to parliament, as will PRA overrides of FCA measures. Public consultation on PRA/FCA initiatives will continue as currently (including for those macro prudential measures implemented at the recommendation of the FPC). However, it is proposed that there be additional flexibility to allow for other approaches when the FPC directs the PRA or FCA. These could include policy statements by the FPC as to how it expects the tool to be used, and the possibility of HMT switching off or modifying the requirements for regulators to consult. While it is understandable to have this flexibility, it will be important that the FPC be seen to be as transparent in its decision framework and possible use of tools, so that markets react in ways that make the tools effective. Experience in developing communication tools for price stability objectives may offer useful insights in this regard.

45. **There will be a new legislative requirement for the regulator to report to HMT where there is a "regulatory failure," addressing actions, decisions and lessons learned for both firms and the regulator.** This report will be laid before parliament. Post mortems can be a very useful tool for ongoing enhancement of a regulatory and supervisory system. However, it is important to recognize that not all failures of institutions represent a regulatory failure. The authorities understand the usefulness of these reports but recognize that the difference between regulatory and firm failure should be better understood.

C. Framework for Cooperation and Coordination

46. **Balancing the enhanced focus of individual authorities with the checks and balances, and coordination needed on an ongoing basis and in a crisis will be key success factors of the new arrangements.** The proposed system rightly includes greater clarity and accountability about the specific powers and responsibilities of the various regulators. It also includes the FPC as a new body focusing on financial stability more broadly, which the government concluded was missing from the previous arrangements. It is inevitable that the mandates and operations of the various authorities will interact to some degree. The authorities have given considerable thought to the communication and coordination issues involved on an ongoing basis and in times of crisis.

47. **One issue is the ongoing coordination between the macro financial stability objectives and the micro prudential operations of the PRA and FCA (considered in the macro prudential section below); there also is a need for cooperation between the PRA and the FCA in the ordinary course of business.** Both may be involved in particular files (e.g., approvals of transactions or SIFI approvals). Both will be conducting prudential supervision. Actions of one could affect the other's ability to achieve its mandate, although it is likely to be a rare occurrence that the actions of one would prevent the other from achieving its mandate. Lastly, there is the issue of coordination in a crisis.

48. **For cooperation and communication to work effectively, the various financial stability authorities need timely access to each others' information.** This is now managed through legal "gateways" specified in legislation and regulations. These have been reviewed based on recent experience to ensure that they are adequate. To preserve maximum flexibility and responsiveness between authorities in a crisis and to foster a culture of mutual trust, the bias should be for maximum access to each other's information. Discussions with the authorities indicate that the existing and proposed legislated powers appear appropriate to ensure this result. They also ensure that information can be collected about activity beyond the regulatory perimeter that is relevant for financial stability purposes. In practice, it would be expected that the FPC will receive information and analysis from the PRA (including information on trends in "problem" or "watch list" institutions and information on securities market developments from the FCA, which may have system-wide implications. Information from the BoE on market and financial stability developments and banks' participation in various payment clearing and settlement systems, and BoE facilities, will be useful to the PRA.

49. **The government proposes legislation that would impose a general duty to coordinate on all of the authorities.** This is preferable to statutory requirements to take others' mandates into account, which was previously suggested. A requirement for various MOUs, including how they will deliver the duty to coordinate and day-to-day coordination will be in legislation. These MOUs must be published, reviewed annually, and laid before Parliament. Cross-appointments are also designed to promote cooperation. Legal

requirements for coordination between regulators will also be built into certain processes, such as the approvals and rule-making functions. The HMT paper indicates that the legislative requirement to consult will have three main elements: where the PRA or FCA are considering action that may 'materially impact' on the other's achievement of its objectives, they must consult; the PRA and FCA must consult in order to take advantage of each other's expertise; and both the PRA and FCA will be under obligation to manage their processes congruently and efficiently. There are obvious issues of interpretation in these provisions, but it appears reasonable to leave the details up to the presumed high degree of cooperation between the authorities and the proposed MOUs, so as to preserve operational flexibility. However, the heads of the PRA and FCA could consider a periodic process to assess how the arrangements are working in practice, with input from regulated firms.

50. **In any regulatory system, cooperation and coordination is essential, based on openness and trust, understanding and respect of each other's mandates and willingness to find solutions that meet as much of the needs of all concerned, for the broader good.** That requires a significant investment of time by senior leaders and their setting the tone for others. That is particularly important where the culture of decision making differs between organizations, as will be the case here. (For example, macro prudential decisions will likely not be frequent and will have potential material consequences for the system. On the other hand, a micro prudential supervisor makes more frequent individual firm and system-wide decisions). It is not possible to legislate cooperative behavior. Ongoing movement of people between organizations and use of inter-agency work teams on specific initiatives can assist in building the cooperation/coordination culture.

51. **The danger in the proposed arrangements is the diffusion of coordination and communication efforts.** It is also not clear what the formal or informal coordination mechanism involving all the authorities, during normal times and in a crisis, may be. A crisis management MOU is planned which will set out how authorities will interact in a crisis. There will also be an MOU on how the authorities will coordinate their international activities. However, there appears to be no one forum where all the key senior regulatory decision makers can focus on relationship and trust building, and the sharing of information and issues, which is necessary for success in coordination and cooperation, including in a crisis. Such a forum need not be formal. If it mirrors the structure of emerging European financial stability bodies and ESAs, it might also assist the United Kingdom's coordinated participation in such bodies. Such a forum could also be useful to identify issues at an early stage (in normal times and in a pre-crisis and crisis period) and provide an opportunity for early discussion among the authorities of possible actions.

52. **The government also proposes certain specific coordination mechanisms between the PRA and the FCA.** One is the interaction between the PRA and the FCA in the case of a potential systemic failure. Essentially, the PRA would be able to veto actions by the FCA that would lead to the disorderly failure of a firm or wider financial instability (both the PRA and the FCA have authority to wind up an authorized firm, though only the PRA can

trigger the special resolution regime). The fact of the veto would have to be disclosed to parliament. This could lead to various accountability issues between the FCA and the PRA. Such a veto should be expected to be used very sparingly. The authorities should consider requiring that any potential veto be consulted on an expeditious basis with the FPC before it is issued.

53. **Coordination in the authorization and variation of permissions processes will also be required.** In cases where a firm is both a PRA- and an FCA-regulated entity, the government proposes that both the FCA and the PRA would have to provide necessary authorization, but mentions other options. Various coordination mechanisms to minimize inefficiencies in the joint authorization process are proposed. Similarly, and understandably, it is proposed that each authority retain the power to vary its permission, which is a key intervention tool. Again, the PRA would have authority to override such actions by the FCA where they would lead to disorderly failure. Whatever is ultimately decided, future standards assessments will want to ensure that each regulator can meet their mandates and the standards requirements.

54. **It is proposed to split lead responsibilities for approval in dual-regulated firms.** Accordingly, the PRA would have the lead on functions related to prudential matters and the FCA on matters relating to interface with customers. It is proposed that the lead would consult with the other in areas of interest but would have the final say. Both regulators would retain authority to ban an approved person working in a regulated firm. Given the importance of the approved person's regime to the U.K. regulatory and supervisory structure, a possible alternative could be to adopt a system of dual approval for certain key positions, with coordinated and harmonized information requests and assessment processes.

55. **The consolidation rules and the new structure will result in the PRA being the consolidated supervisor for major U.K. bank and insurance groups**. Where the supervision of authorized entities in the group is split between the PRA and the FCA, they will be expected to coordinate. There will be new powers of direction by the consolidated supervisor over other supervisors with respect to the authorized entities they supervise and over unregulated holding companies of groups. It will be important that these arrangements work effectively in practice to allow comprehensive consolidated regulation and supervision of financial groups, including necessary access by the group supervisor to all entities in the group for the purpose of assessing safety and soundness.

III. Macro-Prudential Policies

56. **Having the macro financial stability insights of the BoE and FPC available to micro supervisors could contribute effectively to the micro prudential work.** In turn, the authorities are appropriately planning to retain their own (reduced) financial stability expertise, so that they can effectively pull together their micro prudential information in ways that inform their own mandates and the FPC.

57. **The authorities are aware of challenges in designing and implementing a macro prudential framework.** A particular consideration is that use of systemic risk measures can be expected to be infrequent, thus complicating the assessment of appropriate timing and effectiveness (it is difficult to calibrate measures based on experience). Another challenge is that systemic risk analysis is often about the tails of the distribution of outcomes, which models have a great deal of difficulty in handling and which tend not to be the focus of other macro-economic or monetary policy work. As there is currently considerable uncertainty about when various factors, such as leverage or credit build ups, are likely to become systemic, there will need to be a period of experimentation before ranges of variables and thresholds for possible action can be identified. Staff responsible for macro prudential risk analysis will need to be encouraged to focus on tail risks and fault lines, not just on higher-probability risks. For the United Kingdom, the analysis of available tools may be dependent on what prudential measures under EU rules will be subject to national discretion.

58. **There may be issues in the interaction between macro and micro prudential measures—ensuring coordinated communication/action by the authorities early in the new regime of macro and micro statements/actions will be a key test of its credibility.** The proposals are designed to, as much as possible, separate these areas, with the responsibility for micro prudential matters being in the PRA and for macro prudential matters being with the FPC. On the other hand, the proposals are designed with the FPC and the PRA in the same institutional structure to help underpin the interaction between macro and many micro-prudential issues. The dividing line is likely to prove less clear-cut in practice. This is especially true in the United Kingdom where only a few banks account for a large share of the market, so their reaction to macro prudential measures is key to the impact. Another implication of the concentration is that material micro prudential measures directed at those banks could have macro aspects that need to be considered. And there may be situations in which the macro interests and the micro prudential interests are not fully aligned. This is especially true when it is recognized that countercyclical measures must be symmetric—for example, additional buffers—should go both up and down. The timing and interpretation of the reduction will be important, for example, as will communication so it is not seen to undercut prudential goals. Various, relatively-formal, coordination and decision-making measures have been designed to deal with this reality of the macro-micro interaction. In addition, authorities should do the most possible to promote consensus building in the new structure to maximize their effectiveness. Discussions with the authorities suggested a good degree of cooperation in thinking through issues, such as the use of tools, data, and risk analysis, at this albeit early stage.

59. **What macro prudential policy can deliver is somewhat of an unknown in any country.** So, as in other countries, there will be a need for communication on an ongoing basis to keep macro prudential expectations reasonable. That communication, and existing stability communication will take on a different importance (and thus itself becomes a tool), as it is understood to be possibly coupled with measures controlled by the FPC.

60. **Work on designing the details of implementing the macro prudential framework is at an early stage.** It will need to involve: enhanced data collection and analysis, including data from outside the regulated sector; an enhanced analytical framework, including a macro risk assessment framework; the development of a suite of indicators, including administrative and market data that are monitored; thinking on thresholds for making judgments on possible actions; and an effective communication approach that supports markets reacting to possible macro prudential measures in the way intended. Thinking also needs to occur on how the BoE and FPC will provide macro prudential and market analysis to the PRA and FCA, which will be useful for their work, and how this analysis will be integrated into their supervisory frameworks. There will also be unique issues, such as risk build ups in CCPs and their risk management capability, which will need active monitoring.

61. **In the near term, markets, governments, and the various U.K. authorities would benefit from greater interim articulation of the macro prudential risk framework and monitoring process.** This would follow on from the comprehensive 2009 BoE macro prudential discussion paper. The BoE (with support from the PRA and the FCA) could consider setting out that framework even before it is final on the understanding that it will evolve with operation and with international progress on analyzing macro prudential issues and tools. Greater articulation of the interim framework to be used by the FPC might also help clarify some of the questions about how macro and micro will interact in practice, added to transparency, and may also lessen the need for early discrete action by the FPC in advance of the framework being more understood by markets.

IV. Supervisory Operating Model for Banking Prudential Supervision

62. **The authorities are developing a revised risk assessment and supervisory model for banking, building on existing and proposed FSA frameworks with addition of systemic elements.** It is designed to deliver on the more judgment-based, proactive, early intervention regime, focusing on what matters for safety and soundness, and financial stability, desired by the authorities. In many ways it is a continuation of the more- intensive approach that is already being implemented for the major banks by the FSA. The FSAP noted the additional considerable work needed to implement elements of the existing framework for very high-impact banks and the need (which the authorities recognize) to extend it to other high-impact banks and insurers.

63. **The FSAP (see also BCP assessment) also recommended that detailed in-depth supervisory review work to confirm FSA assessments of the inherent risk and quality of risk management and risk governance be more frequent**; **other enhancements are also suggested.** There is room to better focus supervisory activity on major areas of potential risk and risk-management deficiencies, to better integrate specialist and supervisory work, to simplify and enhance the usefulness of the ARROW risk model, and to de-layer and better integrate the various supervisory processes to free up more time for focused supervisory work. That could also result in further enhancement in the clarity of messages to bank senior

management and boards. Moving to a single-purpose prudential organization in the PRA provides an opportunity for more senior management engagement on prudential issues on an ongoing basis. It is intended that ARROW will be replaced by a new PRA risk model which will focus on the impact on the stability of the system of firm failure. Forward-looking analysis on the basis of a balance of risks will be a core of the model and it will be simpler than ARROW, and allow significant space for supervisory judgments. This model was not fully articulated at the time of the mission, however the mission discussed current thinking (which had been reviewed and approved at senior levels by the BoE and the FSA).

64. **Broadly, the starting point for the new supervisory model is the new Supervisory Enhancement Program (SEP) and Core Prudential Program (CPP), currently being implemented in the FSA over the next 18–24 months, with additions for systemic impact assessment and an explicit resolvability assessment.** The existing approach to major firms broadly encompasses business model analysis, assessment of risk management and governance, and assessments of resilience such as capital and liquidity. It is proposed that a new initial module that assesses the gross impact on the system of a firm's failure be added. This is to be based in part on recovery and resolution plan analysis and on an assessment of inter-linkages between the firm and the wider financial system.

65. **The second major add-on in the new methodology is the assessment of banks' recovery and resolution plans, which has started.** This is useful work and can help identify vulnerabilities and measures that can be taken to improve resolvability. It will require an effective partnership between macro and micro prudential staff. But the effectiveness of the new resolution tools for major banks may be largely untested for some time. This is commented on in the FSAP Technical Note on crisis management and bank resolution. Both of these additional modules are likely to be resource-intensive, involving various specialist resources working with the supervision teams. The authorities plan to revisit some of the other supervisory processes that have been layered on during the crisis, and to revisit the ARROW risk framework, with the objective of simplification designed to support the judgment-based approach desired.

66. **The authorities need to ensure they are not seeking false precision in these new systemic add-ons, at the expense of having resources available so that he enhancements in core supervision are implemented effectively in a timely way.** The frequency of doing full assessments of these systemic modules in the steady state mode (as well as the frequency of recent initiatives such as cross-system stress tests conducted by the authorities) should be considered. The new model also implies considerable work on identifying interconnections between firms, and between firms and markets. This is a key part of the benefit of integrating the macro and micro views and is well worth pursuing. That said, knowledge and information on network impacts is not easy to assemble or analyze, and there is a very important international dimension being considered by other bodies. So the authorities need to be realistic about the time frame for major enhancements.

67. **The responsibility and accountability for risk assessment and supervisory planning risks are being diffused in this model as more macro analysis is brought into the current risk-assessment model.** What are the relevant roles of the supervisor, the risk group in the FSA that specifies "standard factors" for businesses in the risk-assessment models, and the BoE macro prudential staff? Achieving constructive bottom-up and top-down risk assessments with constructive challenges will be very important, and thinking has started in this regard. Active monitoring of the new risk assessment and intervention system by the senior leadership of the BoE and the PRA early in its implementation will be essential to ensure it is producing the desired results.

68. **The new approach to macro prudential analysis, resolvability, and the new SRR (as well as the possibility of requiring material capital buffers) does not reduce the need for intensified supervision (as started by the FSA) that focuses on the effectiveness of risk management and governance as well as on capital and liquidity.** That focus on "not yet problem" banks is important to increase the chance of catching early indicators of material future problems that might otherwise test the capital, liquidity, and resolution regimes.

A. Supervisory Operating Model for Insurance Prudential Supervision

69. **It is intended to develop a revised risk assessment and supervisory operating model for prudential supervision of insurance.** Currently, the BoE and the FSA are considering what, if any, elements of insurance are potentially systemic, and the place for prudential insurance regulation and supervision in that regard (in addition to its policyholder protection role). While no finalized model for insurance supervision was available at the time of the mission, the mission discussed current thinking with staff of the FSA and the BoE. The United Kingdom will implement the Solvency II directive. For very-high-impact insurers, the model will use parts of the CPP (with less- formal emphasis on the risk management/governance module), supplemented with a resolvability analysis. For the smaller insurers, the supervisory operating model will likely be based more on monitoring and outlier analysis, with occasional in-depth focused reviews to confirm risk assessments and resolvability. There are also medium-size insurers in the United Kingdom who are not very high-impact but are material in their importance and complexity. For these, there is likely to be an intermediate intensity model with more frequent detailed reviews than for the smaller insurers. The proactive intervention framework will apply.

70. **The issue of the potentially systemic nature of insurers is also being considered in other fora such as the FSB and the IAIS.** These are legitimate issues and the systemic aspects of insurers are different from and likely less than for banks. Experience in other jurisdictions indicates that failures of insurance companies could be locally systemic through temporary disruption of insured activity, if insurance of that activity is concentrated in a few companies. In addition, experience suggests that failure of a large insurer could temporarily destabilize markets through actions the insurer may take on the asset side of its balance sheet,

such as semi-forced asset sales. Anticipation of such actions could also affect markets. While the traditional view is that insurance cannot suffer liquidity runs, experience suggests that this may not be wholly accurate, because of the nature of certain insurance liabilities or quasi-insurance liabilities. Within insurance or reinsurance groups, there may well be liabilities that are as potentially volatile in certain markets as equivalent liabilities of banks. Balance sheets of major insurance groups and reinsurance groups can contain liquidity risk and market risk as material and complex as that for a commercial or investment bank. Lastly, there may be risk transfer between banks and insurers and opportunities for arbitrage.

71. **It may be easier to assess these aspects and take advantage of supervisory expertise across both sectors, if supervision of major banking and insurance groups are in the same authority.** For these reasons, the mission supports continuing to assign the regulation and supervision of insurers to the PRA. As insurance is to be part of the PRA, the BoE will need to enhance its expertise on insurance matters and consideration should be given to having some insurance expertise on the FPC.

72. **The FSA and the BoE are examining the framework for resolving insurance companies and this may lead to changes in legislation.** The SRR does not now apply to insurers, either on a stand-alone basis or on those that are part of banking groups. Resolving insurers through solvent run-off will need to be supplemented by the ability to "close" or restructure insurers that have breached capital thresholds (using existing or new tools), and the issue of applying the SRR to insurers is rightly being considered. Resolving a major insurer is likely to be very complex and challenging, with a considerable degree of uncertainty.

73. **In designing the new framework, it will be important for the authorities to take account of several factors (which also will be key to future standards assessments).** The use of risk specialists (e.g., for market, credit, and operational risks) is essential for the effective supervision of insurers, in addition to actuarial analysis; and this is recognized by the authorities. Business model analysis and financial risk assessment, including stress testing, are important for insurance regulation and supervision, but so is assessment of the quality of risk management and governance in order to reduce the risk of material problems. The enhanced use of models under Solvency II poses challenges for the supervision of insurers, as it does for banks and bank regulators in many countries. It is important that the qualitative conditions for model use (such as sound risk management and governance) continue to receive adequate attention. The United Kingdom needs to preserve its ability to use individual capital guidance (Pillar II) as a regulatory tool for insurers. But this, plus a robust resolvability regime, cannot be a perfect substitute for adequate supervision to reduce the risk and impact of unanticipated or disorderly failures.

V. Proactive Intervention Framework

74. **The authorities intend to implement a proactive intervention regime, which the mission supports.** It will not be referred to in legislation. Authorities may want to revisit the consideration of including some reference in the legislated mandate for early intervention, as recommended by the FSB. That can be an important parliamentary signal about the desired culture and approach to supervision. The proposed regime is likely to specify various stages of intervention without basing these on pre-set triggers, recognizing that triggers can be inadequate measures of problems.

75. **The current thinking appropriately recognizes that an early intervention regime operates at various stages of the evolution of a bank and all should be covered.** The early stages are when there are important elements of the business that contain actual or potential inherent risks that are not sufficiently appreciated by the firm, or which are beyond the firms' risk management/governance capability to measure, monitor, and manage, or are inconsistent with the firm's financial cushions. Action by the regulator at these early stages can significantly reduce the likelihood and/or severity of the ensuing problem actually occurring. It can also reduce the risk of surprises. Stress testing may not reveal these weaknesses, as they may be only evident after deep dives (without that, the stress test is essentially operating on incomplete data).

76. **The latter stages of an early intervention model are closer to the potential demise of a firm and can benefit coordination of necessary timely actions and support the will to act.** Even with such a framework, difficult decisions often have to be made by the supervisor about the credibility in particular cases of firms' plans to restore health. Closer to the serious problem stage, coordination of various authorities, such as the supervisor and the resolution authority, is desirable. Hence, the early intervention model should include guidance as to when different responsible authorities, including the FSCS, should be informed.