

**United Kingdom: Basel Core Principles for Effective Banking Supervision Detailed
Assessment of Compliance**

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

UNITED KINGDOM

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING
SUPERVISION

DETAILED ASSESSMENT OF COMPLIANCE

JULY 2011

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GLOSSARY

AC	Additional criteria for the assessment of a principle
AIRB	Advanced internal rating-based approach for credit risk
ALCO	Assets-Liabilities Committee
AMA	Advanced measurement approaches for operational risk
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
APB	Auditing Practicing Board
APS	U.K. Asset Protection Scheme
ARROW	FSA Advanced Risk-Responsive Operating Framework
BBA	British Bankers' Association
BCBS	Basel Committee on Banking Supervision (also, the Basel Committee)
BCD	EU Banking Consolidation Directive
BCP	Basel Core Principles for Effective Banking Supervision
BIPRU	FSA Prudential Sourcebook for Banks, Building Societies and Investment Firms
BHCs	Bank holding companies
BoE	Bank of England
CASS	FSA Client Assets Sourcebook
CEBS	(Former) EU Committee of European Banking Supervisors; presently EBA
CEO	Chief executive officer (managing director or chief executive)
CFP	U.K. banks' Contingency Funding Plan
CGS	U.K. Credit Guarantee Scheme
COND	FSA Threshold Conditions
COREP	EU Common Reporting framework
CP	Core Principle
CPMA	Consumer Protection and Market Authority
CPP	FSA Core Prudential Program
CRD	EU Capital Requirement Directive
CRE	Commercial real estate
C&C	FSA "close and continuous" supervision of banks
DEPP	FSA Decision Procedure and Penalties Manual
DMO	U.K. Debt Management Office
DTR	FSA Disclosure and Transparency Rules, also containing corporate governance rules
EC	Essential criteria for the assessment of a Principle
EEA	European Economic Area
EL	Expected losses
ERM	Comprehensive enterprise-wide risk measurement and risk management
EU	European Union

FATF	Financial Action Task Force
FIU	Financial intelligence unit
FIRB	Foundation internal ratings-based approach for credit risk
FRC	U.K. Financial Reporting Council
FSA	U.K. Financial Services Authority
FSAP	Financial Sector Assessment Program
FSMA	U.K. Financial Services and Markets Act 2000
FTE	Full-time equivalent of a full-time staff
GABRIEL	FSA Gathering Better Regulatory Information Electronically
GDP	Gross domestic product
GENPRU	FSA General Prudential Sourcebook
GRS	U.K. Government Recapitalization Scheme
HMT	Her Majesty's Treasury
IAS	International Accounting Standards
ICAAP	Pillar 2 internal capital adequacy assessment process
ICG	FSA Individual Capital Guidance
IFRS	International Financial Reporting Standards
ILAA	FSA Individual Liquidity Adequacy Assessment
ILG	FSA Individual Liquidity Guidance
IMF	International Monetary Fund
IRB	Internal ratings-based approach for credit risk
IRRBB	Interest-rate risk in the banking book
ISA	International Standards on Auditing
ITAP	FSA Information Technology Architecture Program
KYC	Know your customer
LGD	Loss-given default
LOLR	Lender of last resort
MiFID	EU Markets in Financial Instruments Directive
MIS (MI)	Management information system
MoU	Memorandum of Understanding
MPC	Bank of England's Monetary Policy Committee
OIVOP	FSA Own Initiative Variation of Permission
OSFI	Office of the Superintendent of Financial Institutions Canada
PD	Probability of default
RMP	FSA Risk Mitigation Program
PRA	U.K. Prudential Regulatory Authority
PRD	FSA Prudential Risk Division
PRIN	FSA Principles for business
RBS	Royal Bank of Scotland (a U.K.-incorporated commercial bank)
RWA	Risk-weighted assets
S166	Section 166 reports, conducted by skilled persons on behalf of the FSA
SECPP	Supervisory Enhancement and Core Prudential Programs

SEP	FSA Supervisory Enhancement Program
SIFI	Systemically-important financial institution
SIV	Special investment vehicle
SLRP	FSA Supervisory Liquidity Review Process
SLS	U.K. Special Liquidity Scheme
SOCA	Serious Organized Crime Agency (U.K.'s FIU)
SREP	Pillar 2 supervisory review and evaluation process
SRR	U.K. Special Resolution Regime
SUP	FSA Supervision Sourcebook
SYSC	FSA Senior Management Arrangements, Systems and Controls
TSA	Standardized approaches for operational risk
T&C	FSA Training and Competence Scheme
U.K. GAAP	U.K. Generally Accepted Accounting Standards
U.K.FI	U.K. Financial Investments Limited
VHIFs	Very high-impact firms

I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

1. **The United Kingdom has a high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs).** As in other countries, the crisis revealed serious deficiencies in risk measurement and risk management at major banks, as well as weaknesses in supervisors' ability to identify deficiencies and have these rectified. The correct response has been put in place and the Financial Services Authority (FSA) has made as much progress as possible in the time available since the crisis, but the process is still at an early stage. The assessors saw many examples of high-quality initiatives, and effective implementation of the already planned work program is now needed to achieve full compliance with the Principles. The programs for enhancing the supervision of capital and liquidity are the most advanced. However, the prudential mandate and the supervisory approach, techniques, and reporting present shortcomings. Data quality should be enhanced and the supervisory organization should continue its change from an approach that was mostly centered on reactive processes to a new one centered on proactive, sound prudential outcomes. The recently established Supervisory Enhancement and Core Prudential Programs (SECPP) are expected to overcome these shortcomings; however, there has been insufficient time for these new programs to become adequately embedded, and to achieve a cohesive implementation will be challenging. Nevertheless, the U.K. authorities are strongly committed to both the supervisory reform programs and the cultural change necessary to implement them. Ongoing focused leadership will be required to implement these core programs well, at the same time as new initiatives related to the addition of macro-prudential overlay in a new organizational structure are developed.

2. **Major changes in the organization of regulation and supervision proposed by the government risk introducing uncertainty.** These changes have the potential to add to effectiveness by bringing into the supervisory and risk assessment framework more focus on systemic linkages of major firms, and their resolvability. However, given the newness of some of these concepts, expectations should be kept at a reasonable level and these new developments should not detract from having core supervision done well. How clear the new objectives for prudential regulation of banks will be, and whether the new mandates for micro- and macro-prudential regulation will interact as intended, is not known at this stage. If not well implemented and resourced, these macro-prudential efforts could detract from effective completion of existing efforts to improve supervisory effectiveness. Furthermore, as the macro-prudential overlay is implemented, the authorities need to keep in mind that the reputation of the supervisory and regulatory program also depends on doing a credible job in supervising and dealing with prudential concerns in smaller- and medium-sized firms.

A. Introduction

3. **This assessment of the current state of the U.K. implementation of the BCPs has been completed as part of a Financial Sector Assessment Program (FSAP) undertaken by the International Monetary Fund (IMF) during January–March 2011, and reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment.** Importantly, it is not intended to assess the merits of the wide-ranging program of structural reforms currently being proposed by the U.K. authorities or by the Independent Commission on Banking. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and detailed examination of the policies and practices of the institutions responsible for banking supervision. In line with the BCP methodology, the assessment focused on the major banks and banking groups, and their regulation and supervision, given their importance to the system.

B. Information and Methodology Used for Assessment

4. **The U.K. authorities agreed to be assessed according to the Core Principles Methodology issued by the Basel Committee on Banking Supervision (Basel Committee) in October 2006.** The assessment of compliance with each core principle (CP) is made on a qualitative basis to allow a judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to indicate that the criteria are met.

5. **To assess compliance, the methodology proposes a set of essential and additional assessment criteria for each principle.** The essential criteria (EC) are the only elements on which to gauge full compliance with a core principle. The additional criteria (AC) are suggested best practices against which the U.K. authorities have agreed to be assessed. Additional criteria are commented on but are not reflected in the grading. The assessment of compliance with each principle is made on a qualitative basis. A four-part grading system is used: compliant; largely compliant; materially noncompliant; and noncompliant. This is explained below in the Detailed Assessment section.

6. **The assessment team reviewed the framework of laws, rules, and guidance, and held extensive meetings with officials of the FSA, the Bank of England (BoE), Her Majesty's Treasury (HMT), and private sector participants.** They also met industry associations representing banks, rating agencies, audit firms, and private sector participants in banking and financial markets. The team examined the FSA's current practices in performing bank supervision of the FSA. It had the benefit of working with a very comprehensive, high- quality self-assessment completed by the authorities, enjoyed the high-quality cooperation of the authorities, and received the information it required. The team extends its thanks to staff of the authorities for their excellent cooperation at a time when

many other initiatives related to domestic and global financial stability initiatives were in progress.

7. **The standards were evaluated in the context of the U.K. financial system’s sophistication and complexity. As such, given London’s role as one of the two most important global financial centers, the expectations applied in evaluating U.K. compliance with the core principles were high.** It is important to note that the United Kingdom has been assessed against the Basel Core Principles as revised in 2006. This is significant for two reasons: (i) the revised Basel Core Principles have a heightened focus on risk management and its practice by supervised institutions and its assessment by the supervisory authority; and (ii) the standards are evaluated in the context of a financial system’s sophistication and complexity. These factors should be taken into account in any comparisons between the U.K. assessment and FSAPs for other countries.

8. **Reaching conclusions required judgments by the assessment team.**¹ Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world after the crisis, and theories, policies, and best practices for supervision are swiftly evolving. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the U.K. authorities with an internationally consistent measure of the quality of its banking supervision in relation to the revised core principles, which are internationally acknowledged as minimum standards.

C. Institutional and Macroeconomic Setting and Market Structure

9. **The U.K. financial sector is large, with bank balance sheets amounting to approximately five times GDP.** Other important sectors include asset management, insurance, and pension plans. Some of the most important assets managers are associated with banks, and the U.K. allows banc-assurance. Leading U.K. banks are among the most complex internationally in the world and London is a premier financial center. Some major banks have more of a focus on retail and business banking, while others have material wholesale and capital markets businesses on a global scale. In addition to the six main banks and building societies, there are important foreign banks (both commercial and investment banks) and some 180 smaller banks and building societies. The FSA has identified some eight very-high-impact banks and approximately 35–50 high-impact deposit takers (banks and building societies), based on their own rating criteria.

10. **The crisis has materially affected the structure of the U.K. banking sector.** The U.K. banks faced losses from structured products and off-balance sheet vehicles to a degree, but also from asset quality problems in mortgages and business lending, as a result of

¹ The assessment team comprised Nicholas Le Pan, former Head of OSFI in Canada; Pierre-Yves Thoraval, former Deputy General Secretary of the Commission Bancaire, France, and Managing Director of Promontory France; and Antonio Pancorbo, Senior Advisor to the Bank of Spain.

previous high growth coupled with over-reliance in some cases on short-term wholesale funding. Certain banks and building societies had strategic concentrations that led to asset quality problems, such as concentrations in commercial real estate. Mergers of banks were already occurring prior to the crisis, and subsequent mergers occurred as part of resolution of specific problems. Concentration in the banking sector has increased. The five largest banks, the largest building society, and the largest foreign bank together account for close to 90 percent of retail deposits.

11. **A number of medium-sized banks and building societies ‘failed’ during the crisis, and two large banks required material injections of public money.** One remains in majority temporary state ownership. Some banks have raised material private capital. The authorities have conducted major stress tests of a range of banks as part of the response to the crisis and to determine recapitalization needs, and the United Kingdom has participated in European stress tests.

12. **The government established the Independent Banking Commission (the Vickers Commission) to review the degree of concentration in banking and whether to require structural changes in how banks are organized** (e.g., between retail and wholesale activities) in order to reduce risk or improve resolvability of a major banking group in a crisis. The Vickers Commission is to report to government by end-September 2011.

13. **The U.K. economy had been slowly recovering and future economic growth remains uncertain.** The central IMF projection for the United Kingdom has a progressive strengthening of private and external demand underpinning a moderate-paced recovery, even as the public sector retrenches. The IMF central scenario envisages real GDP growth of 2 percent in 2011, rising gradually to 2.5 percent in the medium term. However, GDP growth unexpectedly turned negative again in Q42010. The BoE operates under a price-stability mandate. Inflation is currently well above the 2 percent target, but the central IMF projection forecasts a steady decline.

14. **The authorities were negotiating a framework relating to pay and lending with a number of the major banks at the time of the mission in January 2011, and the framework was agreed shortly thereafter.** It includes certain commitments by banks on better relating pay to performance, the total level of bonus pools, and greater pay transparency. It also includes commitments to have available capital and other resources to support specific targets for increased gross new lending to businesses, and, within that, specific increases in new lending to small- and medium-sized business. The BoE is to monitor and report on performance against the lending commitments. It will be important that banks and regulators ensure that sound risk management considerations are not neglected in banks’ pursuit of the lending targets

15. **As a result, the U.K. banking system is facing a number of risks.** Household indebtedness is high and could be affected adversely by future increases in interest rates or an economic slowdown. There are downside risks to asset quality, though the level of new impairments has trended down over the past year. The government has introduced an austerity program even though it is necessary to consolidate public finances, the impact on short-term growth is uncertain. There are significant exposures of the banking system to commercial real estate. While prices have rebounded to a degree after a 40 percent decline, risks remain. The U.K. system has material indirect exposure to vulnerable Euro-zone economies. There are substantial wholesale funding maturities that major U.K. banks will be facing over the coming one to two years, though the FSA reported they all have plans to manage that risk.

16. **In terms of mitigation, Tier 1 capital for the U.K. banking system has risen from the 8 percent range on average over 2005–2007 to some 12 percent at mid-2010, and compares favorably to other major international banking systems.** Actions by the authorities, market pressures, and experience from the crisis have led to banks enhancing short-term liquidity. A number of banks have made material progress in longer term programs to reduce their structural liquidity position through less reliance on wholesale funding.

D. Preconditions for Effective Banking Supervision

17. **Overall, the public infrastructure supporting effective banking supervision in the United Kingdom is well developed.** That said, the government has identified areas where the arrangements between the authorities responsible for various aspects of financial stability did not work as well as desired. A major restructuring has been proposed and its implementation has already started.

18. **Business laws including contract, bankruptcy and property law are well developed and reliable.** There is an independent judiciary operating under a mixture of common law and statute law. Accounting, auditing and legal professions are long established, well resourced and well regulated.

19. **International Financial Reporting Standards (IFRS) are used by U.K. listed companies.** Companies which are not listed can use U.K. GAAP, which is substantially harmonized with IFRS. There is oversight of the auditing profession through the Financial Reporting Council (FRC). Bodies within the FRC, such as the Auditing Practices Board and the Accounting Standards Board, set U.K. auditing and accounting standards, harmonized with international auditing and accounting standards. The prudential authorities use the accounting and audit professions and other skilled persons to conduct investigations on their behalf (“section 166 reports”). The number of these procedures has increased in the last two years, but from a very low base. There is room to do more of these investigations and to make sure they are more in-depth as necessary, but they are not a substitute for the revamped

supervisory process. Recently, the FSA has begun to express a general desire that the audit profession exercise more professional skepticism and that auditors do more work in selected areas that are important for the prudential framework, such as valuation of complex products. Auditors have a statutory duty to inform the FSA whether any concerns of material significance have arisen during the course of their work. The FSA has indicated it would like auditors to do more in this regard. The authorities have also begun to deepen their ongoing relation with auditors which had lapsed somewhat over the preceding decade.

20. **The Financial Reporting Council (FRC) sets governance guidelines for listed companies with premium listing through the U.K. Corporate Governance Code (formerly the Combined Code).** This Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions, or where they have not, to provide an explanation. In May 2010, the FRC issued a new edition of the Code, which will apply to financial years beginning on or after June 29, 2010.

21. **The Walker Report reviewed U.K. corporate governance requirements for banks and other financial institutions and made a number of recommendations in November 2009.** The recommendations to strengthen the role of Boards included having enhanced expertise, separating the roles of chair and CEO, and setting up risk committees of the Board separate from audit committees. These are being implemented by U.K. banks, and a number of the Walker Report recommendations have been adopted by the FRC as applying to all listed companies. The FSA has used the Walker Report recommendations as its best practice standard in reviewing banks' governance arrangements.

22. **In terms of market discipline, the United Kingdom has an extensive presence of institutional investors and high involvement of major rating agencies and analysts, but the authorities should review the adequacy of disclosure.** There are well-developed mechanisms that support market discipline, including a system of regular disclosure by public companies. For banks, that has been materially enhanced through the additional annual disclosures mandated by Pillar 3 of the Basel Capital Accord, which applies to banks of all sizes. These are however, as in other countries, often behind market developments. Some banks make quarterly financial disclosures and some half-yearly. Regular financial statement disclosures related to market risk, liquidity risk and credit concentrations, for example, appear to be less than in some other major markets. The FSA does not itself publish extracts from regulatory returns, but this is recommended. The FSA publishes an annual Financial Risk Outlook (replaced starting in 2011 by a Prudential Risk Outlook and Conduct Risk Outlook) and the BoE publishes twice-yearly financial stability reports. Overall, disclosure is less than in other leading markets and the authorities should review the adequacy of disclosure.

Supervisory and regulatory architecture

23. **The U.K. authorities, since the creation of the FSA in 1998, have operated a ‘tripartite’ system involving the BoE, Her Majesty’s Treasury (HMT) and the FSA.** There various responsibilities were set out in a public MOU. Under these arrangements, the responsibility of the FSA has been prudential regulation and supervision of authorized firms including banks and other deposit takers. The FSA also has responsibilities for regulation of markets. The FSA, as an integrated regulator, is also responsible for prudential regulation of insurance firms, broker dealers, and a range of other participants in financial markets, as well as for conduct of business regulation and supervision and consumer protection. Overall, it regulates about 16,000 firms including about 235 deposit-taking organizations (banks and building societies).

24. **The tripartite role for the BoE prior to 2009 related to oversight of payment systems, maintaining a broad view of the system as a whole, and acting as a lender-of-last-resort (LOLR).** Since then, amendments to the Banking Act have given the BoE resolution authority over banks. The role of the HMT in the tripartite arrangements was responsibility for the institutional structure of regulation and legislation, accounting to parliament for the management of serious problems in the financial sector and authorization of support operations beyond the normal framework.

25. **Prior to the crisis, the U.K. FSA had been operating what came to be called a principles-based regulatory approach following a deregulation philosophy that was widely supported.** (It was also referred to as a “light touch,” though this was not a term that was generally used by the FSA). It involved a risk-based supervision philosophy. The authorities have since indicated that, in hindsight, the crisis demonstrated that supervisors had placed too much confidence in banks’ internal risk management and governance systems. The engagement of the FSA with firms had been neither as frequent nor as probing as it should have been. A number of commentators were also critical of how the tripartite arrangements worked in practice during the early stages of the crisis, including in coordination and information sharing.

26. **Following the failure of Northern Rock, the parliamentary investigation and the FSA published internal audit report revealed significant deficiencies in the FSA’s practices.** The incoming chair of the FSA conducted a review (The Turner Review) in March 2009. It set out a number of enhancements to FSA policies and practices for prudential regulation and supervision, including internal improvements in governance and oversight. It also expressed views on a wider range of policy issues facing authorities in the United Kingdom and other countries, such as the need for higher levels and quality of capital, much more focus on adequate liquidity, and more of a focus on the resolvability of systemically-important financial institutions. Implementation of the recommendations related to the FSA started immediately.

27. **In 2010, the new government released a white paper proposing major changes in regulatory and supervisory responsibility, and formal implementation of a macro-prudential overlay on traditional micro-prudential regulation and supervision.** Under the proposals the FSA is to be split into: (i) a prudential regulator (PRA) regulating banks, banking groups, insurance companies and larger broker-dealers, and a (ii) consumer and markets authority (CPMA), taking over the FSA's conduct of business mandate, including wholesale markets, market enforcement, market infrastructure, AML/CTF, and prudential regulation of smaller dealers, asset managers, financial advisors, and so on. The PRA is to become a semi-autonomous subsidiary of the BoE with the BoE being given authority over certain macro-prudential tools. The legislation implementing these changes is to be in place by year-end 2012. To reduce internal uncertainty and pilot the new arrangements, the FSA and the BoE are starting shadow implementation beginning early in 2011, to the extent permitted by the existing law and consistent with the effective operation of the FSA.

Crisis management and safety nets

28. **The U.K. framework for crisis management and safety nets has evolved rapidly since the start of the crisis.** The failure of Northern Rock exposed significant gaps in the legal framework for bank resolution, prompting an emergency response in the form of the Banking (Special Provisions) Act (2008). Consequently, the U.K. authorities had to take decisive policy actions to support the stability of the financial system:

- In September 2007, the BoE acted as a LOLR to Northern Rock, following consultation with the HMT and the FSA.
- In February 2008, parliament passed emergency legislation in the form of the Banking (Special Provisions) Act. It provided resolution tools (that were later enacted permanently in the 2009 Banking Act) to facilitate the resolution of failing banks. These powers were used in the resolution of Northern Rock and of Bradford and Bingley.
- In April 2008, the BoE, in coordination with HMT and the Debt Management Office (DMO), launched the Special Liquidity Scheme (SLS), which allowed banks and building societies to swap their high-quality, mortgage-backed, and other securities for U.K. treasury bills for up to three years.
- In October 2008, at the height of the crisis, the U.K. authorities took several measures:
 - The guarantee on bank deposits was raised from £35,000 to £50,000.
 - The Government Recapitalization Scheme (GRS) was launched, wherein the government made capital investments in Royal Bank of Scotland and Lloyds/Halifax Bank of Scotland (all U.K. incorporated banks, including

subsidiaries of foreign banks that have substantial business in the United Kingdom, would have been eligible), in order to help increase their Tier 1 capital and strengthen their finances; a holding company, the U.K. Financial Investments Limited (U.K.FI) was set up to manage investments in those banks.

- The Credit Guarantee Scheme (CGS) was launched, under which the government would guarantee new issuances of short-term or medium-term debt securities by eligible institutions in order to help refinance their funding obligations.²
- In January 2009, the government introduced two other facilities:
 - An Asset Protection Scheme (APS) to insure/guarantee participating banks' toxic assets (ultimately, only Royal Bank of Scotland (RBS) participated in the scheme).
 - An Asset Purchase Facility (APF) in which the BoE would buy high-quality assets, financed by the issue of treasury bills and the DMO's cash-management operations. Under the program, the central bank would purchase assets (U.K. government bonds and high-quality debt issued by private companies) from private sector institutions (e.g., insurance companies, pension funds, banks or nonfinancial firms). In March 2009, the Monetary Policy Committee (MPC) began a program of asset purchases for monetary policy purposes (quantitative easing) under the APF.

29. **In February 2009, the Banking Act 2009 was passed.** The Act established a permanent regime for the resolution of distressed banks and building societies. The Special Resolution Regime (SRR) provided the BoE (in the case of bridge bank resolutions and private sector rescues) and HMT (in cases of temporary public ownership) with resolution tools involving mandatory transfers of property and forced changes to capital structure pre-insolvency. The trigger for resolution is a determination by the FSA that a bank breaches its conditions of authorization (including operating without adequate resources and that no other options than resolution are available). The act also modified the arrangements for the liquidation and administration of insolvent banks and building societies. Also noteworthy are the provisions of Part 5 of the act, which enhanced BoE's role in payment system oversight. The resolution regime was used successfully in the resolution of a moderate sized building society in 2009 (Dunfermline Building Society).

² On November 15, 2010, the BoE announced that it would withdraw immediately the never-tapped facility to purchase bonds issued by banks under the government's CGS.

E. Main Findings

Objectives independence, powers, transparency, and cooperation (CP 1)

30. **As an integrated regulator, FSA has been able to benefit from synergies in understanding banks and the market that come from a broad view of all aspects of the financial system and from all aspects of firms' operations, both those that relate to safety and soundness and those that relate to market conduct.**

31. **However, assessors have also seen at many levels the impact of a lack of clarity about how the FSA intended to meet its very-generally-worded mandate.** Prudential objectives were not explicitly mentioned in the statutory mandate and regulatory objectives, nor had they come to be expressed in a clear and coherent fashion as an agreed-upon approach (as can be found in other jurisdictions that have unclear statutory mandates). Key planning and accountability documents, and public statements for many years, did not draw out the key role of prudential regulation in contributing to maintaining market confidence and protecting consumers. In addition, lack of adequate tools within the FSA to monitor the use of resources allocated to various parts of the regulatory objectives, or monitoring outcomes at a high level related to various parts of the mandate did not appear robust. Also, certain other statutory qualifiers to the core regulatory objectives (such as the desirability of maintaining the competitive position of the United Kingdom, and the need to minimize the impact of FSA actions on) may have been understood in ways that undercut adequate prudential supervision and regulation. 'Contributing to financial stability' was added to the regulatory objectives in 2010 and the FSA published its board-approved strategy to comply with the new regulatory objective and what that would mean in practice, but it is too soon to observe the impact of this change.

32. **The way that regulatory objectives are to be expressed in the new structure was under discussion at the time of the assessment.** It will be important that they, and any related communications, contain as much clarity as possible about parliament's intention.

33. **The FSA enjoys operational independence in its day-to-day decisions and sets its own budget needed to meet its regulatory objectives.** It operates a comprehensive consultation and decision making process on its rules. Following the regulatory objectives, it has a commitment to formally assess the costs and benefits of new initiatives. These processes ensure it is well aware of the impacts of its actions and takes them into account. The Chairman of the FSA is appointed for a five-year term, but the legislation allows for removal by HMT with no explicit grounds being required and no explicit requirement for public disclosure of the reasons for removal. This has never happened in practice, and the tradition of ministerial accountability to parliament would be expected to lead to appropriate disclosure, were removal ever to be necessary.

34. **While the FSA has materially increased resources in the past two years to implement a more ‘intensive and intrusive’ regulatory and supervisory process, it appears that a further increase in human resources will be required.** Resources in supervision have been markedly increased, as have specialist support resources in various risk areas. Some of the newly launched processes are not embedded in the FSA and some parts of the new processes are at an early stage of being rolled out. So it is difficult to assess steady state resource requirements. Assessors were not in a position to do a detailed analysis, but their strong sense is that additional resources for prudential regulation and supervision (some combination of enhanced skills and additional people) are required, while recognizing that some of this could be funded from efficiencies in existing processes that the FSA is now assessing. Such additional resources are essential to (i) enable the FSA to implement fully the planned enhancements; (ii) deal with a number of recommendations in this assessment such as for a more proactive detailed review of key risk areas; and (iii) implement the new macro overlay without drawing resources away from the necessary core prudential work.

35. **Other areas for enhancement include information reporting from banks, and the availability of more detailed data for effective peer analysis.** This is important for the supervision of small- and medium- sized banks (through outlier analysis, for example), as well as for the assessment of large banks. Legacy systems issues exist; these may need remediation, but also offer opportunities for efficiencies.

36. **Mechanisms are in place for information sharing and cooperation among the authorities.** While there may have been some issues at the beginning of the crisis, the authorities report that cooperation is working well. Assessors saw evidence of that in practice. As they move to the new structure proposed, it will be important that new coordination and cooperation mechanisms are built (for example to deal with potential conflict between macro-prudential and micro-prudential measures). It will also be essential that the new mechanisms (formal and informal) work well in practice on an ongoing basis, not just in times of stress or crisis.

Licensing and structure (CPs 2–5)

37. **The FSA runs a comprehensive and effective licensing and approvals structure.** A key part of their supervisory methodology is satisfying themselves that the overseers of authorized firms, and persons in positions of significant influence such as Board members and senior management, are ‘fit and proper.’ Assessors saw the comprehensive nature of that process and the importance the FSA places on it.

Prudential regulation and requirements (CPs 6–18)

38. **The FSA has put considerable effort into enhancing the quantity and quality of capital in the banks, and this is showing results.** This priority was understandable, given the U.K. experience in the crisis. Capital rules are compliant with Basel and European requirements. The FSA has gone beyond this in some respects, including by promulgating an

interim capital regime starting in 2009, based on total capital, Tier1 and Core Tier1 expectations in normal and stressed conditions. The FSA has also built on its long tradition of setting individual capital targets, and now capital guidance, for banks above the minimum. The robust stress testing process for major banks is instrumental in the FSA setting further capital buffers for major banks, above the normal FSA individual capital guidance. Banks are operating with material cushions above the guidance and buffers. Bank capital levels have risen, as has the level of Core Tier 1. Further consideration is occurring in various international and U.K. fora about what levels are appropriate for the very high-impact banks on an ongoing basis.

39. **Severe shortcomings in certain bank risk measurement and risk management practices were revealed in the crisis and supervisory oversight was not always effective in identifying those weaknesses and having them remedied.** While it would have been unrealistic to expect a financial crisis of this magnitude not to have revealed weaknesses, the extent and seriousness of them, particularly at some major U.K. banks, was remarkable. As noted in the reports released by global senior supervisors, many of these were not unique to the United Kingdom. However, given the systemic importance and size and complexity of the U.K. banking system and markets, bank risk management practices, and the U.K. authorities' ability to assess them, must be held to a very high standard.

40. **The FSA has responded with high-quality measures to enhance risk measurement, risk management, risk governance and supervisory assessment and intervention, with a multi-stage supervisory enhancement program.** Sustained leadership is required to ensure continued implementation of these measures and to achieve real judgment-based intensive supervision. The latter will include prompt intervention based on sufficient detailed supervisory work to identify and to deal with problems before they become serious. Banks are also undertaking major risk management and risk governance improvements. There is a broad shared understanding of the improvements needed and the strategy is well in place with concrete progress being made. Improvements can be complex and time consuming to embed properly as they involve changes in risk architecture and data capture in complex global banks and culture changes in banks and for supervisors. The assessors believe that the strategies are the correct ones. However, execution of the strategies is challenging in the current environment and completion of the enhancements is expected by end-2012.

41. **Processes to relate capital to risk are more advanced.** This is in no small measure due to the FSA's longstanding focus on stress testing and on a robust Pillar 2 process. However, there is a danger that inadequate assurance of the robustness of banks' underlying processes such as loan classification, impairment determination, valuation of complex products, and inadequate assurance of the robustness of models, could lessen the true effectiveness of the stress testing process. FSA processes to enhance in-depth assessments of these areas with more transaction testing and 'on-site' and detailed work as part of 'deep-dive' and peer theme reviews need to be built on.

42. **The FSA needs to materially enhance its focus on credit risk at a more detailed level, with more, regular and proactive reviews of the quality of banks' portfolios.** This will also involve more granular data from the banks operating credit risk models so that the FSA can perform assessments of the integrity of those processes and conduct effective peer analysis. While it is building parts of that capacity, an overall enhancement strategy should be developed and implemented as a priority. Current detailed reviews need to be expanded, and resource constraints should be addressed to enable such priority work to be identified and undertaken as soon as possible. These reviews should also consider the quality of banks risk management, provisioning and governance processes. More transaction testing on a select basis is required. Areas of exposure with potential material problems need to receive more proactive attention. Use of more skilled persons' reports could be a short-term partial bridge to the new more intensive approach. Proposals to enhance FSA data and analytical tools for peer analysis are important and should proceed.

43. **FSA capabilities for liquidity risk assessment and effective intervention on liquidity issues are well advanced and have shown results.** This has involved updated guidance that in a number of ways pre-dated the recent global regulatory initiatives by the Basel Committee on Banking Supervision (BCBS). It also has involved intense supervision and specialist involvement in liquidity assessments for major banks and sound liquidity stress testing approaches and assessments of banks' liquidity contingency plans. New supervisory tools and reporting have been developed and these are in the process of being rolled out more generally. The liquidity positions of major banks have improved as a result. There is a plan for these detailed assessments to be extended to a wider range of high-impact banks, and this needs to proceed expeditiously.

44. **For market risk and interest-rate risk in the banking book (IRRBB) the FSA demonstrates all the necessary skills and understanding of these risks in both major banks and smaller and mid-sized banks.** The assessors saw excellent examples of supervisory reviews. These have benefitted from the recent material increase in FSA risk specialist resources. But the assessors also noted that there was room to increase the number of proactive deep-dive reviews and the amount of peer analysis based on improved reporting. Such enhancements would provide further assurance of the quality of market risk measurement, risk management and risk governance. This issue is more of a deficiency in the FSA's overall supervisory approach (CP 19), rather than a specific issue in the market risk area. The FSA has the ability to conduct these reviews as evidenced in the recent review of valuation practices for complex products, and other reviews being conducted at certain banks. Recent increases in resources should permit further deep-dive and theme reviews. The core prudential program enhancement framework for assessing risk measurement and governance in the eight very-high-impact banks will start being implemented over the next 18-24 months, and will be rolled out more broadly subsequently.

Methods of ongoing banking supervision (CPs 19–21)

45. **The enhancement of the overall supervisory approach, which has already been started, needs to be continued with the same rigor, adequately embedded, and materially augmented to incorporate more detailed, in-depth reviews and a consistently-proactive review strategy (among other improvements to its effectiveness), in order to achieve compliance with the principles.** While the FSA has generally demonstrated its ability to use various supervisory techniques, the overall supervisory approach needs to (i) be enhanced to ensure coherence; and cohesion; and (ii) continue to incorporate detailed supervisory reviews. In this context, it is critical that the new macro-prudential overlay assist in the re-engineering process, and not divert resources from effective core supervision. The FSA recognizes the issues, and has responded with its new Core Prudential Program for very high-impact banks as part of its supervisory enhancement program. But much of this of this is at early stages of implementation and will not be embedded for a number of years. The ARROW risk assessment process, which is at the core of the current methodology is complex and does not seem to adequately discriminate among risks at major banks. A forward-looking element in ratings is under-developed. There is room for better integration of specialist work into the supervision program and implementation of more peer analysis. Without more detailed verification, the assurance given by the current assessments of the quality of risk management and governance processes may not be adequate. The degree of detailed review that the FSA will conduct is unclear in the parts of the Core Prudential Program not yet implemented (such as review of risk management and governance). There is room to better integrate the results of reviews with the risk rating and the feedback to bank Boards. That could also help focus on the most important issues in a proactive way. It is also necessary to ensure that management and oversight processes adequately monitor on an ongoing basis whether staff judgments in the new ‘intensive and intrusive’ approach are those desired.

46. **Senior FSA management recognized the need to improve the existing supervisory framework and has therefore committed much more time to oversight of the key risks in meeting the FSA regulatory objectives.** Major issues and decisions are escalated by supervisory teams through a “Watch list” process for consideration by the FSA Senior Executive team. This essentially amounts to a high level judgmental overlay on the supervisory process. The FSA has also introduced a regular and direct contact program between the most senior FSA team and the CEOs of the United Kingdom’s largest firms. All major supervisory judgments are communicated both by its senior management team as well as the lead supervisors. The FSA believes that this approach has been broadly successful in identifying potential major issues in the recent past. However, it is not a sustainable substitute for the necessary enhancements and carries risks, as the FSA itself recognizes.

Accounting and disclosure (CP 22)

47. **Banks' public disclosure can be improved in terms of comparability, relevance, scope, and timeliness.** The FSA is open to considering disclosing nonconfidential firm-level prudential returns, such as the balance sheet and income statement, loans and investments (sectoral information), asset quality (past-dues, nonperforming loans, charge offs), funding structure, capital structure, and off-balance sheet exposures.

48. **The FSA has initiated more regular discussions with banks' auditors.** The FSA has established periodic meetings with external audit firms to discuss issues of common interest relating to bank operations. The FSA's Supervisory Enhancement Program requires supervisors of high-impact banks to meet with the auditors of their firms at least annually. In addition, the FSA meets bilaterally with financial services audit partners for the largest audit firms. Recently, the FRC and the FSA have expressed some concerns about the quality of audits, including such matters as the need for more professional skepticism.

Corrective and remedial powers of supervisors (CP 23)

49. **The FSA identifies problems in banks that require remedial action as part of their supervisory program, but could improve the linking of interventions to the seriousness of issues.** As noted in CPs19–21, the supervisory approach needs to strengthen the focus on the important deficiencies. The supervisory approach is also still moving from a more-reactive to a more-proactive stance. Implementing an early intervention framework could assist in this regard.

50. **An early intervention framework, and other enhancements identified in this assessment, would assist the FSA in ensuring that there is the appropriate and consistent degree of forcefulness in interventions applied.** That would also ensure that escalation of interventions from informal to the more formal stages occurs in a way that reinforces the level of intrusiveness desired. Intrusive judgment-based interventions are not about saying 'no' to everything, but making the consequences fit the seriousness of the issue in an effective way to achieve results. The culture change will understandably take time and leadership focus. In doing this, the FSA would benefit from a more centralized way to capture reasonable detail on informal and formal interventions in high-impact firms (separate from enforcement actions) to enhance consistency and to allow senior leadership to monitor what is occurring.

51. **The FSA would benefit from having a well articulated, judgment based, prompt intervention framework (not necessarily with pre-set triggers).** This should deal with (i) desired actions to address material issues of controls, governance or risk management identified in the supervisory process, which, if not corrected, could lead to banks having serious problems; and (ii) actions closer to the point of nonviability or breach of the threshold conditions. It is understood that this will be part of the new arrangements.

52. **The FSA has the necessary tools for corrective and remedial actions and the assessors saw evidence of their use in practice.** These tools include remedial action plans for banks as part of the supervisory process, the ability to set capital add-ons, formal power to impose conditions on a banks authorization if it is not abiding by FSA rules, and the ability to levy fines. However, the use of these various tools does not appear as consistent or clear as would be desired. It is difficult for assessors to confirm (based on information presented by the FSA) that the desired proactive intervention is applied clearly and consistently.

53. **The FSA also has authority to declare a bank nonviable by determining that it is not meeting, or is likely not to meet, specified threshold conditions.** These conditions include adequacy of resources. If that condition exists, and if it is also determined that there is no immediate prospect that the bank could meet those conditions, the FSA can trigger the start of the special resolution process conducted by the BoE. This process, which is relatively new, has been used once in the resolution of a medium-sized building society. In putting in place a prompt intervention framework and in enhancing arrangements between the authorities, they should consider lessons learned from that experience.

Consolidated and cross-border banking supervision (CPs 24–25)

54. **The United Kingdom applies consolidated supervision.** The FSA under the legislation (as derived from the Capital Requirements Directive and Financial Conglomerates Directive) applies a variety of rules on a consolidated basis to banking groups. A banking group includes the highest U.K. parent entity (e.g., holding company) of the U.K. authorized entity in the group and all entities below that in the United Kingdom and outside (there are detailed rules on how and when to include various noncontrolled interests). In some situations, group supervision extends to the highest parent entity in another EU member state. The scope of group supervision includes both regulated and nonregulated entities. These rules on a consolidated basis include such matters as requirements for group-wide systems and controls, group-wide risk management, consolidated capital and liquidity standards, connected lending, and large exposure limits. There are also solo bank requirements, such as solo capital adequacy rules. Certain FSA powers (such as to collect information or to require a skilled person to report on any matter) apply to authorized and non-authorized entities in the group, and the power to collect information extends to entities above the parent entity.

55. **The existing legislation for consolidated supervision needs to be strengthened.** The authorities report that they get excellent cooperation from banks in meeting these rules and providing related reporting. However, the FSA has no legal power directly over the parent holding company of the banking group. So, formal remedial action, if necessary, has to be through the authorized firms in the group, which might not always be possible if the authorized firms are not sufficiently significant within the consolidated group. The alternative is for the FSA to use its powers to ring-fence the bank from the rest of the group, which may not be appropriate in the circumstances. As a result of the lack of power over parent holding companies, the FSA has no direct authority to approve the acquisitions of

banks or other financial firms by the parent holding company (it would have authority if the bank in the group was making the acquisition or if the target-entity was another FSA-authorized entity). This could be problematic if the target-entity is not a U.K. firm. The FSA is required to assess the risks posed to the regulated entity as a result of its close links to other entities. At the time of the assessment, the U.K. government was consulting on extending FSA powers over unregulated holding companies.

56. **The FSA has an extensive network of MOUs and informal arrangements with other home and host supervisors, as well as appropriate legal powers to share information and to keep information confidential, as necessary.** Given the openness of the U.K. market and the global reach of major U.K. banks, it is essential that these arrangements, and their enhancement through supervisory colleges, work well. The United Kingdom is also host to a number of major branches of EU banks. Under EU single-passport rules, these are not to be supervised by the host-country, except for liquidity. It is essential that home-host arrangements work well in these cases to ensure the effectiveness of both the home- and host- supervisors. The assessors discussed the practical arrangements with the FSA and examples where they need to be improved.

57. **Table 1 below offers a principle-by-principle summary of the assessment results.**

Table 1. United Kingdom: Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	LC	
1.1 Responsibilities and objectives	MNC	Statutory regulatory and supervisory mandates are open to very considerable ranges of interpretation and lack clarity with respect to prudential objectives and how these are to be interpreted vis-à-vis statutory 'principles of good regulation,' such as, maintaining the competitiveness of the U.K. and minimizing impact on competition. Under fundamentally the same supervisory mandate, a recent material change from what the authorities described as 'principles-based' to 'intensive and intrusive,' 'judgment-based' supervision is underway in response to experience in the crisis. The full impact of the change will occur over the next two years. There is a risk that the mandate and objectives of the various new agencies proposed, and how they interact, will be unclear for some time.

Core Principle	Grading	Comments
1.2 Independence, accountability and transparency	LC	The reasons for removal of the head of the supervisory authority are not specified in legislation, nor is there a requirement to make those reasons public. The assessors were not in a position to do a detailed analysis, but their strong sense is that additional resources for prudential regulation and supervision are required (some combination of enhanced skills and additional people), while recognizing that some of this could be funded from efficiencies in existing processes that the FSA is now assessing.
1.3 Legal framework	C	
1.4 Legal powers	C	
1.5 Legal protection	C	
1.6 Cooperation	C	
2. Permissible activities	C	
3. Licensing criteria	C	
4. Transfer of significant ownership	C	
5. Major acquisitions	C	A particular issue is that the power to review acquisitions does not extend to acquisitions by parent holding companies of banks. This flows from issues identified and assessed in CP 24.
6. Capital adequacy	LC	Strengthening the quantity and quality of capital is occurring, including through setting individual capital guidance for banks above the minimum, capital buffers through stress testing and the interim capital targets, which are higher than the new Basel minimums. Assessments of use of advanced models by banks to determine their capital position (both qualitative and quantitative requirements) are not sufficiently detailed. This foundation needs to be in place, so that the authorities can rely fully on the model results for prudential purposes.
7. Risk management process	LC	Comprehensive enterprise-wide risk measurement and risk management (ERM) remains a challenge for some major banks. The FSA's enhanced program of supervisory assessment of ERM is just starting. Programs to relate capital to risk are well advanced.
8. Credit risk	MNC	Assessment of credit risk management

Core Principle	Grading	Comments
		and asset quality by the FSA needs to be enhanced to include sufficient, timely, proactive, and in-depth reviews as well as some degree of transaction testing. Specialist resources have been enhanced, but an in-house and/or external on-site approach to credit risk is also needed. Plans to enhance data and analytics to perform better peer comparisons are sound but need to be executed. The Core Prudential Program for credit risk has not yet been fully rolled out and could not be assessed, including for how much detailed onsite credit risk assessment will actually occur. A full roll out is expected to be completed by end-2012.
9. Problem assets, provisions, and reserves	C	Focus is placed on capital and not on provisioning and reserves. New EU rules, following revised IAS39 (EL-driven), will require a change in this approach.
10. Large exposure limits	C	The FSA should encourage banks to set stricter limits to large exposures as part of sound risk-management practice.
11. Exposure to related parties	LC	The FSA relies on general rules to deal with related-party issues, for which they are not really tailored. This is supplemented with supervisor discretion. These transactions appear not to be sufficiently considered.
12. Country and transfer risks	C	A more proactive approach to supervision generally, as per CP 19, would naturally apply to country risk.
13. Market risks	LC	There is room for more proactive cross-system, in-depth reviews of market risk using the recently enhanced specialist resources, linked to supervision processes under the enhancement program; full compliance with this principle is also affected by the weaknesses in the supervisory approach assessed in CP 19.

Core Principle	Grading	Comments
14. Liquidity risk	LC	The FSA has made major and successful efforts to ensure that very high-impact banks increase their liquidity, and to enhance FSA supervision. Further efforts are required, including detailed drill-down supervisory work for high-impact banks, as per current plans.
15. Operational risk	C	The FSA has a general thrust to encourage large, sophisticated institutions to upgrade their internal operational risk management.
16. Interest rate risk in the banking book	C	There are deficiencies in reporting that partially hinder outlier analysis for smaller and mid-sized banks.
17. Internal control and audit	C	The FSA is following the “Walker Review” recommendations to improve bank governance.
18. Abuse of financial services	C	The FSA’s use of risk-based methodology means that smaller banks receive less on-site AML/CFT attention than optimal. Attention also could be increased on foreign branches of U.K. banks.
19. Supervisory approach	MNC	<p>The crisis revealed serious weaknesses in the supervisory approach and the ability of the FSA to maintain a thorough in-depth understanding of banks’ safety and soundness. Plans to address these weaknesses have been developed, but implementation, which has started, is several years away from completion for major banks with roll-out for other high-impact banks even further away. In this context, it is critical that the good progress is maintained and that core supervisory work does not receive reduced priority in favor of the new macro-prudential overlay, which could affect the quality of that overlay’s assessment. To achieve compliance with this principle, and taking into account the size and complexity of the U.K.’s largest banks, the identified weaknesses include:</p> <ul style="list-style-type: none"> ➤ The need for more in-depth reviews to ensure that supervisors understand banks, and their risk

Core Principle	Grading	Comments
		<p>management and governance capabilities.</p> <ul style="list-style-type: none"> ➤ The need to comprehensively shift to more proactive rather than reactive review strategy to confirm inherent risk, risk management, and governance assessments. ➤ The need to rectify deficiencies in the ARROW framework. ➤ The need to improve in communication. This includes (i) increasing clarity in the communication of key supervisor messages to banks; (ii) enhancing assurances that there is coherence between supervisory assessments and Board-level communications of the most important issues; and (iii) ensuring all material issues are brought together in a Board-level wrap-up with senior FSA participation at major banks at least once a year. <p>The Core Prudential Program to address these issues in the very high-impact banks is a multi-year effort, which is at an early stage in some areas. It is important to ensure that linkages between modules are taken into account. Applying this approach to other high-impact firms is necessary.</p>
20. Supervisory techniques	LC	There is an unbalanced mix between what would be commonly described as sound 'on-site' and 'off-site' supervision, with less 'on-site.'
21. Supervisory reporting	LC	To achieve full compliance, FSA supervisory reporting would benefit from more regular use of granular data on advanced bank portfolios, which would better permit identification of outliers and peer analysis. Improved regular reporting from smaller and mid-sized banks in select areas (e.g., IRRBB) would also allow effective outlier analysis.

Core Principle	Grading	Comments
22. Accounting and disclosure	C	There is room to improve public disclosure by banks.
23. Corrective and remedial powers of supervisors	C	While the FSA generally has adequate legislative powers, and there is evidence of their use, there is no framework for early intervention. That is being considered as part of the new arrangements.
24. Consolidated supervision	LC	The FSA practices consolidated supervision, including applying rules for such matters as liquidity, capital, large exposures, risk management and controls, and governance of the whole banking group. However, the legislation does not give the FSA formal enforcement powers for these matters to be applied at the parent bank holding company level. Rather, powers only apply at the bank or other authorized firms. This also affects the FSA's ability to review acquisitions that the parent bank holding company might make in banks or other entities which are not FSA-authorized firms.
25. Home-host relationships	LC	Appropriate legal agreements to share information and preserve confidentiality are in place. There is room to improve the information sharing between the United Kingdom and others on both a home and host basis.

Aggregate: Compliant (C) – 17, Largely compliant (LC) – 10, Materially noncompliant (MNC) – 3, Noncompliant (NC) – None (note: CP 1 is divided into six components for this analysis.)

F. Recommended Action Plan and Authorities' Response

Recommended action plan

58. **Table 2 lists the suggested steps for improving compliance.** Recommendations are proposed on a prioritized basis.

Table 2. United Kingdom: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.1 Responsibilities and objectives	<p>In the short run, clarify the objectives of intensive, intrusive and judgment-based supervision. Ensure management oversight focuses on whether the on-ground activities are consistent with the desired outcome. Ensure new mandates in the reorganization are clear.</p>
19 Supervisory approach 20 Supervisory techniques	<p>Develop an integrated multi-year plan for enhanced supervision, including more on-site and in-depth reviews, more peer benchmarking, a desired coverage model that is more frequent, and amendments to the risk-rating framework, so that it is more discriminating, proactive, and forward looking. This plan should include the Core Prudential Program and its extension to a range of banks beyond those that are very high-impact (ultimately, all banks need a degree of more in-depth proactive reviews). It should also include risk-model changes.</p> <p>Tighten specialist-supervisor linkages and linkages between new initiatives (e.g., stress testing of capital and liquidity).</p> <p>Improve reporting of results to banks, so that they get clear messages of the most important matters that need to be dealt with.</p> <p>Determine resource requirements for this new model and a reasonable timeframe.</p> <p>Ensure the new macro-prudential overlay does not detract from delivering on this enhanced micro-prudential core work.</p>
8 Credit Risk	<p>Develop a strategy for materially enhanced in-depth review of credit risk, resource adequately and execute, starting in 2011.</p> <p>Proceed with additional data gathering and analytics to permit better peer analysis.</p> <p>Consider multi-year plan to extend this approach as necessary.</p> <p>In the short term do more in-depth reviews of commercial real estate exposures either using FSA staff or skilled persons (Section 166 reports).</p>
7 Risk management	<p>Implement the Core Prudential Program to assess enterprise-wide risk management.</p> <p>Ensure adequate review and assessment of major banks' risk architecture and risk-measurement capability.</p> <p>Consider which smaller and mid-sized banks should be subject to more-rigorous FSA stress</p>

	<p>testing.</p> <p>By end-2011, review adequacy of specialist resources in light of then-current and expected demands.</p>
21 Supervisory reporting	Develop a comprehensive plan to enhance prudential reporting.
6 Capital adequacy	<p>Change the policy and provide adequate resources to conduct more in-depth reviews of credit, market and AMA models.</p> <p>Implement the announced policy to proactively review the more important models on some cycles, even if there are no changes that would trigger a reactive review.</p> <p>Consider extending this beyond the 10 most important system-wide models.</p>
14 Liquidity risk	Continue with the planned roll out of the new approach beyond major banks.
13 Market risk	Perform more in-depth proactive reviews, including more regular peer analysis or 'theme' reviews.
24 Consolidated supervision	Amend legislation to give FSA powers over holding companies of parent banks as a priority.
25 Home host	Work to enhance colleges and home host information sharing within the current framework
1.2 Independence, accountability, and transparency	Amend FSMA to specify the conditions under which the FSA head could be removed and provide for explicit requirements to make these public.
5 Major acquisitions	<p>Ensure that the FSA has the legal authority to approve all financial institution acquisitions made by parent bank holding companies (related to CP 24).</p> <p>Clarify the threshold for pre-notification in the rules or guidance.</p>
23 Corrective and remedial powers	Enhance early intervention through developing and promulgating an early intervention framework. In the reorganization, include in the FSMA a general objective of early intervention.
22 Accounting and disclosure	Consider disclosing regularly a portion of regulatory returns with suitable caveats that the FSA is not responsible for their accuracy
11 Related parties	Consider developing more explicit rules. These include (i) automatically defining more persons as related parties consistent with this CP; (ii) explicitly requiring transactions at market value; and (iii) requiring that transactions above a materiality threshold to be set by banks, be approved by a Board committee and with FSA approval. Ensure adequate supervisory focus on this as part of the reviews.

15 Operational risk	Pursue a program to encourage major banks to upgrade their operational risk management capability.
17 Interest rate risk in the banking book	Amend reporting to permit high-quality peer analysis of this risk for smaller and mid-sized banks.
18 Abuse of financial services	Amend the risk-assessment methodology to ensure adequate on-site coverage of smaller and mid-sized banks in line with AML/CFT risk. Ensure adequate on-site work (FSA or skilled persons) at foreign branches of U.K. banks.

Authorities' response to the assessment

59. **The U.K. authorities (HM Treasury, the BoE and the FSA) welcome this comprehensive IMF review of the United Kingdom's supervisory and regulatory framework for the banking sector.** The assessment has come at an important time for the United Kingdom, as the transition to a new regulatory structure begins, and the authorities appreciate this opportunity to comment on it.

60. **The report highlights that due to the domestic and global significance of the U.K.'s financial sector, the IMF review assesses the United Kingdom against a particularly high standard.** Furthermore, this is a point in time assessment and therefore it has not been possible to give credit for a number of the supervisory reforms that are in train but not fully embedded.

61. **As with many other major jurisdictions, the United Kingdom's supervisory and regulatory credibility was severely tested during the global financial crisis.** The review recognizes that the FSA has responded to the crisis, making good progress on initiatives to enhance prudential requirements for banks and imposing a more intensive supervisory strategy. As the FSA has previously articulated, these supervisory reform programs will take time and there is still some way to go to fully implement them. The authorities are therefore pleased that the IMF recognizes that the FSA has made considerable progress on reforming its regulatory approach. The report also acknowledges that the continuing effective implementation of the reform programs will further improve the United Kingdom's compliance with the core principles.

62. **The assessment concludes that supervisory judgments and actions taken since the crisis have been effective in identifying emerging risks in good time to enable the FSA to pro-actively manage them and, as such, the U.K. authorities believe that the FSA's supervisory approach is currently closer to compliance than the IMF has concluded.** It is the authorities' intention that the new Prudential Regulation Authority's (PRA) approach to supervision will be based on this type of forward-looking judgment, clearly directing supervisory intervention at reducing the major risks to financial stability.

63. **A theme running through the IMF's recommendations is that the current reform plans could be augmented, in particular through even deeper supervisory assessments of banks' key risk categories.** The U.K. authorities believe that effective supervision should encompass three elements: policies and rules on firms' resilience (covering such areas as capital, liquidity and leverage); supervisory assessments and interventions; and policies and mechanisms to support resolution. It is the authorities' intention that the PRA will combine use of all these elements in order to effectively contribute to the financial stability of the United Kingdom.

64. **The U.K. authorities want the PRA to be compliant with international supervisory standards and will consider the IMF recommendations carefully in the design of the operating model for the PRA.** HM Treasury is already consulting on proposed legislative reforms that will go a long way to address a number of the identified gaps in the United Kingdom's regulatory framework. Most important of these is setting a single and clear mandate for the PRA to contribute to the promotion of the financial stability of the United Kingdom. The authorities concur with the IMF that a clear and focused mandate is the cornerstone of an effective regulatory regime. Other reforms include extending the regulatory perimeter to financial holding companies, and introducing a Proactive Intervention Framework.

65. **The PRA's future approach to regulation will certainly draw on current FSA best practices, but will enhance and tailor them in way that is conducive to meeting the PRA's financial stability mandate.** The PRA's approach will thus consist of policy making to guard against a range of possible outcomes and the application of that policy through effective supervision. All banks will be subject to a baseline level of supervisory oversight designed both to reduce the probability of failure and, as it is not the PRA's role to prevent bank failure, to ensure that if a bank does fail, it does so in an orderly manner. The PRA will not view orderly failure as regulatory failure. For those banks posing greater risk to the stability of the system, the PRA's supervisory approach will be more intensive and focused, including:

- analysis of a bank's financial position;
- ongoing evaluation of a bank's business model, capital and liquidity plans, governance and culture, risk management and controls, to understand key risks to financial stability;
- stress testing against a range of possible future states of the world;
- regular assessment of a firm's resolvability and the state of its resolution plans;
- regular contact between a firm's senior management and senior PRA management; and

- early and proactive supervisory interventions under the Proactive Intervention Framework designed to reduce risks to the stability of the system.

66. **The report also mentions in several places that additional supervisory resources are likely to be required to continue to deliver on, and augment, planned enhancements to supervision and to develop the new macro-prudential overlay.** The authorities agree that good progress should be maintained on core supervisory work, as the PRA's main contribution to macro-prudential policy will be on the position of individual banks and sectors and understanding their impact on the stability of the system. Therefore the FSA and the Bank of England are already assessing resource requirements through the process of designing the PRA's operating model. This assessment includes determining the desired intensity of supervisory assessments; defining how the macro-prudential overlay will work; and identifying efficiency savings through simplifying supervisory processes.

67. **Finally, the authorities wish to express their strong support for the role the FSAP plays in promoting the soundness of global financial systems and look forward to a continuing dialogue with the IMF and other global counterparts in seeking to improve the stability and effective supervision of the global financial system.**

II. DETAILED ASSESSMENT

68. The assessment of compliance of each principle is made based on the following four-grade scale: compliant, largely compliant, materially noncompliant, and noncompliant.

69. To achieve a “compliant” assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that principle. Under the BCP methodology, a “materially noncompliant” assessment is given whenever there are severe shortcomings, despite the existence of formal rules, regulations, and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A “noncompliant” grade indicates that no substantive progress toward compliance has been achieved. No principle, however, has been assessed as noncompliant in the United Kingdom. In interpreting the grading, it is also important to note that for some principles the assessment takes into account both compliance at banks and compliance of the supervisors.

70. Table 3 below offers the detailed principle-by-principle assessment. It provides a “description” of the system with regard to a particular principle, a grading or “assessment,” and “comments.”

Table 3. United Kingdom: Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	EC1. U.K. legislation (primarily the Financial Services and Markets Act –FSMA) gives the FSA sole responsibility for the supervision of banks in relation to their deposit-taking. The BoE contributes to the stability of the system through its lender of last resort operations and macro-prudential surveillance. Under the Banking Act 2009, the BoE or the treasury is responsible for dealing with failing banks after the FSA has triggered the SRR.

	<p>The responsibilities and objectives of the FSA, as the supervisor/regulator of banks, are set out in FSMA. In discharging its general functions (FSMA Section 2(4)), the FSA is required to act in a way that is compatible with the 'regulatory objectives' (FSMA Sections 3-6A). The FSA's regulatory objectives pursuant to FSMA are:</p> <ul style="list-style-type: none"> • market confidence, i.e., maintaining confidence in the financial system; • the protection of consumers, i.e., securing the appropriate degree of protection for consumers; • the reduction of financial crime, i.e., reducing the extent to which it is possible for a business carried on (i) by a regulated person; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime; and • financial stability, i.e., contributing to the protection and enhancement of the stability of the U.K. financial system (added by the Financial Services Act 2010). <p>The FSA published in 2010 a general description of how it viewed its strategy and operations under this objective.</p> <ul style="list-style-type: none"> • In discharging its general functions the FSA is also required to have regard to the matters ("principles of good regulation") specified in FSMA Section 2(3), such as: • the need to use its resources in the most efficient and economic way; • the responsibility of those who manage the affairs of authorized persons; • the principle that a burden or restriction, which is imposed on a person or on the carrying on of an activity, should be proportionate to the benefits, in general terms, which are expected to result from the imposition of that burden or restriction; • the desirability of facilitating innovation in connection with the regulated activities; • the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom; • the need to minimize the adverse effects on competition that may arise from anything done in the discharge of those functions; • the desirability of facilitating competition between those who are subject to any form of regulation by the FSA; and • the desirability of enhancing the understanding and knowledge of members on the public of financial matters (including the U.K. financial system). <p>The government has announced (HMT paper 2010) that, as part of the proposed reorganization of regulatory responsibilities, it intends to clarify the regulatory objectives and 'have regards' with respect to prudential supervision. The proposed mandate is broadly similar to that found in other major markets. However, how other factors, such as competitiveness, are handled in the new mandate is unclear, as is the possible overlap between macro- and micro-prudential regulation. This legislation</p>
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is targeted for adoption by the beginning of 2013.

While prudential regulators can and do have (explicit or implicit) objectives that call for attention to impacts that affect competition or competitiveness, it is rare to have a mandate that explicitly requires the regulators in their actions to have regard to the need to minimize the impact on competition. It is also rare to have a mandate that explicitly mentions the competitive position of the country.

The financial stability objective for the FSA was only explicitly added in 2010. Prior to that, the FSA was left to interpret its market confidence mandate as including the traditional prudential objectives of safety and soundness. The U.K. approach came to be called 'light touch' or 'limited touch' regulation by some. Partly, this was the general U.K. regulatory philosophy, which was widely supported. The FSA was left to itself to determine how to allocate its resources between prudential regulation and other primary objectives such as treating customers fairly. The mandate contained no indication of the supervisory or regulatory culture desired. FSA staff assessors spoken to indicated that the focus on treating customers fairly probably crowded out necessary prudential work.

FSA staff indicated to assessors that, during the period preceding the crisis, more focus was put on treating customers fairly than on safety-and-soundness issues, partly because routine supervision in these areas kept finding risk of inappropriate treatment, which had actually crystallized. Review of FSA priorities, as expressed in annual reports prior to the crisis, does not indicate a degree of projects related to safety and soundness. Indeed the annual reporting framework prior to 2008 does not contain financial stability or prudential sections. Staff indicated to assessors that FSA senior management and the Board did not have access to accurate information that would permit them to assess and monitor the balance of effort and resources in prudential regulation and supervision versus market conduct.

Since the crisis, senior FSA staff has indicated that their approach put far too much reliance on firms without significant verification of the basis for that trust.

The government's recent white paper indicates that one of the advantages of moving to a separation of prudential from conduct of business regulation is to permit a clearer mandate for the various authorities and to take account of the different types of operations and culture desired. The assessors discussed with staff more detailed examples of the trade-offs that were made in resource allocation. For example, staff indicated to the assessors that a much larger portion of specialist time pre-crisis was spent on conduct matters than on prudential matters. The Turner Review noted the importance of the FSA's objectives being explicit about financial stability.

Under the legislative arrangements in FSMA, the regulatory objectives also have direct consequences as they are explicitly linked to various intervention powers of the FSA and to criteria for approvals and permissions.

In response to the crisis, the FSA has re-interpreted its mandate to become 'intensive and intrusive' and 'judgment based.' There is talk by the regulator of people needing to be 'fearful of the FSA.' It is not fully clear in FSA statements or practice what these concepts mean for actions on the ground. Again, in discussions with staff, it is hard to see cohesion at this point in the transformation as to what this is to mean in practice.

The FSA has consistently tried to link its methods and actions to its regulatory objectives. During the mission, a wide variety of staff that assessors met used that phraseology. Assessors also saw repeated evidence of how the interpretation of the statutory objectives had affected a wide variety of FSA operations such as: how much in-depth review work was done; an approach to resourcing that, until recently, was reluctant to increase resources in the face of extra demands; the risk assessment methodology and risk tolerance; and the approach to how much information was to be collected from firms, among others.

EC2. The FSA operates with a comprehensive framework of minimum prudential standards. Banks are required to meet the Threshold Conditions (FSMA Schedule 6) and comply with the rules made by the FSA, in order to be authorized and to continue to be authorized. The Threshold Conditions include, in particular, the obligation to have adequate financial resources. Under FSMA the FSA has extensive rule making powers which may be used to introduce new prudential rules or amend existing ones in order to take account of e.g., market changes. The FSA has made use of these powers to approve the General Prudential Sourcebook (GENPRU) and in the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). These cover such matters as risk-management standards, and rules and standards re capital and liquidity. Rules are legal instruments. In addition, FSA issues guidance in various areas as to how it applies rules and its expectations of firms.

EC3. The FSA updates its handbook of rules and guidance on a regular basis to take account of market changes and to implement European directives. A majority of recent rule changes are European directive-related.

EC4. Aggregate information on the financial strength and performance of the industry is publicly available from several sources. The BoE publishes a *Financial Stability Report* in June and December each year and the FSA publishes a *Financial Risk Outlook* in March each year. These give an overview of the key developments affecting the U.K. financial system. The FSA also provides quarterly aggregate statistics on mortgage lending.

<http://www.bankofengland.co.uk/publications/fsr/2010/index.htm>

http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2010.pdf

Pillar 3 information on major banks is readily available in banks' regular reporting. The FSA provides a register on its website of which firms are authorized. However, there is no ready comprehensive information on key financial information or ratios such as capital for individual banks that is maintained by the FSA or the banking association.

AC1. As a single regulator with a broad remit and a finite amount of resource, the FSA has a single risk framework (called ARROW) that allows it to adjust supervisory intensity according to the risks a bank presents to its various statutory objectives.

The ARROW framework assesses banks in terms of their impact (the scale of the effect bank risks would have on consumers and the market if they were to crystallize) and their probability (the likelihood of the particular issue occurring in the bank). This impact and probability assessment determines the intensity of the supervisory approach applied to each bank. All banks (except some branches and individual

	banks within groups) are currently subject to a relationship-managed supervisory approach.
Assessment	Materially noncompliant
Comments	<p>The mandate given by government initially to the FSA is very broad and generally stated. An explicit mandate regarding prudential objectives is missing. Nor did the FSA itself formally clarify publicly, early on, how it saw safety and soundness as part of its 'market confidence' objective. There is little statutory guidance on how to deal with the trade-offs among primary objectives.</p> <p>More recently, under essentially the same mandate, the FSA embarked on an "intensive and intrusive," more judgment based approach. There is insufficient clarity and cohesion around what this is to mean in practice at this stage of the roll-out process.</p> <p>There was no explicit stability or prudential objective in the FSA mandate prior to 2010 and this situation will not be formally clarified until 2013. Even when 'financial stability' was added in 2010, it did not refer to safety and soundness of firms. As a result, it is unclear how the various FSA powers linked to that objective can be used in practice.</p> <p>Under the new arrangements, there are proposals to clarify mandates, but there is a risk of a continued lack of clarity. There is also a risk of new lack of clarity in how the micro-prudential and macro-prudential mandates will interact. It will also be important to clarify any early intervention mandate that is given by parliament.</p> <p>By combining prudential and conduct of business regulation in the same broad market confidence statutory mandate, there was always a risk of not being clear about the effort and focus desired by government related to the safety and soundness of institutions. Internal FSA management information did not permit a regular strategic assessment and discussion of the allocation of resources between these mandates, nor did it allow monitoring of possible unintended drift that might occur. In addition the 'have regard' to aspects of the mandate could be read to overly suggest that the prudential authority ought to give more concern than in other jurisdictions to promoting London as a financial center and supporting innovation. The mandate was also far from clear about how to balance these 'have regard' objectives with safety and soundness, or whether what indeed was desired was not balance but minimizing the impact of regulation. As the recent HMT paper concludes, there is a sound argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a general acceptance of a 'light touch' orthodoxy (though the FSA did not generally use this language.) Assessors share this view (as well as the view that there was tension between the prudential and market conduct objectives).</p> <p>Assessors saw evidence of the implications of this lack of clarity at all levels of the organization. The mandate issues and the 'light touch' philosophy they spawned permeate discussion about resourcing, the core risk assessment model (Arrow) (CP 20), which is used as more of a resource management model than a risk assessment model, the lack of regular pro-active in-depth reviews (CP 19 and other risk CPs), adoption of a capital model validation policy that did not encompass any replication of firms' data accuracy and model integrity (CP 6), a 'light touch' approach to collection of data (CP 21) and the inadequate use and availability of specialists to assist with supervision, which has only been rectified recently and is not yet effectively integrated</p>

	<p>into the supervisory process.</p> <p>Under the new 'intensive and intrusive' approach, there is a risk of being intrusive for the sake of it in reaction to the crisis, without focusing on the deficiencies in banks' practices that really matter, and ensuring prompt action on those. This will require ongoing management and leadership focus to ensure desired results in practice. There is also the possibility that the mandate will be interpreted as focusing on capital and liquidity mitigants at the expense of basic assessment and supervision of risk management, governance, understanding risks in business models, and related matters. The immediate priority of the FSA on capital and liquidity is, however, understandable.</p>
Principle 1(2).	<p>Independence, accountability and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.</p>
Description	<p>EC1. The FSA has operational independence, having been established as a private company, limited by guarantee and financed by direct levies (and fines) on the industry with responsibility for its own budget and regulatory decisions. Its governance structure including responsibilities of the Board (which has a majority of non-executive members) is set out in FSMA. An early exchange of letters between the Chancellor and the FSA Chair when the FSA was created made clear that the FSA is to operate with operational independence. Assessors saw no evidence that was not the case in practice.</p> <p>Other aspects of the governance structure, such as the requirement for there to be a practitioner panel and a consumer panel with input on budgets and overall operations, are also set out in statute. So is the requirement to be accountable through an annual report to the Chancellor that is tabled before parliament.</p> <p>The non-executive Board members determine the remuneration of the FSA's chairman and executive members of the Board. They must report on these matters to the treasury (Schedule 1 paragraph 4). The non-executive Board members currently do not include any persons who are affiliated with regulated firms. High-level minutes of the FSA Board are published on the website.</p> <p>FSMA Schedule 1 (Schedule 1 paragraph 2) requires that the chairman and other members of the FSA's governing body must be appointed, and be liable to removal from office, by the treasury. These appointments are made by treasury officials not by ministers in order to avoid the FSA becoming a government department. The requirements do not include provisions detailing the circumstances in which the chairman can be removed from office. Nor do they require that the reasons be publicly disclosed. The CEO is appointed by the Board to the CEO position (but is appointed by treasury officials to his or her position on the FSA Board) and the legislation does not include requirements as to the criteria for his/her removal as CEO or as a member of the Board. For his/her role as CEO these are contained in an employment contract, and are the standard criteria one would expect. Employment contracts for the CEO are for three years and the chairperson is appointed for five years.</p> <p>EC2. The FSA is accountable under FSMA for its performance against its statutory objectives. It must at least once a year make a report to the treasury on, amongst other things, the discharge of its functions. The treasury is required to lay a copy of each such report received by them before parliament. This report includes further information on objectives and performance. The FSA publishes its strategic plan. In addition, the FSA must hold an annual public meeting to discuss its annual report, must consult practitioners and consumers 'on the extent to which its general policies</p>

and practices are consistent with its general duties, and must have a mechanism to receive and deal with complaints. The treasury may appoint an independent person to conduct a review of the economy, efficiency and effectiveness with which the FSA has used its resources in discharging its functions. This has never occurred.

The non-executive committee of the Board reviews the FSA's internal financial controls and use of resources. In addition, the Treasury Select Committee of the House of Commons from time to time considers the FSA's performance in carrying out its functions under FSMA and requires the senior executives of the FSA to appear before it.

Lastly, the subjects of FSA's decisions may challenge those decisions before the Upper Tribunal where expressly stated by FSMA or, otherwise, via judicial review.

EC3. The FSA has a rigorous recruitment process and has taken steps in particular post-crisis to ensure that staff has a wide range of expertise and backgrounds. On joining the FSA, all staff is required to sign up to the Code of Conduct, and declare any possible conflicts of interest. There is a regular process to update employees' compliance. Staff that the assessors met uniformly showed a high degree of professionalism. Industry groups that the assessors met commented on the generally high level of professionalism of staff.

EC4: The FSA Board has the power to require the payment of fees, with the costs of meeting regulatory objectives, as determined by the FSA, being met by an annual fee (authorization being charged for separately). (FSMA Schedule 1 paragraph 17). In making such rules, the FSA is required to follow the consultation procedures in FSMA (Section 155). Salary scales are set by the FSA. Salaries paid by the FSA take into account pay levels within the financial services industry and the FSA is able to recruit expert assistance where needed.

Prior to the crisis, the number of staff was relatively constant. The FSA was considering a target headcount cut of some 200 (or a little less than 10 percent). Fees in the four years prior to 2005 rose at approximately the rate of inflation. Previously, the FSA reported that it did not increase resources to deal with such matters as Basel II. This is cited in some FSA reports as a contributing factor in its crisis preparedness as less resources were available for regular supervision work. Since the crisis, the revised regulatory philosophy and operating model has been complemented by investment to create the capacity and capability to deliver more intensive supervision and delivery of the credible deterrence agenda. The number of FSA staff has increased from around 2,500 in early 2008 to nearly 3,900 today. FSA staff assessors met indicated that the recruitment campaign was broadly effective. Additional staff went predominantly to supervision and specialist areas. FSA planning considers total staff in supervision of various types of firms, related risk specialists, and other functions. It is not possible to determine how many full-time equivalents (FTEs) are devoted to prudential supervision compared to conduct supervision and supervisory teams conducting both types of work.

Staff turnover is around 10 percent overall and there is a considerable number of departures of senior staff. Turnover is higher in the specialist areas. The executive committee and the Board monitor this closely. Senior staff indicated to assessors that they did not consider the level of turnover and vacancies to be a matter of concern at this point, but they were increasingly concerned with the loss of senior staff.

The supervisory team for a major bank now consists of some 15–20 FTEs depending on the bank, with 5–10 for a major foreign bank. This is an increase from 4–6 a few years ago. The major bank division staffing has risen from some 140 to 260 in the past few years and related specialist resource staff has risen from 100 to 200. For

	<p>smaller banks, supervision is not based on an individual supervisor having a portfolio but rather operates on the basis of various functions being performed by various teams.</p> <p>With the new influx of staff, the FSA devotes considerable resources to provide training opportunities for its staff. The FSA's Training and Competence Scheme (T&C) is a framework for assessing the competence of individuals on the job.</p> <p>The FSA is able to hire or contract external specialists, and has a specific power to appoint one or more competent persons to conduct investigations on its behalf. Firms can also be required to provide the FSA with specified reports by "skilled persons" nominated or approved by the Authority, and appearing to the FSA to have the skills necessary to make a report on the matter concerned (section 166 reports). This power was used approximately 175 times in 2010. Assessors understand that a relatively small number of those relate to prudential matters. Supervisory responsibility remains with the FSA.</p> <p>Staff met by assessors, indicated that the FSA suffers from legacy system issues, some of which date from the FSAs creation in 1998. The FSA is proactively reviewing the 'legacy' systems to ensure their stability. As noted in CP 21, data and systems appear fragmented, material silos exist, and there is a need for material upgrades. The FSA is implementing a new records management system which will materially improve access to unstructured and ad hoc data which is stored in a variety of locations. Assessors discussed how the new macro-prudential aspects will affect data and systems demands. Over the past year or so, the FSA has added a number of new responsibilities beyond those envisaged at the time the additional staffing for the supervisory enhancement program (SEP) was determined. These include work on living wills and resolution arrangements, much enhanced work on stress testing which is to be repeated regularly, work on compensation matters and better relating compensation to risk, and a much enhanced core prudential program (CPP) for further enhancement of supervision of major banks (beyond the SEP). That involves much more in-depth reviews of governance, risk management capital and liquidity. These are not fully implemented. Assessors discussed with staff examples of where this work was leading to delays in other supervisory work. Some of these new initiatives are to be applied later to smaller and mid-sized banks, which is understandable as complexity is not limited to the major banks. The resource implications of this have not been determined.</p> <p>HMT has indicated that it expects that the proposed reorganization will not increase costs. Senior staff indicated that the public and government expectation was for restraint in the current environment and that was taken into account in FSA thinking and planning.</p> <p>AC1. The treasury has appointed the chairman of the FSA for a minimum term of five years. The CEO has been appointed for a minimum term of three years.</p>
Assessment	Largely compliant
Comments	<p>The governance arrangements do not include provisions detailing the circumstances in which the chairman or the CEO can be removed from office. Nor is there a requirement that these reasons be made public.</p> <p>With respect to resources, there appear to be a number of unresolved issues. The assessment team is not confident that the FSA has a full understanding of its likely resource needs under its new supervision and core prudential model. Systems capability probably needs enhancement. The assessment team's impression is that the previous bias has been to not increase resources for fear of overburdening</p>

	<p>industry, even when that would have been desirable and justifiable for financial stability reasons. Assessors were not in a position to do a detailed analysis, but their strong sense is that additional resources for prudential regulation and supervision (quality and quantity) are required. Assessors recognize that some of this could be funded from efficiencies in existing processes that the FSA is now assessing. Such additional resources are essential to enable the FSA to (i) implement the planned enhancements well; (ii) deal with a number of recommendations in this assessment such as more proactive detailed reviews of key risk areas; and (iii) implement the new macro overlay without drawing resources away from the necessary core prudential work.</p> <p>The FSA needs to do a rigorous update of its needs (including data and analytical systems), and possible synergies internally and with the BoE, as part of the reorganization planning.</p>
	The FSA should satisfy itself that its resources are adequate.
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>EC1. Under FSMA “Accepting deposits” is a specified kind of activity and therefore, it is subject to a prior FSA permission under Part IV of the statute. A deposit-taking permission may also be amended or removed by the FSA in accordance with Part IV of FSMA. The legal framework for licensing banks also includes the rules made by FSA using its powers under FSMA (see the Handbook issued by the FSA).</p> <p>EC2: The FSA has powers to make rules applying to banks as it appears to it to be necessary or expedient to meet any of its regulatory objectives (section 138 of FSMA). The FSA’s Handbook rules (and guidance) include prudential matters (see reference above to GENPRU and BIPRU). The FSA also has the power to modify or waive rules in particular cases (FSMA Section 148). Conditions can be attached to waivers granted from FSA rules.</p> <p>There is an extensive consultation process. The FSA must publish a draft of the proposed rules in the way appearing to it to be best calculated to bring them to the attention of the public. The draft rules must be accompanied by a cost-benefit analysis (required by the ‘have regards’ to the statutory regulatory objectives); an explanation of the purpose of the rules; an explanation of the reasons why the FSA believes that making the proposed rules is compatible with its general duties under FSMA; and a notice that representations may be made about the proposals within a specified time (section 155 of FSMA).</p> <p>EC3: The FSA has wide powers to require information from banks and from persons connected with banks (FSMA Section 165) and to require the production of reports by skilled persons on any matter about which the FSA could require information under Section 165 (FSMA Section 166) (see comment on CP 21). Since 2010, the FSA powers to require information relevant to the stability of the financial system were broadened.</p>
Assessment	Compliant
Comments	The application of a cost-benefit analysis to every rule appears overdone. In financial regulation decision makers can take false comfort in the supposed precision of this technique. In some cases (e.g., modernizing regulatory reporting from banks), it appears that this requirement has been a factor in the reluctance to proceed with necessary improvements. The FSA should review the application of this requirement.
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.

Description	<p>EC1. The FSA is required (FSMA Schedule 1 paragraph 6) to maintain arrangements to determine whether a bank is complying with requirements imposed by or under FSMA (such as rules by the FSA). The FSA is able to exercise its judgement in determining whether a bank is in contravention of regulatory requirements subject to a bank's rights of appeal to the Upper Tribunal (established under FSMA Part IX). The FSA has wide powers under FSMA to take action against banks which do not comply with the requirements set out in FSMA, in the secondary legislation under FSMA, and in its rules, which enable it to deal with a problem bank situation. Although the FSA has formal powers to take action in such cases (e.g., placing requirements on the bank's permission to accept deposits), the FSA would, where appropriate, pursue informal action to resolve problem cases.</p> <p>Under the Banking Act 2009, a new Special Resolution Regime ("SRR") was introduced. The FSA triggers the SRR where it is of the opinion that a bank is failing or likely to fail the threshold conditions (such as having adequate resources) (cross reference CP 23).</p> <p>EC2. The FSA has full access to a bank's Board, management, staff and records by virtue of its powers to gather information under section 165 of FSMA and to conduct investigations under sections 167 and 170 of FSMA. Failure to provide information requested by the FSA without reasonable excuse, or knowingly providing false or misleading information to the FSA and other actions to, for example, destroy or falsify documents, constitute a criminal offense.</p> <p>EC3. The FSA has wide powers under FSMA to take action against banks that do not comply with the requirements set out in FSMA, the secondary legislation under FSMA, and in its rules. In cases where the bank is failing or likely to fail to satisfy threshold conditions, the FSA may vary the bank's permission on its own initiative under section 45 of FSMA (Own Initiative Variation of Permission or OIVOP). The FSA may also exercise this power where it considers that it is desirable to do so in order to meet any of its regulatory objectives. An OIVOP may include withdrawing a bank's authorization, limiting its ability to accept deposits, or requiring it to take or refrain from taking a specified action.</p> <p>Where a bank has contravened a legal requirement (including a rule) the FSA may take disciplinary actions under Part XIV of FSMA which may include:</p> <ul style="list-style-type: none"> • suspending the bank's permission to carry on a regulated activity; • imposing limitations on the carrying on of a regulated activity; • publishing a statement of public censure; and • imposing a financial penalty. <p>The FSA also has the power to impose a penalty on a person who at any time performed a "controlled function" in a bank without FSA's prior approval.</p>
Assessment	Compliant
Comments	
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>EC1: FSMA (Schedule 1 paragraph 19) provides that the FSA and any person who is, or is acting as, a member, officer or member of staff of the FSA is not to be liable for damages for anything done or omitted in the discharge, or purported discharge, of the FSA's functions. However, this protection does not apply if the act or omission is shown to have been in bad faith, or unlawful as the result of Section 6(1) of the Human Rights Act 1998.</p>

	EC2: The FSA covers the legal costs of defending its staff in legal actions against them in relation to their work as FSA employees. The FSA has the power to require the payment of fees, to cover the costs of defending its actions.
Assessment	Compliant
Comments	
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>EC1. The MOU between the tripartite authorities governs the relations between the FSA, BoE and treasury. Regular meetings take place at a senior level and are minuted. Working-level groups are set up to deal with and resolve specific institutions or issues. Information sharing is, in addition, governed by various service level agreements and the MoU. The MOU covers information sharing and crisis management.</p> <p>In general, in dealing with specific institutions post-2007 the authorities report that the arrangements have worked well.</p> <p>EC2. For foreign supervisors, FSA's policy is to identify all the foreign supervisor/s involved in the supervision of the relevant international bank and engage with them under the home/host framework to enable FSA to fulfil its supervisory obligations in the most effective and efficient manner. Since the end of 2010, it is an EU legal requirement to map the foreign entities of U.K. banks on an annual basis and to identify both its subsidiaries and significant branches in order to include relevant EEA supervisors as a minimum in a supervisory college. The FSA will also seek to include all supervisors of systemic entities of the group. For EU/EEA supervisors, the CRD and agreements designed to underpin each supervisory college set out the basis for regular information sharing on the financial condition and performance of relevant operations, and these are used to undertake the required joint risk and capital adequacy assessment, and make decisions.</p> <p>For non-EEA supervisors, the EU Directives require that the FSA should have an MOU with the relevant non-EEA supervisor. For those countries with which the FSA does not have a gateway and MoU, the FSA's policy is to engage with the relevant supervisor under the home/host framework. The FSA establishes informal supervisory arrangements to share nonconfidential information and agree the key issues for each supervisor considering the supervised entities. There are emergency information sharing provisions that can be used.</p> <p>EC3. Legal 'gateways' allow the FSA to disclose confidential information to other EEA or non-EEA supervisory authorities. In the case of non-EEA supervisory authorities, the FSA can only disclose confidential information, which it has obtained in the course of carrying out its duties under various EU single-market directives, to these authorities if (i) the FSA has a memorandum of understanding ("MoU") relating to information-sharing with that non-EEA authority; and (ii) the FSA has assessed that the confidential information disclosed to the non-EEA authority will be subject to equivalent protections for confidential information as exist in the United Kingdom/EEA.</p> <p>The terms of the MoUs typically stipulate that confidential information disclosed by the disclosing authority may only be used by the recipient authority for supervisory purposes, and contain terms relating to the confidential treatment of that information by the recipient authority.</p> <p>EC4. The FSA can only disclose confidential information if (1) it has obtained the consent of the person to whom the information relates or (2) if it can legally disclose</p>

	<p>the information through a gateway. The FSA does not have Gateways which would allow it, for example, to disclose confidential information relating to another person/firm pursuant to a freedom of information request or in relation to civil proceedings. The Gateways are also discretionary—i.e., the FSA is not obliged to disclose confidential information to bodies it has Gateways with if those bodies request the information.</p>
Assessment	Compliant
Comments	<p>Both the FSA and the BoE have information that is relevant to the other in pursuit of the financial stability mandate. The same will be true for the newly-formed CPMA when it is split from the FSA. As part of the new arrangements, the FSA and the BoE should review the operation of the gateways to ensure the adequate amount of information sharing between them (in both directions) related to financial stability. As much as possible, there should pre-determination of how much discretion will be exercised so as to make information sharing as smooth as possible.</p> <p>The effectiveness of the cross-border arrangements is commented on in CP 25.</p>
Principle 2.	<p>Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.</p>
Description	<p>EC 1. The U.K. authorization structure is based on activities. Deposit taking is a regulated activity in the United Kingdom and there is a general prohibition on individuals or firms undertaking such activity unless authorized (or unless exempt) under the Financial Services and Markets Act 2000. ‘Bank’ is defined in the FSA’s regulations for the purpose of determining which parts of the FSA rulebook apply to different categories of firms. The use of the word ‘bank’ (and related terms) is restricted under the Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2009. ‘Building society’ is defined in the Building Societies Act 1986 and this Act also restricts the use of ‘building society.’ The FSA’s register provides details of all authorized firms with details updated daily and there is also a separate list of all banks and a separate list of all building societies published monthly.</p> <p>The term “bank” is a “sensitive word” governed by the Companies Act 2006 (“the Act”). The Act provides that Regulations may be made in which sensitive words are set out. If a proposed business name contains a sensitive word as listed in the Regulations, the Act states that the person wishing to use the proposed business name is under an obligation to contact the particular government body or public authority as specified in the Regulations, requesting that the public authority (the FSA in the case of the term “bank” indicates whether they object to the proposed use of a sensitive word.</p> <p>However, the extent of this obligation is only to seek the view of the specified public authority, and not to give its consent. The Registrar has the responsibility delegated to them from the Secretary of State to approve the particular use. In practice, however, were a proposed name to be objected to, it is unlikely that the Company Registrar would act against that objection and register the company name. The FSA considers whether the proposed name might be misleading and whether the use of the word “bank” is misleading and could cause the public harm as a result. The Act makes it a criminal offence for any person not to comply with these rules.</p> <p>EC 2. The Financial Services & Markets Act 2000 (Regulated Activities) Order 2001</p>

	<p>sets out activities which are regulated activities for the purpose of FSMA. One such activity is accepting deposits.</p> <p>EC 3. The use of the term “bank” (and related terms) is restricted under the Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2009. FSMA also provides that it is an offense for a person to describe or hold themselves out to be an authorized person (e.g., and authorized deposit taker), if they are not. The use of a banking name would imply that the person concerned is carrying out a banking business. In this case, if no authorization is in place, there may have been an offense under FMSA Section 24 and the FSA could take action accordingly. FSA indicates that they have received 46 applications for consent for the use of the term “bank” in the three months to end of October 2010 and have rejected 11 because of the risk of harm to the public from the use of the proposed name.</p> <p>The building societies act also provides that no person other than a building society can use a name or description that implies they are a building society, or hold themselves out to be one, or to be connected with one, if they are not.</p> <p>EC 4. In general, the taking of deposits from the public is a regulated activity that must be authorized, as described above. Deposit taking can be done by banks and building societies (deposit takers with mutual ownership) and they are subject to banking regulation and supervision by the FSA under generally the same prudential regulatory regime set out in the FSA Handbook. The differences primarily relate to the mutual ownership model of building societies. Credit unions are also authorized deposit takers, and are subject to their own specialist prudential regime under the FSA’s Handbook. Under the “passporting” regime, which operates under the European Banking Directives, deposit-taking institutions authorized in their home Member State are able to establish a branch in the United Kingdom or provide cross-border banking services on the basis of the fact that they are authorized and supervised by their home state regulator and are deemed to have a permission under FSMA. Some deposit taking is permitted in entities not authorized under FSMA, nor regulated by the FSA. This includes acceptance of deposits by the public sector or other banks, deposit taking in the form of debt securities (at least if they are over one year), and deposit taking by municipal banks and local authorities.</p> <p>EC5. The FSA publishes monthly on its website a list of banks (including branches of foreign banks) and building societies authorized to undertake regulated activities in the United Kingdom. The FSA maintains a Register of all authorized firms, which is updated on a daily basis and is publicly available through the FSA’s website.</p>
Assessment	Compliant
Comments	
Principle 3.	<p>Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>

Description	<p>EC 1. The FSA performs the role of both the authorizing and supervisory authority with the exception of branches of EEA banks operating in the United Kingdom. The EEA single market EU legislation provides for the mutual recognition of the equivalence of EEA member states' supervision of banks and for the authorization of a bank in the home member state to be recognized in the host member state. EEA home state supervisors authorize the establishment of a branch of a bank they regulate in the United Kingdom.</p> <p>EC 2. FSMA (Section 41(2)) provides that in giving or varying permission under FSMA Part IV, the FSA must be satisfied that the applicant will satisfy and continue to satisfy the "Threshold Conditions" set out in FSMA (Schedule 6) in relation to all of the regulated activities for which they will have permission. The Threshold Conditions cover matters such as the applicant's connection to other parties ("close links"); the ability of the group to be supervised, including that the close links are not likely to prevent effective supervision by the FSA; ownership; fitness and propriety of the Board and senior management; governance arrangements; risk management and internal controls; adequacy of capital and liquidity; and other resources (human resources—quantum and skills, Systems and controls—such as policies and procedures, and the views of other relevant supervisors).</p> <p>The financial resources test is not concerned only with the absolute level of capital and liquidity, but also involves an assessment of the resources needed for the planned development of the business and the probability of the firm concerned surviving any particular level of disturbance or shock.</p> <p>These various threshold conditions are not considered in isolation. The FSA considers the means by which the applicant manages (and, if it is a member of a group, which other members of the group manage) the incidence of risk in connection with its planned business: in considering this, the FSA would consider the firm's systems and controls; its IT systems; and human resources: the outcome of this would then inform the FSA's view on the adequacy of financial resources.</p> <p>The suitability ('fit and proper') test is assessed in regard to all the circumstances such as the connection that the applicant has with any other person; the nature of the regulated activity concerned; and the need to ensure that its affairs are conducted soundly and prudently.</p> <p>EC 3. The Threshold Conditions set out in FSMA for judging whether to authorize a new bank are used on an ongoing basis to judge whether a bank should continue to be authorized. As noted below, they also are considerations in triggering FSA intervention of various forms.</p> <p>EC 4. The FSA has the power to reject an application if it considers that an applicant does not satisfy one or more of the Threshold Conditions. This includes the FSA also refusing an application where inadequate information is provided.</p> <p>EC 5. The third Threshold Condition includes the provision that the FSA must be satisfied in respect of persons with close links (which are defined) to the applicant, and that those close links do not hinder effective supervision of the applicant on both a solo and a consolidated basis. FSA staff indicated to assessors examples of where this consideration was applied in practice, and had been a factor in how the</p>
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application was handled and whether it was approved.

EC 6. In the licensing process, the FSA considers the suitability of major shareholders and those able to exercise or control the exercise of voting power in accordance with the Threshold Conditions ('controllers'). The transparency of an applicant's ownership structure is assessed (e.g., where shares are owned or control is exercised through a trust) in order that the FSA can determine the identity of controllers, their suitability to fulfill that role and the effectiveness with which the structure can be supervised. The source of capital is addressed as part of this process.

EC 7. In accordance with the provisions of GENPRU 2.1.47/8R, a minimum amount of capital of not less than €5m is required at the time a bank obtains a permission to accept deposits (or the higher of €1m or £1m in the case of a building society). In practice, considerably more capital than this to start a bank or building society would be required, in order to satisfy the threshold conditions.

EC8. FSMA (Section 59) gives the FSA the power to specify any number of positions or roles within a bank that must be performed by individuals who have been assessed as fit and proper by the FSA (approved persons). The FSA exercises this power and sets out its approach within its Handbook. The fit and proper test for approved persons sets out the minimum standards for becoming and remaining an approved person and this covers: honesty, integrity and reputation, competence and capability, and financial soundness. Typically, competence and capability assessments will include filling out an extensive questionnaire and a formal structured interview with relevant experts and FSA senior advisors (experienced senior industry practitioners). This type of review also applies to new persons taking up positions of significant influence in an existing bank. Assessors reviewed examples of how this review process works in practice.

EC 9. The applicant is required to provide a strategic and operating plan, setting out planned activities (and related risks), together with the systems and controls to support them, and to comply with the rules appropriate for the business performed. The FSA requires an applicant to provide details of its management and organizational structure, operating procedures, systems and controls to be used and any proposed outsourcing arrangements.

The FSA reviews the proposed strategic and operating plans of the bank. The proposed system of corporate governance is assessed to determine whether it is proportionate to the bank's business, and that the bank will be managed in a competent and prudent manner.

The FSA uses the information to assess the adequacy of the application against the FSA's requirements, which consider these factors in the context of the complexity, nature and scale of the business the firm plans to undertake.

EC10. The FSA requires a proposed bank to provide a business plan as part of the application, setting out both the planned regulated and unregulated activities. This would include financial forecasts reflecting the business plan and the bank's own assessment of capital required for the period of the business plan (and related stress testing). This has to include the bank's risk appetite; an assessment of the risks within

its business model and related mitigants; and the capital needed to support the business. The bank has also to submit an assessment of its liquidity needs (plus related stress testing). This would include setting out its liquidity risk appetite; funding model; liquidity policy; assessing the liquidity risks and controls relating to the planned business; and setting out its contingency funding plans. The application forms for the approval of major shareholders (controllers) are supported by financial information on the major shareholders.

EC11. The FSA seeks the views of home country supervisors in assessing the application of an overseas bank wishing to establish a branch or subsidiary. In the case of a bank incorporated or controlled outside of the EEA, before issuing a license in the United Kingdom, the FSA establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations, the FSA will undertake an assessment of the home country supervisor to ensure it has a broadly equivalent regulatory regime to the United Kingdom, which would include an assessment of whether it practices effective global consolidated supervision.

The FSA does not authorize branches of EEA banks; rather the FSA is notified by the home country supervisor that it consents to the establishment of such a branch. In the case of branches of EEA banks, no assessment of the effectiveness of the global consolidated supervision of the home state supervisor is undertaken as the home state's regime is based on the same EU legislation as the United Kingdom. As a global financial center, London does have material branches from EEA and non-EEA countries.

EC12. The FSA determines that the license was based on false information, the license can be revoked. FSMA (Section 398) provides that it is an offense if any person in purported compliance with any requirement imposed by or under FSMA knowingly or recklessly gives the FSA information that is false or misleading. Providing false information calls into question the fitness and propriety of the applicant and the integrity of the business.

EC13. Individuals who will need to be approved by the FSA (which includes all Board members) are tested in the assessment of their knowledge of all the financial activities that the bank intends to pursue and the associated risks. The FSA understands that these individual assessments are expected to cover the Board collectively.

AC1. The fourth threshold condition requires an assessment of the adequacy resources of the applicant for the purpose of carrying on the business. This would include assessing the applicant's ability to deal with the incidence of risk in connection with the business, and would therefore involve an assessment of the capacity to obtain whatever additional financial resources might be required to deal with contingencies. The status of the shareholders and their ability to support the business is considered as part of this process. In appropriate cases the FSA would obtain letters of comfort from the major shareholders.

AC2. The FSA is responsible of the supervision of new entrants to monitor progress in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.

Assessment	Compliant
Comments	Assessors discussed the licensing process with those responsible and are satisfied that it is working in practice. However, as the complexity of banking groups continues to increase, and given heightened standards for effective risk management and governance, and better relating of compensation to risk, it may be necessary to reflect these higher expectations in the assessment of initial authorizations or changes in control (CP 4). Any changes in permissible structures flowing from the recommendations of the Independent Banking Commission would also need to be reflected in the approval process.
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	<p>EC1. The EU acquisitions directive is a maximum harmonization directive which was implemented into U.K. legislation in April 2009 as the Financial Services and Markets Act 2000 (Controllers) Regulations 2009. Broadly, a proposed new controller of a bank must seek approval from the FSA to acquire an interest of 10percent or more in the bank or the parent undertaking of a bank (directly or indirectly). Controllers of a bank must obtain further approval for increases in ownership when they pass thresholds of 20percent, 30percent or 50 percent. To acquire control or increase control over these thresholds without FSA approval is a criminal offence. The criteria cover significant influence as well as direct share ownership.</p> <p>The rules define the acquisition of control (in section 181). Section 182 defines the levels of ownership at which a controller must seek further approval from the FSA prior to acquiring the interest. The FSA has no power to implement additional requirements on controllers above the requirements set out in the EU acquisitions directive.</p> <p>EC2. Under section 178 of the Financial Services and Markets Act 2000 (Controllers) Regulations 2009 a person who decides to acquire or increase control over an authorized firm must give the FSA notice of its intention to acquire and obtain approval before it acquires or increases control in relation to the thresholds set out above. The FSA has 60 working days (plus up to 30 working days when the clock is stopped) to object or provide approval for an acquisition. This also includes beneficial ownership.</p> <p>EC3. The FSA may object (under section 186 of the regulations) to the acquisition or ongoing ownership by a controller. Under the assessment of whether the authorized institution will continue to meet its prudential requirements the FSA considers, amongst other things, compliance with the Threshold Conditions which is the same test used for authorizations of a new bank. It is important to note that the FSA can object to a new or existing controller on the above grounds for shareholdings, voting power or significant influence of 10 percent or more. The conditions for objecting also include: reputation of the proposed controller; reputation and experience of any person who will direct the business; financial soundness of the controller; ability to comply with prudential requirements as a result of being controlled; whether the groups proposed structure allows the firm to be effectively supervised; whether exchange of information among regulators is clear; and whether there are reasonable grounds to suspect an increased risk of money laundering or counter-terrorist financing as a result of the change in control.</p>

	<p>If the FSA objects to a person holding or acquiring a controlling interest it also has powers to issue a restriction notice limiting the way that the shareholding can be exercised (for example restricting voting powers and preventing the payment of dividends).</p> <p>EC4. Banks are required to report their controllers and close links on an annual basis. In addition, banks are required to notify the FSA when they become aware of a possible change in their controllers.</p> <p>EC5. Under Section 191A, the FSA may object to a person’s control over a U.K. authorized firm and in some cases may launch proceedings if the controller failed to seek approval prior to acquiring control, acquired control after receiving a Warning Notice or breached an interim order. The FSA also has powers, under Section 191B, to issue a restriction notice following the issue of a Warning Notice objecting to a controller which limits the way in which control is exercised (e.g., prohibiting the voting, payment of dividends or disposal of the shares). The FSA has the power under section 191C to apply to the court for an order for the sale of shares following an objection to control.</p> <p>AC1. Under Principle 11 of the FSA’s Principles for Businesses, banks are required to deal with the FSA in an open and cooperative way and must disclose to the FSA anything relating to the firm of which the FSA would reasonably require notice. This includes any material information which may negatively affect the suitability of a major shareholder. The FSA can, and has, taken action against firms that have failed in general to comply with this principle.</p>
Assessment	Compliant
Comments	
Principle 5.	<p>Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
Description	<p>EC1. Under PRIN 11 (relations with regulators), banks are obliged to disclose to the FSA anything relating to them “which the FSA would reasonably expect notice.” In accordance with SUP 15.3.8G, this would generally include “any proposed restructuring, reorganization or business expansion which could have a significant impact on the firm’s risk profile or resources,” and specifically “setting up a new undertaking within a firm’s group, or a new branch (whether in the United Kingdom or abroad)” and “commencing the provision of cross-border services into a new territory.”</p> <p>In accordance with SUP 15.3.9G, the period of notice that should be given to the FSA to comply with PRIN 11 will depend on the event, “although the FSA expects a firm to discuss relevant matters with it at an early stage, before making any internal or external commitments.” The FSA has provided more detailed guidance in chapter 15.3 of its Supervision Manual (SUP) on the circumstances in which it would expect banks to pre-notify a major acquisition or investment.</p> <p>Despite this general obligation to pre-notify major acquisitions and investments, the U.K. regulatory system does not clearly define what types and amounts (absolute or in relation to a bank’s capital) of acquisitions and investments need prior supervisory</p>

approval. Assessors discussed this with staff, who indicated that the FSA's expectations were generally understood. They noted also that existing banks would have the incentive to err on the side of more pre-notification rather than less, since they would not want to put their ongoing relationship with the FSA at risk.

The regime covers acquisition/investments in the United Kingdom or abroad by FSA authorized banks. It does not apply to acquisitions/investments that are made by the parent of the bank. This is because, as noted in CP 24 (consolidated supervision), the FSA's powers do not extend to bank holding companies. Of course, if the U.K. parent holding company is acquiring a bank in the United Kingdom, the FSA approval powers would apply from the perspective of the target. But that would not be the case where the target is outside the United Kingdom. There are cases where the FSA believes this gap may have hindered their ability to effectively apply their approval regime. As noted in CP 24, the issue of extending FSA powers to bank holding companies is under active discussion.

EC2. The so-called "Threshold Conditions," the minimum standards for a bank becoming and remaining authorized, provide criteria by which to judge individual proposals. This includes, most notably, the requirement to maintain adequate resources. In reviewing a bank's major acquisition, the FSA would also assess whether the bank will be able to continue meeting any other applicable prudential requirements under BIPRU and GENPRU (for example, the large exposure rules in BIPRU 10, which under U.K. regulations are not very demanding, as discussed in CP 8). There is also a general requirement, that following the acquisition/investment, the bank will continue to be suitable with regard to its connection with any person and the need to ensure that the bank's affairs are conducted soundly and prudently.

When a bank acquires another FSA bank, the approval requirements from the perspective of the target firm also apply.

EC3. The FSA has the power under section 45 of FSMA to prohibit a bank from undertaking a major acquisition or investment in cases where, as a result of it, it would no longer meet its Threshold Conditions in FSMA (Schedule 6 of FSMA). In addition, the FSA could use this power to prevent any breach of the bank's prudential requirements under GENPRU or BIPRU where this would be justified for the FSA to fulfill its regulatory objectives. The FSA may use its power under section 45 to vary a bank's permission and impose requirements or limitations in relation to an acquisition or investment. The so-called "close link" requirement in the Threshold Conditions states that a bank must not become closely linked to any person subject to the laws, regulations or administrative provisions of a territory (other than an EEA State) which would prevent the FSA's effective supervision of the bank. Therefore, this would constitute valid grounds for the FSA to prohibit an acquisition/investment.

As noted above, the FSA does not have direct power over an unregulated bank holding company to block an acquisition. A further difficulty is that PRIN 11, under which banks must pre-notify the FSA of significant events such as major acquisitions, would not apply to the unregulated holding company of the bank.

However, if an unregulated holding company of a U.K. authorized banking group plans a major acquisition in a foreign bank that exposes the U.K. banking group to undue risks or hinder effective supervision, Part XII of FSMA, control over authorized

	<p>persons, allows the FSA to take action against the holding company on the ground that the U.K. bank would cease to be suitable (i.e. it would be in breach of its “threshold conditions”) due to its connection with the holding company or with the new sister company. The FSA would exercise this power by serving a warning notice to the holding company under section 191A of FSMA to object to the holding company’s on-going control over the U.K. bank in the event that it completes the proposed acquisition. Should the holding company refuse to comply with the warning notice, the FSA would be entitled to make an application to the High Court for an order of sale of the holding company’s shares in the U.K. bank (section 191C of FSMA). The FSA has not yet used these powers under Part XII to object to an existing controller. However, that remedy may be unduly cumbersome, and require a much higher threshold for action than would be the case by simply applying the acquisitions/investment regime to bank holding company acquisition. That would also allow applying conditions to individual approvals.</p> <p>EC4. The regular supervision of the FSA over all U.K. banks to ensure that they continue to hold adequate resources in relation to all the regulated activities for which they have permission (section 41 of FSMA) is the basis by which the FSA determines that the bank has, from the outset, adequate financial and organizational resources to handle major acquisitions.</p> <p>EC5. There is no obligation to notify the FSA of acquisitions below the minimum threshold for change of control or close links (established in SUP 11.9). However, in this case, a post-acquisition notification under PRIN 11 (relations with regulators) would be expected if any acquisition below the relevant threshold could be considered a matter in relation to which “the FSA would expect reasonable notice.” FSA staff advised that U.K. banking practice is to disclose to the FSA anything of which the FSA would reasonably expect notice.</p> <p>EC6. The FSA’s assessment of a bank’s ability to continue to meet the Threshold Conditions will take into account the risks posed by nonbanking activities and, under sections 43 and 45 of FSMA, the FSA may exercise its “Own Initiative Variation of Permission” (OIVOP) powers in relation to a bank by imposing a requirement on the banking group’s nonregulated activities. The FSA has the means to take action to block major acquisitions, even in the case of holding companies.</p> <p>Discussions with FSA staff indicate their awareness of the risks that nonbanking activities can pose to a bank within a wider corporate group. Examples were provided of the use of setting of capital guidance or ring fencing of capital or limits on intra-group transactions being imposed to deal with these issues.</p> <p>AC1. When a bank wishes to acquire a significant holding in a financial institution in another country, the FSA takes into consideration the quality of supervision in that country and its own ability to exercise supervision on a consolidated basis. There are a number of different equivalence assessments undertaken by the FSA in assessing the quality of supervision undertaken in overseas jurisdictions. This includes Home Country Supervisory Assessment and Third Country Group Assessment, as discussed in CP 25.</p>
Assessment	Compliant
Comments	The U.K. authorities should make explicit in its regulatory framework what types and amounts of acquisitions/investments need prior supervisory approval, and for which

	<p>cases notification after the acquisition is sufficient.</p> <p>In addition, the acquisition/investment authorization powers should as soon as possible be applied to transactions made by holding companies and controllers of U.K. banks. Failure to do that would be a serious deficiency. This deficiency has been factored into the assessment of CP 24 (consolidated supervision) as the issue of unregulated bank holding companies is broader than the power over acquisitions per se.</p>
Principle 6.	<p>Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.</p>
Description	<p>EC1. All U.K.-incorporated banks are required to operate to Basel and European capital standards. The legal underpinning for this is established under European Law (Title V, Chapter 2, Section 1 (Own Funds) of the recast Banking Consolidation Directive (2006/48/EC)) The FSA has incorporated the Banking Consolidation Directive and Capital Adequacy directive into the Handbook.</p> <p>The Financial Services Markets Act 2000 (“FSMA”), Threshold Conditions require all banks to maintain adequate resources. This is embedded in the FSA rules in covering the components of capital, the method of calculation and capital ratio. Capital components that are available to absorb losses are emphasized in the Basel requirements. In May 2009, the United Kingdom defined the standard for Core Tier 1 capital, which is more stringent than the Basel II and Directive definition. It makes some of the regulatory deductions from capital at Core Tier One level. This interim capital regime sets targets for Core Tier 1 on an ongoing basis and in stressed conditions. It is used for the purpose of stress-testing the capital position of the banks involved on a forward-looking basis, and determining capital buffers.</p> <p>In addition to meeting an individual capital ratio, banks must have a minimum amount of more than Euro 5mn at the time it obtains its permission under FSMA to accept deposits. This is a threshold condition that cannot be breached without risk of regulatory action.</p> <p>EC2. The capital adequacy regime in the United Kingdom applies to all U.K. incorporated banks, including those that are internationally active and those that are domestic.</p> <p>EC3. The FSA has power to impose a specific capital charge. This is done through the Pillar 2 regime and additional bank-specific capital planning buffers. The risk-based capital adequacy regime requires banks to hold capital commensurate with the level and nature of all risks to which they are exposed. This is set out in the overall Pillar 2 rule in GENPRU 1.2.30R. The FSA under this authority sets individual capital guidance levels (ICG) for each bank based on the FSA assessment of the firm’s Pillar 2 system. Breaching ICG, or capital deteriorating in a way that might be expected to breach the ICG, is a trigger for FSA actions.</p> <p>For the eight very high-impact banks, the ICG target ranges from 110 percent to 198 percent of their pillar 1 minimum capital requirement. It is usually expressed in terms of total capital, but other rules maintain a reasonable balance between Total capital and Tier1 or core Tier1. For the approximately 180 smaller and medium-sized deposit takers, ICG targets fall in a range. The median is between 150 percent and 175 percent of minimum, with about 15 percent of firms in each of the 100 percent to</p>

125 percent and 125 percent to 150 percent ranges. Some 40 percent of smaller and mid-sized deposit takers have ICG levels above 175 percent with half of these being above 200 percent.

Actual capital levels exceed ICG targets for all but a handful of smaller banks (where they also exceed minimum requirements), and remedial plans are in place at these banks.

In addition, following the Basel III rules, the FSA is now setting a more clearly identified and separate capital planning buffer for all deposit-takers and some investment firms under Pillar 2. Firms are expected to maintain this capital planning buffer and it does not form part of ICG; meaning firms are allowed to draw down on the buffer in a downturn so that firms are able to remain adequately capitalized at all times. It is based on the general rule on capital planning and stress testing. It is determined as the maximum change in surplus over ICG arising over a three-to-five-year stress period (based on an anchor scenario) between actual capital and ICG set by the FSA. The projected amount (measured in £) arising from the stress scenario is added on top of the current capital ICG. The FSA has assessed the resilience of some high-impact firms against them being able to meet predetermined Core Tier 1 targets after stress (i.e. 4 percent Core Tier 1).

The FSA does not have explicit authority to limit exposures but can achieve similar results through its authority to set individual capital targets.

EC4. The U.K. risk-based capital rules reflect the risk profiles of individual banks and capture both the on-balance sheet and off-balance sheet risks as set out in BIPRU. This is achieved through pillar 1 requirements under Basel II/III, risk-based pillar 2 requirements (covering the risks not covered under Pillar 1 including pension risk, concentration risk and interest rate risk in the nontrading book. The Pillar 2 assessment includes a qualitative assessment of the firm's governance, on the basis of which the FSA may add to their individual capital guidance ("ICG").

BIPRU 3 sets out the risk-weights to use to calculate the capital ratio in respect of on-balance sheet risks and also classifies items that are included as off-balance sheet items.

EC5. Effectively the FSA, like many supervisors in Europe limits exposures through its interim capital target regime, setting higher capital than the current Basel requirement or advancing Basel requirements. The core Tier1 interim targets are also implemented earlier than the Basel requirements. This was in part due to U.K. authorities' views, following the crisis, that their banks needed to hold more and higher quality capital than the international minimum. In practice, the actual capital levels of banks are also well above the buffers. Assessors discussed this with FSA personnel. The major banks could absorb losses of 21 percent to 82 percent of their ICG before hitting the ICG plus capital buffer.

The effort to push up capital levels has been working. The four major banks' Tier I ratio in 2007 was around 8 percent. It has now risen to the 12 percent average (10 percent to 14 percent range). The current core tier 1 range is 9 percent to 11 percent for the four main banks, again increased from a few years ago.

EC6. Any breaches of individual capital ratios must be immediately notified to the FSA, which would lead to agreement of a clear plan and timetable to achieve compliance with the individual capital ratio. This would normally be achieved through a capital injection or a balance sheet restructuring. The FSA has a range of powers available under FSMA if any bank fails to comply with the Threshold Conditions (e.g.,

the requirement to maintain adequate financial resources) or fails to comply with capital adequacy rules in the Handbook. Such powers include variation and cancellation of permissions and withdrawal of authorization.

For serious issues with deposit takers, if the threshold conditions set out in section 7 of the Banking Act 2009 are not met, then the U.K. authorities could use the tools available as part of the SRR to resolve that institution. The triggers are twofold and both conditions must be satisfied. First, the bank must be failing, or likely to fail, to satisfy its 'threshold conditions.' Second, it must not be reasonably likely that action will be taken by or in respect of the bank (other than potentially through the SRR) that would enable it once again to satisfy the threshold conditions. These threshold conditions are the same regulatory requirements for initial FSA authorization.

EC7. [BIPRU 4](#) sets out the approach for firms with permission to conduct their internal assessments for calculating credit risk capital requirements. The United Kingdom has adopted the Internal Ratings Based approach ("IRB") under Basel II/III. AMA, the advanced approach for the Operational Risk, is also available and is being used by two banks. Eight firms use advanced IRB (AIRB) and seven use foundation IRB (FIRB). Some AIRB firms are recognized from other jurisdictions. The FSA did not originally increase overall resources to implement Basel II; rather it redeployed and reprioritized specialist resources. The FSA policy is not to push major banks to move to higher standards. The FSA has adopted the market risk amendment and is planning to adopt the new market risk measures agreed by the BCBS in their entirety. Major banks can run 70–80 IRB models, with FSA experience being that 5–10 models would cover 50–60 percent of assets. The IRB banks must pre-notify the FSA when a model change decreases a portfolio capital calculation by 5 percent or more, or affects the overall group capital by 1 percent or more. In the past year this has resulted in approximately 90 model change requests. Of those the FSA reviews approximately half, with perhaps half of those having a more in-depth review (as opposed to a desk review of documentation and model performance data). The in-depth reviews would account for perhaps 40–50 person-days of work for two credit model specialists and a more general credit specialist to review the use test. These specialists would be on site for 1 day. There is also a six monthly process for a high level model review, which is carried out by considering model performance using firm MI and related documentation.

As in other jurisdictions, firms that have been through major mergers have leeway to discuss a reasonable firm-wide implementation plan with the FSA. The United Kingdom's initial policy for rollout was that IRB banks could have no more than 15 percent of their portfolio on standardized approach within three years of first use. Currently, for the major banks the range on IRB is 67 percent to 89 percent. The assessors discussed cherry picking concerns with supervisors. It was also indicated that this situation can make interpreting peer comparisons of capital numbers expressed as percentages of RWA difficult.

IRB reporting is analyzed, but it is by major portfolio breakdown. The credit specialists are planning to obtain more granular PD/LGD data regularly, which will enable them to do more focused analysis of likely IRB issues and reasonableness, and more meaningful peer analysis. The FSA policy from the beginning of Basel implementation was not to do any model replication work or data base replication. Section 166 skilled person reports can be commissioned to do this where issues arising indicate there might be problems. None of these were done in 2010, but two are in the process of being instigated for 2011. Until now, the FSA has not proactively reviewed a selection of models to assess their performance. Starting in 2011, FSA will do this for the top 10 IRB models across the system.

In certain areas such as commercial real estate, the FSA is finding that previously-

	<p>approved models (or ones that were initially 'waived' (i.e. approved) without assessments are now proving problematic to measure the appropriate amount of capital. This is due to firms' inability to build compliant models. This has prompted a guidance paper late in 2010 indicating that the use of models in this area needs to change, with material impact on capital.</p> <p>The credit model team is 12 specialists and as noted above they are supplemented by credit specialists from other PRD groups. Supervisory teams typically do not have credit model specialists but will in some teams contain people with moderate levels of familiarity with detailed IRB issues. There is an enhanced group of market risk specialists, and some supervisory teams have persons with market risk experience.</p> <p>The FSA has processes in place to review and assess the internal processes of risks to the calculation of regulatory capital. In BIPRU, the FSA has built upon the IRB qualification requirements in the Capital Requirements Directive, which has transposed the text of the Basel framework into EU legislation. BIPRU 4.2 sets out the requirements the firm needs to meet to have permission to use the IRB approach. Applications by banks for the use of the IRB approach are formally considered by specially-constituted committees within the FSA. This follows detailed reviews of compliance with the FSA's criteria of a materiality-based selection of a bank's rating systems by the specialist IRB modeling team within the Prudential Risk Division. Ratings systems include the surrounding governance processes, which are also assessed. Market risk specialists do reviews of those models.</p> <p>The FSA then reviews ongoing compliance of the bank's rating systems, including whether the models are performing as expected. It also, on a risk-based basis, assesses the acceptability of extension of the scope of rating systems used for IRB, and of changes to the existing models. Monitoring occurs of how market risk models are performing in practice, and selected drill-down reviews can be performed.</p> <p>Assessors conducted a high-level review of this process. There are no significant variations from the Basel rules. There may be some issues, as the extent of use of IRB apparently varies considerably across the major corporate groups. This opens up the possibility for cherry picking.</p> <p>AC1/2. The capital adequacy regime applies to all U.K. incorporated banks, including those that are not internationally active, as per the European directives. It also applies to the parent holding company in the banking group. As noted in CP 24, however, the FSA's intervention powers do not apply to holding companies. So in cases of capital deficiencies at a consolidated group level that the group did not voluntarily rectify, the FSA would have to take action at the level of the regulated deposit takers. The FSA reports a very high level of cooperation by holding companies in practice.</p> <p>AC3. The rules in GENPRU 1.2 http://fsahandbook.info/FSA/html/handbook/GENPRU/1/2 and BIPRU 4.3 http://fsahandbook.info/FSA/html/handbook/BIPRU/4/3 for Pillar 2 require banks to conduct forward-looking scenario testing³ that is appropriate to the nature of those major sources of risk that the bank is currently or may be exposed to in the future.</p>
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³ Scenario analysis examines the impact of adverse events on a bank's financial position of simultaneous variation in a range of parameters, e.g., simultaneous movements in a number of risk categories affecting a bank's business operations (such as volumes, investment values and interest rate movements). It is a subset of stress testing, which may also include analysis of the effect on a bank's financial position of changes in individual parameters.

	<p>The time horizon is typically three to five years, incorporating scenarios representing future economic downturns (on a “severe yet plausible⁴” basis) and modeling the impact that such deterioration might have on both their capital resources and the capital requirements. A “capital planning buffer” is identified based on this so that over the horizon, the capital resources of the bank do not fall below the minimum capital requirements that the FSA has advised to them. The bank can utilize the identified capital planning buffer to absorb losses during such period of stress.</p> <p>The stress test also applies on a consolidated basis and allocates the total amount of capital resources between each firm that is a member of the relevant consolidated group.</p> <p>The stress test exercise has been material. It involved 40-50 people per firm for a period of two to three months. The intention is to perform this annually. The FSA will look for ways to automate the process somewhat to achieve efficiencies.</p> <p>AC4. The capital adequacy ratios apply on an unconsolidated (solo) and consolidated basis. Consolidated supervision takes into consideration activities of all the entities within the group by reviewing intra-group transactions/exposures, contingent liabilities and sources of funding and capital. The supervisor looks to identify multiple gearing (upgrading the quality of capital in the group), contagion and risks from shared services (risks from sharing market infrastructure). Where group risk is reflected within group capital requirements, the regulated firm is required to hold resources on both a group and a solo basis in proportion to the risks posed by the group. Specifically, the solo capital adequacy regime as set out in GENPRU 2.1 and GENPRU 2.2 ensures that each regulated entity within the banking group maintains adequate capital resources according to the risk of that entity.</p>
Assessment	Largely compliant
Comments	<p>The FSA has put in place capital requirements that are higher than the Basel requirements. The Pillar 2 approach and the use of stress testing to set capital buffers are well advanced. Adequacy of capital and related stress testing receives a very high level of attention in the FSA supervisory process, using a mix of supervisors and risk specialists. This priority is understandable given the current conditions.</p> <p>It will be important going forward not to overly focus on capital and liquidity at the expense of a better understanding of banks’ inherent risks in their businesses and accurate risk assessments, based on robust detailed supervision work.</p> <p>Staff that assessors met were knowledgeable and professional.</p> <p>However, for a market as complex and material as the United Kingdom, and with banks as important as the major U.K. banks, the approach to initial and ongoing model assessment seems insufficiently rigorous, and may have been artificially affected by earlier resource constraints. The Basel rules require ongoing assessment that the qualitative and quantitative factors necessary to apply models-based capital calculations are in place. Accuracy in models and related data feeds is crucial in giving integrity to the banks’ capital calculations have integrity.</p>

⁴ “Stress and Scenario Testing: Feedback on CP08/24 and final rules,” December 2009 (http://www.fsa.gov.uk/pubs/policy/ps09_20.pdf).

	<p>In addition, some senior persons in discussion and in published statements seem to suggest that capital, if high enough, can be the virtually-complete mitigant to potential risk crystallizing in major banks. The issue of the level of appropriate capital for major banks is of course being explored in a variety of international fora and by the Independent Banking Commission in the United Kingdom. The appropriateness of this view will need to be rigorously tested before it can be relied on, as experience suggests that there is a need for sound forward-looking proactive risk assessment and supervision related to risk management, and that capital is often a lagging indicator of problems arising.</p>
<p>Principle 7.</p>	<p>Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.</p>
<p>Description</p>	<p>EC 1. The FSA Handbook requires individual banks and banking groups to have in place policies and effective risk management procedures to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms (SYSC 4.1.1R and SYSC 7.1.2R). The rules require the processes and controls to be comprehensive and proportionate to the nature, scale and complexity of firms. The adequacy of a firm's financial resources needs to be assessed in relation to all the activities of the firm and the risks to which they give rise.</p> <p>The FSA operates the Advanced, Risk-Responsive, Operating frameWork (ARROW). It provides a comprehensive, regular assessment of the risks posed by the firm in question to the FSA objectives. Assessment of the firm's risk management is a key component of the ARROW. The FSA is supported in its risk management assessment by the Prudential Risk Division. This is a division of over 250 professionals, covering credit, market, operational, insurance, capital and liquidity risks and includes extensive industry experience. This Division provides an in-house resource and is used to support the Supervision divisions in many ways through expert reviews and recommendations for supervisory actions. For high-risk firms, full arrow assessments, which can take six months or more are done every two years. In between, ARROW risk assessments are updated depending on market developments and macro risks, changes in the firm's business, supervisory monitoring, in-depth or theme supervisory reviews and other matters.</p> <p>As part of the ARROW firms risk assessments, and on-site visits, supervisors determine if the risk management processes are adequate for the size and nature of firms' activities and are periodically adjusted in the light of their changing risk profiles and external market developments, as well as to what degree risk policies and procedures are documented and how often they are reviewed.</p> <p>Starting in 2008, the FSA adopted the supervisory enhancement program. For the eight very high-impact firms this was subsequently elaborated in the Core Prudential Program. It has separate assessment modules with in-depth reviews and extensive on-site and detailed work in understanding and challenging the risks in the firm's business, risk management and control, governance and enterprise wide risk management (ERM), capital, and liquidity. This program has progressed farthest in the areas of capital and liquidity (including extensive stress testing). The other modules are at very early stages with parts of them being piloted in some supervisory programs. FSA staff advised assessors that the goal is to complete the first pass-through of the CPP in 18–24 months. The FSA appears also to be approaching the CPP mostly module by module.</p>

	<p>The Core Prudential Program is to apply also in due course to the further 50–60 high-impact firms, but this roll-out has not started. Elements may also apply later to other smaller and medium-sized deposit takers. But many of these firms are already subject to the SEP including what the FSA styles as ‘close and continuous’ supervision.</p> <p>The FSA has the power to require a bank or banking group to strengthen their risk management processes if the FSA determines that they are not adequate for the size and nature of their activities.</p> <p>The assessment team discussed risk management capabilities with FSA supervisory staff and PRD staff, reviewed selected supervisory reviews and reports, and discussed the state of risk management (especially ERM) with the banks that it met. Assessors are also aware that the crisis revealed that major global banks (including U.K. banks) had difficulty in performing comprehensive ERM well. The issues are summarized in the Senior Supervisors group report in which the U.K. FSA and U.K. banks participated. They include: too many risk silos and some banks’ inability to measure and assess the interactions between risks, especially the interactions between credit and market risk; some banks’ risk architecture that did not permit timely aggregation of position exposures and concentrations in ways that permitted as active risk assessment and mitigation as desired; insufficient knowledge among senior management and Boards about risks they were running and insufficient attention to determining and operationalizing risk tolerance in advance. Risk architecture and data issues were particularly difficult in banks with far-flung global operations and banks that had gone through major mergers. While many banks are in the process of rectifying this, it takes considerable resources and time.</p> <p>Discussions and documents reviewed revealed that the issues for certain major U.K. banks are similar to those elsewhere. There is a considerable range of practice, with some having considerable way to go to achieve the desired position. Also, the extent and depth of the supervisory assessment of ERM in major banks is at various stages. For those reviews that have been done, a material number are revealing issues. As noted in the assessment of CP 19, ARROW seems also to have a number of issues as a risk rating tool.</p> <p>EC 2. As noted, Board and senior management oversight and understanding of the comprehensive risk process was an issue identified at some banks during the crisis. The FSA Handbook, section SYSC 7.1.4R, requires that banks’ senior personnel approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the bank is or might be exposed to. Section SYSC 14.1.11G places on banks’ governing bodies and relevant senior managers, the ultimate responsibility for the management of prudential risks and specifically responsible for overseeing the establishment of an appropriate risk management strategy.</p> <p>In its turn, the ARROW assessments require supervisors to verify that there is a clearly-defined strategy approved by the Board and effectively implemented by senior management. This includes verification that Boards fully consider oversight over firm-wide risks and have accurate and appropriate information. FSA staff responsible for the supervision program for major banks does interact with individual Board members. The FSA conducts Significant Influence Function (SIF) reviews of new Board members and through this process has some information on the qualities of a Board. Certain in-depth reviews also consider the degree of Board involvement and</p>
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oversight of the area under review.

Review of documents and talking to banks and to FSA staff indicated that practice was patchy in this area. There are material gaps in the comprehensiveness of certain major banks' oversight process. Some banks have only recently formed separate sub-committees of the Board dealing with risk (following the recommendations of the Walker report on bank governance). Banks differ considerably in their development of effective risk appetite statements that are linked to strategy and to operating limits and **metrics**, with appropriate Board reporting. Some told assessors that they are likely several years away from having this in their desired state. They emphasized the difficulty of doing this in a meaningful way that does not become a compliance exercise. Banks are also at various stages of relating compensation to risk.

EC3. The FSA Handbook section SYSC 7.1.8G (1) requires banks to document their risk management framework, setting out how risks are identified, measured, monitored and controlled. In addition, risk-specific Handbook sections set out further requirements around risk management documentation. As part of the ARROW assessments, FSA supervisors are expected to verify if banks have documented terms of reference for their risk management, which include how well risk policies and procedures are formalized, documented and implemented; and how exceptions are dealt with, e.g., what controls are in place over any override of credit granting policies by Board members (including preventing unacceptable behavior such as generating short-term profits while deviating from policies and established limits).

EC4. The FSA Handbook section SYSC 4.3.2R requires that senior personnel regularly receive written reports on risk matters, indicating whether remedial measures have been taken in the event of any deficiencies. As part of the ARROW assessments, FSA supervisors are expected to verify that the Board has access to adequate and appropriate information for the effective oversight of the business (including internal audit reports). Supervisors have indicated that they seek to know what risk management information is provided to the Board and executive management, and if risk reporting lines are clear and independent. Supervisors also seek to verify if senior management understands the market risk reports and the limitations of the risk measures within them. The ARROW process also seeks to establish if directors and senior management of banks provide adequate input and challenge into the calculation of capital. As noted in EC1/2, developments toward full effectiveness in this regard at some banks are in progress.

EC5. BIPRU 2.2.4G states that the adequacy of a bank's capital needs to be assessed both by a firm and the FSA. This process involves an internal capital adequacy assessment process (ICAAP), which a firm is obliged to carry out in accordance with the ICAAP rules; and a supervisory review and evaluation process (SREP), which is conducted by the FSA. Banks are required to document their ICAAP and provide ICAAP documents to their supervisors (which is part of the ARROW process). The supervisors assess banks' ICAAP in accordance with the SREP process and issue the individual capital guidance (ICG) that banks are required to observe. The nature of the specific methodology used for this assessment will depend on the proportionality principle which relates to the nature, scale and complexity. Noncomplex banks may opt for a more qualitative approach to capital planning by adopting the Basic Indicator Approach (BIA) under the Capital Requirement Directive (CRD).

The FSA has had considerable experience of setting individual bank capital targets or guidance even before the introduction of Pillar 2 of Basel II. In 2009 and recently, the United Kingdom has also conducted several rigorous stress tests of major banks' capital positions. There is clear evidence that these processes have been effective in raising bank capital. Various actions by the FSA, including the use of benchmark scenarios for stress testing, and requiring reverse stress testing, have also enhanced banks practices and got them to better link their risks to their desired capital position.

EC6. Where banks and banking groups use models to measure components of risk, the FSA Handbook specifies general requirements on methods of valuation and systems and controls in section GENPRU 1.3. The FSA Handbook also lists risk type-specific requirements around periodic and independent validation and testing of the models and systems. The FSA website lists the Handbook requirements for model validation (Guidance for Model Validation). As part of the ARROW assessments, FSA supervisors are required to verify that banks make use of techniques that are regarded as current good practice in risk management. Supervisors also seek to establish (i) if banks dealing in complex and innovative products rely on complex mathematical models to measure and manage risk; (ii) what policies and processes are in place for the development and validation of those models; and (iii) if those are effective. However, complex institutions and supervisors have placed much reliance on mathematical modeling to measure components of risk. Quantitative models are useful tools as rough approximations to an enormously more complex reality. Models, therefore, cannot replace expert judgment by banks and supervisors.

Recent supervisory reviews have led to some questions about the adequacy of independent model validation, and the FSA is following up.

EC7. The FSA requires that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. The FSA Handbook places requirements on banks to have effective processes to identify, manage, monitor and report the risks it is or might be exposed to (SYSC 4.1.1 R), as well as that banks should satisfy themselves that their systems are sufficiently sound to support the effective management and, where applicable, the quantification of the risks (GENPRU 1.2.89 G). As part of the ARROW assessment process, the FSA supervisors check the quality of banks' management information systems and reporting to their Boards and senior management in general. Large banks, however, are affected by the common inadequacies in information technology systems to manage timely aggregation of risk information on broad financial risks as market events unfolded rapidly and intensely. Risk management cannot be effective if risk monitoring is not adequate. Industry representatives underscored that major efforts to rectify weaknesses are underway, these necessarily take time to design and implement properly. For the time being, therefore, it is not possible to fully evaluate the adequacy of those banks' risk measurement and monitoring.

EC8. FSA supervisors are expected to check how new product developments are approved and controlled and verify that senior management is involved in the trading strategies and there are sign off protocols for significant new strategies. FSA supervisors should also check if there is evidence that new product approval processes are effective. The ARROW process also seeks to determine the levels of involvement of banks' Boards and corresponding sub-committees (e.g., Risk Committee, ALCO) in setting and approving risk policies and risk appetites. The crisis

	<p>revealed, however, that a significant number of banks did not understand the risks embedded in some of their complex products.</p> <p>Recent selected supervisory initiatives have started to review the new product approval process for certain more complex products. It identified material weaknesses in a number of banks, and these are in the process of being fed back to firms with remedial action plans. This sort of review is a new activity for the FSA and there are plans to broaden it in future to cover other product areas.</p> <p>EC9. As part of the ARROW assessments, FSA supervisors are expected to verify if banks have independent risk management functions; whether the risk management functions have Board representation, or report to the Board independently of the business; whether risk management functions have credibility with the business and senior management; and whether they are seen as business-oriented or remote.</p> <p>EC10. The FSA Handbook has specific sections on credit risk (sections BIPRU 3, 4, and 5), market risk (BIPRU 7), liquidity risk (BIPRU 12), interest rate risk in the banking book and operational risk (BIPRU 6), specifying standards and requirements on evaluation, monitoring, and control or mitigation of those risks.</p> <p>AC1. The FSA Handbook section SYSC 7.1.6R requires banks to establish and maintain independent risk management functions that implement and maintain risk management policies and procedures and provide reports and advice to senior personnel. Section SYSC 4.1.2R states that these arrangements must be comprehensive and proportionate to the nature, scale and complexity of the common platform firm's activities. The ARROW process seeks to establish if banks' procedures to assess risks and report on them are challenged by an independent party, such as internal audit or an independent risk committee.</p> <p>AC2. The FSA Handbook (GENPRU 1.2.42R) requires banks to carry out stress tests and scenario analyses for their major sources of risk. As noted above the authorities' recent focus on stress tests has been considerable and it has impacted banks' capital and liquidity positions.</p> <p>AC3. The FSA Handbook requires banks to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the firm's activities, processes and systems (SYSC 7.1.2R). Section BIPRU 2.2 of the FSA Handbook provides guidance on risks to be covered in an internal capital adequacy assessment process (ICAAP) of a firm, stating that a firm may take into account factors other than those identified in the overall Pillar 2 rule when it assesses the level of capital it wishes to hold. These factors might include external rating goals, market reputation and its strategic goals.</p>
Assessment	Largely compliant
Comments	<p>In a complex innovative global market like the United Kingdom, with large far flung banks, the standard for risk measurement and risk management capability has to be very high. Capabilities for risk measurement and risk governance and oversight at major banks are not at all uniformly where they should be, though there are clearly examples of leading practices. Getting all major banks to acceptable positions will take further time. Nor is the FSA's ability to assess enterprise-wide risk management capability where it should be. However, it will be materially improved when the first</p>

	<p>stage of the new SEP and Core Prudential Program is completed in 18–24 months. And that program may well uncover further material weaknesses at some banks that will need remediation and testing to be judged effective.</p> <p>So the parts of this principle related to the existence of a comprehensive risk management process that has passed a rigorous test of supervisory satisfaction are not materially in place. However, the FSA program of stress testing and scenario analysis has received considerable priority and resources and is achieving results. It is fully compliant with this Principle and means that the shortcomings mentioned above are not issues of serious concern from the point of view of effective supervision.</p> <p>FSA specialist staff noted that the recent material increase in resources was assisting in assessing the quality of firms risk management. They also indicated that, as in other supervisors, there were issues in having specialist input clearly and effectively linked to supervision programs. Assessors saw examples of that in practice. Leadership will be required to make these links more effective. They also judged that the supervisory assessment program was less than halfway to where it should be. Further material investments in data and modeling capability to assist assessments are needed. In part, this is just a matter of time, as the broad direction is set and is in the right direction.</p> <p>Until the FSA has further completed the body of work planned, it is not possible to say if adequate resources are available. But the FSA should do a formal assessment of this toward the end of the first cycle of Core Prudential Program reviews. The FSA should also make sure that the horizontal linkages between CPP modules are fully identified. For example it is only possible to determine the adequacy of risk management and risk governance in relation to a full understanding of the nature of a firm's business model and the inherent risks it contains.</p> <p>Supervisors are encouraged to continue the development of existing programs. It may also be a challenge for the FSA process and culture to become more proactive rather than being reactive to developments in the market and in individual firms.</p> <p>Recently the government and banks have apparently been considering entering into certain understandings related to growth in lending to support economic growth. It will be important to ensure that these do not undercut sound risk management practices.</p>
Principle 8.	<p>Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.</p>
Description	<p>EC1: The FSA has a formal system to verify that BHCs, banks, mutual banks and building societies have in place a credit risk management system.</p> <p>The rules are indicated in the FSA Handbook, the responsibilities of the management in the SYSC Senior Management Arrangements, Systems and Controls (SYSC), whereas the prudential rules are in the General Prudential sourcebook (GENPRU) and the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU), that state the rules and guidance around the</p>

regulatory capital requirements for credit risk.

Guidance is also given around the regulatory capital requirements for credit risk (e.g., the Standardized and IRB approaches, credit risk mitigation, and concentration and counterparty risk exposures) and how these risks should be evaluated, managed, monitored, controlled and reported. This FSA approach relies considerably on the verification of the responsibilities of directors and senior management in banks, including for systems and controls in respect of credit risk.

Supervisors and Risk Specialists at the FSA review the governance procedures that set out the credit risk management policy, process and appetite at each firm – a core part of the ARROW process. This includes assessing how well the Board sets, monitors and controls risk appetite, how effectively these powers are delegated to senior management, and what level of oversight exists. This assessment is made in various ways, including review of Board minutes discussions with Board members, and review of banks MIS information and material going to senior management and the Board. These documents are assessed to ensure they fully capture the actual level of credit and counterparty risk the firm is exposed to, and that the material is presented to senior management and the Board in a timely manner.

For wholesale firms, supervisors emphasize the challenge given to the firm's articulation of the Board's Credit Risk Appetite through continuous dialogue with Senior Credit Risk Management officers and monthly review of required MI to ensure practice aligns with policy and the firm's risk appetite. Firms are also challenged to present Credit and Counterparty Risk exposures in a clear, consistent, and concise way so that the Board of Directors has a transparent view on the nature and materiality of the credit risk exposures the firm is running. Assessors discussed this process with supervisors and confirmed how it works in practice. Assessors also saw evidence of where the high-level approach to assessing Board and senior management oversight did not prove to be robust or was not working as previously described to supervisors. Such evidence came to light when a more traditional in-depth assessment of credit risk was undertaken by the FSA.

EC2: The assessment of whether a firm has appropriate policies and processes and a properly controlled credit and counterparty risk environment are carried out by the FSA through six primary methods:

- 1—The use of the Arrow model;
- 2—The “close & continuous” dialogue with banks (CCO, CRO, CEO);
- 3—Semi-annual discussion on the credit risk models;
- 4—So-called “deep-dives”;
- 5—Stress-tests; and
- 6—On-site reports commissioned under section 166 of FSMA by skilled persons to review specified control areas or risk measurement or management processes.

The United Kingdom does not have a credit register or a regular cross-industry process to review major credits. When mortgage brokers became regulated by the FSA, the FSA continued collecting comprehensive data on all mortgages underwritten in the United Kingdom, but this data base does not have a loan history after inception that would permit analysis of loan migration or default characteristics, as exists in some other countries.

Deep-dives cover more detailed reviews of firm processes around governance, risk appetite, credit risk and concentration policies, control and mitigation of exposures,

risk rating systems, MIS, limit exceptions, problem assets and write-offs. These are normally conducted by a team involving personnel from the supervision team for the bank and credit risk specialists from the Prudential Risk Division. Some but not all supervisory teams for high-impact banks have staff with credit risk experience. Specialist resources have been built up materially in the past 18–24 months. The core prudential program will add materially to detailed work, but the risk management portions of that are at very early stages of roll out.

Assessors were conscious that serious credit risk issues were a major factor in many of the banks that failed and assessors wanted to understand where the FSA was in the process of enhancing its assessments. Assessors discussed with FSA staff actual practice in assessing credit risk. They saw examples of deep-dive reviews that were conducted and reviewed the FSA program to deal with commercial real estate assessments, which is an important issue given the earlier run up in prices, the approximately 40 percent decline, the uncertain economic recovery and some banks' considerable exposure in this area. Supervisors confirmed that deep-dive reviews of credit risk were often done in a reactive way after issues were revealed in other ways. Several 'deep-dive' reviews at a bank consisted of 3–4 people for 3–4 days, with some examination of files. There was no policy of a planned cycle of reviews involving some sample replication of the robustness of credit risk ratings. The number of in-depth reviews seemed limited.

Assessors discussed examples with the FSA where deep-dive and thematic reviews of important credit risk areas had to be postponed due to resource pressures (in favor of other tools such as enhanced monitoring, stress testing and "Dear CEO" letters). However, subsequent selective in-depth reviews requested by individual supervisors revealed material differences between the risks in the actual book at those banks and what had been described in the close and continuous meetings. The use of s.166 skilled persons reports for prudential matters is growing, but from a low level.

Credit risk prudential specialists analyze returns data on PDs and LGDs, but the data are by broad portfolios only. They are in the process of developing more granular data requests and related analytical systems that would permit better peer analysis and identification of potential problems earlier. This is an excellent initiative. Staff has sound plans for enhanced approaches to credit risk assessment.

Stress testing to assess capital adequacy and set capital planning buffers is advanced, as indicated in commentary in other CPs. However, without adequate assurance that underlying portfolio data and risk measurement is robust, the accuracy of the stress test may be reduced.

Supervisors and risk specialists both confirmed that there is room to materially enhance the use of feedback from specialist work, including on stress testing by incorporating it into supervisory assessments and interventions with individual banks on control and risk management weaknesses that are revealed.

EC3. During its credit review process, the FSA makes sure that firms have developed policies and practices to prevent conflicts of interest from influencing credit decisions. During ARROW reviews, extensions of credit to employees, directors, principal shareholders or related parties may be examined to ensure they were carried out on an arm's length basis and on market terms and pricing. This process is made easier in wholesale firms which have reputational risk committees. Firms are asked to provide for the policies and the facts determining that the loans are made at arm's length and on normal conditions of term and pricing.

	<p>The building societies act has explicit restrictions on loans to directors and persons connected to them, and related reporting. There are no equivalent specific requirements for banks, and so general sound credit risk management principles apply.</p> <p>Assessors were not able to see examples of the scope and depth of these reviews.</p> <p>EC4: Under FSMA, the FSA has the power to request all information maintained by a firm, its third party providers and its employees. The FSA’s Handbook also specifies the level of information, at a minimum, that a firm should maintain in the course of running and managing its business. Information on credit and investment portfolios received from SIFI and Large complex groups is more extensive, as is the specialized monthly report for Building Societies –an inheritance from the past. There is no doubt - and this is evidenced by the documentation reviewed by the mission- that the FSA has the right of “full access” to banks’ information.</p> <p>AC1: As part of the ARROW processes, the FSA effectively ensures that limits are established for credit exposures, including single name and sector limits, and that approval processes are clearly defined. The FSA will also ensure that materially large and/or high-risk exposures have to be approved by senior management, and are reported to, and regularly reviewed by, the Board.</p> <p>The limit on large exposures is the maximum in the European Capital Requirements Directive—the total of all large exposures (defined as those above a 10 percent of capital threshold) to a connected corporate group, must not exceed 25 percent of a bank’s capital. A number of other countries have adopted a lower limit.</p> <p>AC2: The FSA’s Handbook details the policies and processes that firms should have in place to identify, measure, monitor and control counterparty credit risk. This includes modeling current and future exposures, in accordance with the various methodologies provided in the Basel capital framework, to ensure the appropriate capital is held against individual products. The adequacy of such processes and models are assessed as part of the FSA’s review procedures.</p> <p>AC3: It is unclear whether the Arrow process ensures that the bank has in place the necessary policies, processes and systems to monitor the total indebtedness of entities they extend credit to.</p> <p>With some of the largest banks moving under IRB systems, the quality and the rigor of the data will increase at least for the wholesale, inter-banking and country risks part of the portfolios. Either by making its Gabriel requirement more explicit or requesting direct PDs percent or by imposing a master scale, the FSA will benefit from much richer and precise information, not only on the results but also on the implicit lending strategy of each bank. The light IRB analysis performed by the FSA today (see CP 6) will hamper its ability to understand the IRB results. However, due to the lack of a balance sheet register and credit registers and of PD evaluation models that can be built on, the FSA will continue to have difficulty in challenging properly the banks’ results, though some partial proxies could be used at lesser costs.</p>
Assessment	Materially noncompliant
Comments	<p>Credit risk problems were material in the crisis and supervisory processes were not sufficient. While there is evidence of capability to perform more detailed credit assessments (including of exposures, collateral and risk mitigants), there is a need for much more proactive, extensive detailed work, including transaction testing. The higher-level monitoring type work through interaction with banks on a regular basis and examination of their MI system is useful but is far from sufficient to get a reliable view of the state of credit risk (asset quality, adequacy of provisions and reserves,</p>

	<p>and disclosure) and credit risk management practices (credit risk analysis, credit-granting process, credit monitoring, and early remedial and workout actions). While stress test work can expose credit risk problems, it cannot give adequate assurance where the bank's own assessment of credit grading and risks is not robust. The issue in the United Kingdom is more challenging because of the lack of a credit register or adequate detailed data from banks to permit analysis and reasonable peer assessments. More detailed analysis of IRB models and data below the portfolio level of granularity, as recommended in CP 6, would be another method to enhance credit risk assessment for those banks.</p> <p>The United Kingdom does not need to adopt the broad-based credit file review process as in some countries, nor does it need to build a comprehensive credit register. But it does need to find organized, proactive ways to do more in-depth analysis. This can involve credit risk specialists who do selective reviews of parts of portfolios (focusing on higher risks) to gain assurance that a bank's risk rating system and risk management and related governance is working as it is supposed to.</p> <p>Assessors did not see sufficient strong consistent evidence of the ability to challenge banks' data on a regular basis.</p> <p>The FSA has recognized these issues and has decided to do more in this domain. However, it appears that tools and human resources and IM/IT constraints have prevented it until now from going deeper. Work to revamp these processes has started, but is still at an early stage, and this is a multi-year process.</p> <p>More in-depth credit reviews would also allow better assurance that the senior management and governance processes reviewed in the ARROW process are actually operating as described and as necessary. If they are not, the detailed reviews would provide necessary evidence to allow the FSA to push for needed improvements.</p> <p>As commented in CP 10, the FSA should review its prudential expectations on large exposure limits to ensure it is satisfied that they are not too high.</p>
Principle 9.	Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	<p>EC1. The FSA takes measures to ensure compliance with the adequacy of policies and processes for problem assets and provisioning. It uses a combination of requirements from the FSA handbook and practical measures and accounting rules (IFRS and U.K. GAAP). Presently, the FSA measures to ensure compliance with the adequacy of policies and processes for problem assets and provisioning are a combination of (i) requirements within the FSA Handbook to which banks, as well as building societies, are subject; (ii) measures taken by the FSA in practice, in accordance with its evolving model of supervision, to monitor compliance with these requirements; and (iii) International Financial Reporting Standards (IFRS), which requires all financial assets (other than those measured at fair value) to be reviewed for impairment. IFRS must be applied at the consolidated level by all listed companies in the EU. A similar impairment model also exists in U.K. GAAP (which is used by banks not applying IFRS).</p> <p>The FSA Handbook requirements are based on the High Level Principles 3 (adequate risk management systems) and 4 (adequate financial resources). Under SYSC 3.1.1 banks are required to establish and maintain such systems and controls as are appropriate to their business. Threshold Condition 4 defines "resources" as extending</p>

to provisions against liabilities (COND 2.4.2(3)).

GENPRU 1.2.30 requires a firm to have in place sound, effective and complete processes, strategies and systems that are adequate to cover the nature and level of risks to which it is or might be exposed; and that enable it to identify and manage the major sources of risk to which it is exposed which, for banks, will include credit risk. Management of problem assets is part of the necessary process.

FSA supervision deals with provisioning issues through various means. Stress test exercises can reveal provisioning deficiencies. Detailed credit risk assessment work, though not frequent (see CP 8), also has been used to assess provisioning. FSA may conduct more reactive work on provisioning when losses are identified. By June 2011, the IFRS is expected to change its rules to make provisioning easier and more forward looking, close to the Basel notion of expected losses. With this new approach, the FSA could be in a better position to challenge the computations made by the banks.

EC2. The FSA seeks to ensure—through ARROW, risk mitigation programs and other works—that procedures for monitoring and dealing with problem loans are adequate. Where there are doubts on the bank’s credit risk control and provisioning, the FSA sends its specialists from the PRD or from its accounting department. It can also commission a report from an expert under section 166 of the FSMA. After the Turner Review (February 2009), there has been a major shift in the role which the FSA plays in relation to published accounts and accounting judgments, with far more intense contacts with bank management and auditors on these issues. The impact of such a move will remain to be seen in the future. But without real on-site analysis, it is difficult to see how “intense contacts” can actually change loan classification and impairment when necessary.

EC3. The FSA indicates that the system for classification and provisioning takes into account off-balance sheet exposures. It has been done with IRB, as the IRB approach in place in some large banks takes into account the off-balance sheet. In time, large banks’ exposures will be fully covered by this system. The IRB validation is light and does not include a credit assessment on site. The classification is given by the banks that produce the COREP call report in GABRIEL. This raises the issue of how, except obvious errors, the classification can be contested. The FSA could consider extending provisioning against off-balance sheet exposures if material for the SA approach.

EC4. The FSA uses its ARROW system to verify that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations. It also uses its Core Prudential Program (CPP), which reviews the key risk elements of the organizations and which in turn may identify the requirement for a specific focused internal or external review of policies or process application. This system, however, remains bank reliant with few tools to challenge it.

EC5. Through the ARROW process, the FSA determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations. If the formal aspects can be covered, the substance is not touched as there are no hard checks on site.

EC6. On the classification of credits and its provisioning, the FSA has access to five sources of relevant information (i) regular supervisory reporting – as outlined in the answer on Principle 21; (ii) information supplied as part of the ARROW assessment or related work; (iii) in-depth reviews of specific business areas as part of the supervisory work of CPP units; (iv) management information; and (v) if needed, the FSA has the power to receive more information from banks.

In addition, the FSA prepares a Risk Mitigation Program, which banks are required to complete to address identified inadequacies in risk management policy or process application following the conclusion of ARROW and CPP review work. FSA also has the power to request and receive further relevant information from banks. The assessors consider that the general internal reporting, GABRIEL, is very limited and the information received through ARROW is mainly on the processes. The CPP uses deep-dives; however, the management information received from banks is not necessarily consistent.

EC7. The FSA deals more with capital than with potential inadequacies in provisions. “The FSA’s approach to Pillar 2 is to increase the total capital required to be held by banks to the extent that has judged the capital held by a bank to be insufficient in relation to its risks. A high level of problem assets which was inadequately covered by the regulatory capital framework would thus provide a reason for such an increased Pillar 2 figure, as would an inadequate level of provisioning.” The present IFRS rule is indeed a hindrance, but the new rules will permit more flexibility and proactive actions. If the level of provisioning is inadequate, the FSA, through Pillar 2, adds an extra capital charge. In the future the use of the two approaches more conjointly could be envisaged.

EC8. Assessors do not have evidence of FSA’s means to judge the classification and the adequate provisioning, except of the work done by the external auditors. However, directly through the ARROW process and through a section 166, the FSA is able to intervene. As indicated by the FSA: “An assessment of the type outlined above under Question 2 would form the basis of a requirement for additional capital under Question 7.” The FSA focuses more on using capital to deal with multiple issues, rather than dealing directly with provisioning problems.

EC9. The FSA follows the EU and Basel rules to require banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. As indicated in its self-assessment, “banks are subject to the capital requirements of the BIPRU section of the FSA’s Handbook, which largely copies out the EU Capital Requirements Directive, itself based upon the Basel II capital framework. These provide detailed rules on the acceptable use of mitigants, and haircut mechanisms for a sufficiently prudent valuation of collateral.”

EC10. The FSA applies the IFRS and U.K. GAAP rules that provide a guide for impairment. Within this framework, a financial asset is considered to be impaired if there is objective evidence, as a result of one or more events that occurred after initial recognition, that its carrying value will not be recovered through future cash flows.

EC11. The FSA makes sure and receives evidence that the Board receives timely and appropriate information on classification, impairment, provisions, and major asset problems. Banks using the IRB approach are also subject to additional specific

	<p>requirements for information relevant to their rating system that must be conveyed to the Board.</p> <p>As described by the FSA in the answers on Principle 8, supervisory and risk specialists within the FSA review the governance procedures in relation to a bank's management of credit risk and this will include information provided to the Board on provisioning and problem assets. Banks using the IRB approach are subject to additional specific requirements for information relevant to their rating system that must be conveyed to the Board.</p> <p>EC12. The FSA has implemented the EU Capital Requirements Directive, which has detailed rules on collection of data and on reporting of the largest single counterparty exposures. The IFRS rules on impairment require impairment allowances to be made on an individual basis, but the FSA takes little proactive action on limits below the 25 percent threshold and orientations for large exposures and country risks.</p> <p>AC1. Banks' provisioning policy statements "should include criteria for loans to be classified as nonperforming. The criteria for such classifications would normally include a minimum number of days of arrears." The Basel system also requires banks to declare the number of past due days, which entails a higher capital charge. Furthermore, the BIPRU capital requirements for both standardized and IRB banks include the number of days past due as a specific criterion which results in higher capital requirements, and therefore requires banks to collect information on this basis. FSA staff does not do extensive checks of banks' compliance with these requirements.</p>
Assessment	Compliant
Comments	<p>The FSA maintains the philosophy and practice that accounting and provisioning are not parts of its realm but implicitly relies on banks and auditors. Assessors' discussions with auditors did not reveal examples of major problems in provisioning. This explains the little attention given to portfolio quality and adequate provisioning, and the FSA having no serious tools to challenge banks or their auditors (as noted and assessed in CP 8). The use of Section 166, skilled persons reports, to offer a sufficient challenge is not used frequently enough if it is to serve this purpose. And use of those processes more frequently may not be a full substitute for more in-depth credit analysis (including provisioning). In this field, indirect means of supervision lack effectiveness to review credit risk. For problem assets, this forces the FSA to lag behind events. On the other hand, extensive stress testing and FSA willingness to require capital well above the minimums are mitigants to the underdeveloped and insufficiently detailed consideration of provisioning practices. The change of the IFRS rule IAS 39 is supposedly in favor of provisioning that would be more EL driven and forward looking. Once the new rule IAS39 is in place, the FSA could consider a material change in the FSA process to be more proactive on provisions, problem assets and reserves. This Rating is to be read in conjunction with Principle 8, on credit risk, and Principle 19, on the supervisory approach, as the issues here also concern the general supervisory approach and the approach to credit risk, rather than being specific to provisioning.</p>
Principle 10.	<p>Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.</p>

Description	<p>EC1: The FSA has rules which require firms to identify, control, and quantify their exposures to single counterparties and groups of connected counterparties. These are contained within the FSA's handbook. BIPRU 10 (Large Exposure Requirements) sets limits to restrict the size of such exposures to single counterparties or groups of connected counterparties, including counterparties connected to the firm.</p> <p>The FSA's handbook provides in its regulation BIPRU 10.3.5G-10.3.8R when firms should be considered "groups of connected clients." This implements the definition of "group of connected clients" in the same way as Article 4(45) of the Banking Capital Requirement Directive (2006/48/EC). The definition in the directive of a "group of connected clients" is consistent with the EU rule. The FSA has also modified its rules to be compliant with the Committee of European Banking Supervisors further guidance on these issues. The FSA references it in its handbook from December 31, 2010.</p> <p>EC2: High level requirements for appropriate systems and controls are set out in the FSA handbook (SYSC). Rules regarding credit and counterparty risk management are set out in SYSC 7.1. This includes sound and clearly established processes for approving, amending and refinancing credits and effective administration and monitoring systems.</p> <p>Regarding Large Exposures, collected through template or Regulatory return FS008, the FSA applies the large exposure elements of the EU Capital Requirements Directive in a similar manner as other European countries. As indicated by the FSA "BIPRU 10.2 (Identification of exposures), both on- and off-balance sheet items are included in the definition of exposure. BIPRU 10.3 (Identification of counterparties) contains rules and guidance regarding how to identify a counterparty and in particular how to determine what constitutes a group of connected clients. BIPRU 10.4 details how such exposures should be measured for the purposes of large exposure limits. BIPRU 10.5 (Limits on exposures and large exposures) defines what the FSA considers to be a large exposure (an exposure > 10 percent of a firm's capital base at a given stage in the capital resources calculation) and sets a limit on the size of these exposures. The CRD2 requirements came into force in Europe as of December 31, 2010. This included a tightening of the European large exposures regime. The FSA has decided "to undertake a robust implementation of these requirements, which will involve declining to implement a number of national discretions."</p> <p>Requirements on prudent limits on large exposures to a single counterparty are part of the FSA handbook (SYSC 2 on Senior Management Arrangements), which requires firms to maintain apportionment of significant responsibilities such that the business and affairs of a firm can be adequately monitored and controlled by the directors, relevant senior managers and the Board. This, in conjunction with the supervisory processes as set out under ARROW, enables supervisors to require appropriate Board approval in the case of transactions with related parties which are large or which pose special risk.</p> <p>The definition of what is a large exposure is found in regulation BIPRU 10.5.1R : a large exposure of a firm is its total exposure to either a counterparty, connected counterparties or a group of connected clients, whether in the firm's nontrading book or trading book or both, which in aggregate equals or exceeds 10 percent of the firm's capital resources.</p>
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The FSA applies EU rules that set a limit of 25 percent of capital resources on large exposure to each of a counterparty, counterparties regarded as connected to the firm, or a group of connected clients, and an aggregate limit of 500 percent on total large exposures that arise from a firm's trading book.

More precisely, in implementation of a discretion in the European Capital Requirements Directive relating to market risk (2006/49/EC), exposures that arise from the trading book are exempt from these limits but are subject to 500 percent or 600 percent limits dependent on their maturity, and to a penal capital add-on for the additional risk of such exposures being in excess of 25 percent of a firm's capital resources. These requirements apply on a solo and group basis.

From December 31, 2010 the FSA subjects all third-party large exposures to the same 25 percent limit regardless of whether they are in the banking or trading book. Intra-group exposures will continue to be subject to a different regime – expanded on in Principle 11.

Regarding off balance sheet exposures, BIPRU 10.2.1R requires exposures to include all claims and transactions that are on and off balance sheet. Furthermore, BIPRU 10.12.1R requires firms to have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, and for that of monitoring those large exposures in the light of the firm's own exposure policies. Firms are required to report all large exposures to the FSA through quarterly reporting requirements and are required to notify the FSA of any breaches of these limits.

The FSA applies the EU Directive, but “a minima” only and does not enforce a threshold below the 25 percent limit.

EC 3. Through its BIPRU 10.12.1R regulation, the FSA requires “firms to have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, and for that of monitoring those large exposures in the light of the firm's own exposure policies.” This, in conjunction with the SYSC provisions and the ARROW supervisory assessment process, allows the supervisors to determine whether banks' management information systems are adequate and timely.

EC 4. BIPRU 10.12.1R requires firms to have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them, and for monitoring those large exposures in the light of the firm's own exposure policies. This, in conjunction with those SYSC provisions and the ARROW supervisory assessment process already mentioned, allow the supervisors to require the firm's Board to consider and approve transactions and exposures which are large or pose a special risk.

EC 5. Information on concentration and remedial action: As indicated in its self-assessment, the FSA receives quarterly large exposure reports that enable its supervisors to determine firms' portfolio concentrations. In addition, as part of the FSA's Pillar II process, the FSA undertakes a supervisory review and evaluation

	<p>process (SREP) which considers firms' concentration risks to sector, geography, liability and asset concentrations. The FSA may require additional remedial actions as are necessary, including firms having to hold more capital or to reduce the risk inherent in their activities, products and systems.</p> <p>AC 1: Following the EU regulation, the FSA defines a large exposure as 10 percent of a bank's capital. The FSA currently sets a 25 percent large exposures limit on exposures to individuals or group of connected clients that arise from a banks' banking book. There are separate limits on trading book exposures of 500 percent or 600 percent based on the maturity of the transactions, and penal additional capital charges (rising to 900 percent RW) are added on exposures over 25 percent in line with discretion in the European Capital Requirements Directive with respect to market risk (2006/49/EC). From December 31, 2010 the FSA will be implementing a number of changes to the large exposures regime. One of these changes will be to introduce a common 25 percent limit to third party exposures arising from the trading book and the banking book.</p>
Assessment	Compliant
Comments	<p>The FSA is compliant with this Principle with effect from December 31, 2010 when it subjected all third party large exposures to the same 25 percent limit regardless of whether they are in the banking or trading book. However, from a supervisory point of view, the 25 percent limit can result in too much concentration and the FSA could consider encouraging banks, as part of sound risk management, to set lower internal limits (especially for large SIFI or High-impact banks). Some EU countries, for example, apply, de facto, a 10 percent standard.</p>
Principle 11.	<p>Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
Description	<p>EC1: The FSA sets out a very broad definition of "connected counterparties" (BIPRU 10.3.8R). There are specified definitions of which corporate entities in a group are automatically connected and these cover most of the corporate entities referred to in the footnote to the principle. In addition there are a range of factors, including qualitative factors (for example, closely related creditworthiness, financial performance or risk of insolvency, significant influence, a person to which a firm has an exposure which was not incurred for the clear commercial advantage of the firm and which is not on an arm's length basis) which are grounds for considering other persons as connected. These provide the supervisor with wide discretion to determine whether a counterpart should be considered to be connected.</p> <p>This is more a supervisory process than a rule but, if monitored and executed, it gives enough powers to the FSA.</p> <p>However, discussions with FSA staff indicated that some of the persons mentioned in the footnote to the principle may not be considered as related parties. For example, Board members of a bank (and thus their personal controlled companies) are not automatically considered connected. Family members may or may not be closely related. Considerations as to whether a party is connected are included in the rules in BIPRU 10.3.</p> <p>EC2: There is no specific requirement that exposures to connected parties be made</p>

	<p>on terms no less favorable than those generally available from the bank. The FSA relies on more general principles of sound risk management and corporate conflict requirements, with review as part of the normal supervision process, to achieve acceptable results. The connected counterparties' requirement applies to firms' exposures which may not have occurred on an arm's length basis.</p> <p>EC3: The handbook (SYSC 2 on Senior Management Arrangements) requires firms to maintain apportionment of significant responsibilities such that the business and affairs of a firm can be adequately monitored and controlled by the directors, relevant senior managers and the Board. This, in conjunction with the supervisory processes as set out under ARROW, enables supervisors to require appropriate Board approval in the case of transactions with related parties which are large or which pose special risk.</p> <p>EC4: The process in place fulfils this requirement. Indeed, Threshold Condition 5 (Suitability) requires a person concerned to satisfy the FSA that he is fit and proper in regard to all the stated circumstances, including "connections with any person." This, in conjunction with the ARROW supervisory process, enables supervisors to require that Board members with conflicts of interest are excluded from the approval process.</p> <p>EC5: The FSA uses the connected lending rules to apply to related party transactions as well. BIPRU 10.5.6R sets a general limit of 25percent of capital resources on a firm's aggregate exposures to connected counterparties. This rule is based on the EU Capital Requirements Directive.</p> <p>However, certain exemptions to this limit - in accordance with the Capital Requirements Directive- are set out in BIPRU 10.6, 10.7, 10.8 and 10.9 (from 31.12.2010 in BIPRU 10.8A and 10.9A) in relation to subsidiaries within the regulatory consolidation group. These exemptions have recently been reviewed and the conditions under which they are granted strengthened.</p> <p>Non-exempt exposures in excess of these limits may be reduced by appropriate credit risk mitigation techniques (e.g., collateralization) that meet minimum standards that ensure the credit protection provided is effective and enforceable (BIPRU 5), and failing that, firms may be required to deduct excess exposures from their capital. GENPRU 2.2.221R-2.2.235R requires that lending of a capital nature to connected counterparties be deducted fully from the firm's capital resources.</p> <p>EC6: There is no specific FSA requirement for banks to have separate internal processes to report and monitor exposures to related parties. The general requirements for sound risk management processes apply. So it is left to supervisors to review the treatment of related party transactions.</p> <p>EC7: Large exposures, including exempted intra-group exposures and non-exempt exposures to connected counterparties are indeed reported to the FSA on a quarterly basis. The supervisor reviews and assesses these FS008 reports as an essential part of off-site supervision.</p>
Assessment	Largely compliant
Comments	<p>The FSA process for related parties relies to a considerable extent on general rules, rather than on a specific regime, though there are rules on connected counterparties. It also relies on supervisors reviewing the operation of the general principles as part of ARROW reviews. Assessors understand that supervisors do take this into account and there have been no identified issues of related party problems. However, even a single material problem could be a reputation risk to the U.K. system.</p>

Principle 12.	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	<p>EC1. The normal rules and processes for credit operations are applied (SYSC 7.1, ARROW). These encompass the usual monitoring of large exposures and concentration limits set in BIPRU 10. Rules requiring firms to identify, control, and quantify their exposures to single counterparties and groups of connected counterparties on country risk are the usual rules for credit distribution. They are contained within the FSA's handbook. BIPRU 10 (Concentration Risk Requirements) sets limits to restrict the size of such exposures to single counterparties or groups of connected counterparties, including counterparties connected to the firm. BIPRU 10.12.1R also requires firms to have sound administrative and accounting procedures and adequate internal control mechanisms for the purposes of identifying and recording all large exposures and subsequent changes to them. The same template as for large exposure reporting is used to monitor large risks. The FSA seems to have no specific tool or requirement on country risk.</p> <p>EC2 The FSA Handbook requires banks to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the firm's activities, processes and systems (SYSC 7.1.2Rhttp://fsahandbook.info/FSA/html/handbook/SYSC/7/1).</p> <p>EC3. For the setting of appropriate provisions against country risk and transfer risk, the bank itself sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor. The FSA can use its own specialists for further investigation and, if deemed necessary, may also commission a report by an external skilled person under section 166 of FSMA. No 166 report seems to have been commissioned on this topic during the last 3 years.</p> <p>EC4. Data relating to country risk and transfer risk that conform to BIS standards are collected quarterly. The country risk reports must be submitted to the BoE within two months of the reporting date. The FSA has access to, and uses, this information. In addition, when specific needs arise the FSA, as for all other aspects, has the ability to collect data on a more frequent and granular basis. The FSA is currently undertaking such an approach for specific sovereigns where it deems this necessary.</p>
Assessment	Compliant
Comments	Country risk and transfer risk can be material for the U.K. banking system. A more proactive approach to the supervision of this risk is recommended.
Principle 13.	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	EC1. The United Kingdom complies with the Capital Requirements Directives ((2006/49/EC and 2006/48/EC) with respect to the measurement of market risk, the calculation of capital required to be held against market risks, and the risk management and control standards required of firms. The rules (BIPRU 7) set out the standards (qualitative and quantitative) required of firms in order for them to be

granted approval to calculate market risk capital requirements using internal models including CAD1 and VaR models.

Banks are also required to conduct a regular program of stress testing and scenario analysis of trading book positions (BIPRU 7.1.17) and include market risk in their overall stress tests.

Compliance with these requirements is monitored by supervisors using a detailed in-house risk assessment and mitigation tool, regular on-site visits and high level monitoring of risk control functions within firms. Supervisors are supported by teams of risk specialists focusing on market risk measurement and valuation. There are some 60–65 market risk specialists in the relevant division, and this has been increased recently.

Assessors talked with FSA staff about the changes underway to deal with the problems and ineffectiveness in the FSA's evaluation of systemically important banks' policies and processes related to the identification, measuring, monitoring and control of market risk revealed by the crisis. From this experience, the FSA has refurbished its market risk supervisory capabilities and is in the process of changing its market risk analysis. This is based on the FSA's powers to require banks to have policies and processes for the measurement and management of all material sources and effects of market risks (BIPRU 7.1). They must establish and maintain systems and controls to manage the trading book and to provide prudent and reliable valuation estimates. Banks with permission to use a VaR model to calculate market risk capital requirements are expected to comply with extensive risk control requirements given in BIPRU 7.10. For example, they must have a separate risk control unit independent from business line units; senior management is required to be actively involved in the risk control process; and the firm must have sufficient numbers of staff skilled in the use of sophisticated models in the trading, risk control, audit and back office areas. The ability to increase the frequency and depth of 'deep-dive' reviews has benefited from recent increases in specialist staff.

Assessors saw evidence that the FSA uses its powers in the supervisory process and under the rules to have deficiencies rectified.

EC 2. Banks with trading activities are required to set limits for positions held in the trading book and to monitor them for appropriateness. Supervisors are supported by specialists from market risk & trading in assessing the calibration, granularity and appropriateness of limits. The limit exception process may be reviewed as part of the FSA monitoring process. Assessors talked with FSA staff about the lessons from the crisis in terms of banks setting market risk limits that were commensurate with the institution's size and complexity and that reflect all material market risks. There were also issues such as the inappropriate use of models, market risk systems not adequately considering certain types of risk, and risk measurement architecture and data issues that may have impeded accurate timely measurement of positions against spot and stress limits. These issues were raised in the Senior Supervisors Group Report in which the FSA participated; the FSA staff and banks confirmed that these issues are relevant for at least some major banks with trading portfolios.

Discussions with banks and other market participants also confirmed the considerable difficulties in the valuation of complex products as regards these limits.

However, the FSA has reacted positively by increasing specialist resources from market risk and trading in assessing the calibration, granularity and appropriateness of market risk limits. Their work will be facilitated by FSA powers to require banks to set limits for positions held in the trading book and to monitor them for appropriateness. A firm with permission to use internal models is expected to set limits which are informed by a rigorous program of stress-testing. The enhanced FSA supervisory model will continue to ensure that the limits are approved by the Board or senior management and are adhered to in practice. The FSA has commenced a program of more detailed reviews of banks' valuation and product control processes.

Assessors' discussions with FSA staff and banks, and their review of various FSA documents indicate that there is a range of practices among major banks; some are in a good position, and some have further to go than others in appropriate market risk measurement and management, but all are making progress.

The FSAs core prudential program for banks will undertake a more structured proactive program of assessing market risk and related risk management and governance (see CP 19). This program has proceeded farthest in stress testing and capital assessment but will move to more in-depth risk assessments over the next two years. For major banks in which the FSA has concerns about market risk management, a range of detailed reviews has been undertaken, in addition to the normal 'close and continuous' and CAD II meetings. These include a few detailed drill-downs as well as reviews of limit structures, MIS and Board and senior management reporting and risk tolerance. These reviews, in total, amount to a pre-implementation of the core prudential program for those banks, with respect to market risk.

EC3. The FSA requires banks (GENPRU 1.3) to establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates. In addition, those systems and controls must include documented policies and procedures for the process of valuation, and reporting lines for the department accountable for the valuation process that are clear and independent of the front office and ultimately lead to a main Board executive director. Banks must ensure that the value applied to each of its trading book positions appropriately reflects the current market value to a high degree of certainty, and trading book positions must be re-valued at least daily. Banks are required to consider the need for establishing reserves for less liquid positions, taking into account factors such as how long it would take to hedge out the position or the risks within the position, the average and volatility of bid/offer spreads, and the average and volatility of trading volumes, among others. Valuation adjustments are also included in pillar 2 (GENPRU 1.2). Compliance with these requirements is monitored by supervisors working with recently strengthened technical expert teams on valuations and product control, market risk and trading, and with operational risk and analytics control teams.

A major thematic review was recently carried out to assess firms' compliance with valuation standards. A sample of the nine commercial and investment banks with large London trading operations was visited to assess their product control functions in their widest context and to assess their approach to applying prudential valuation principles. The results of this review indicated shortcomings, which are being fed back to a more complete population of the larger banks. In particular, firms will be expected to report prudent valuation adjustments for 31 Dec 2010 in Feb 2011, after

	<p>which there will be quarterly reporting by the end of the following month. Banks will be asked to construct an approach that they believe captures the valuation uncertainty of their fair valued positions to ensure that all the elements of prudent valuation (such as illiquidity, concentration and model risk) are captured.</p> <p>In the future, the FSA expects to more regularly review and formally assess each bank's prudent valuation framework and methodology through comprehensive product control reviews and close and continuous meetings with the banks.</p> <p>EC4. U.K. banks are subject to comprehensive stress testing requirements which are set out in GENPRU 1.2. Firms must carry out at least annually stress tests and scenario analyses that are appropriate to the nature, scale and complexity of the major sources of risk (including market risk) and to the nature, scale and complexity of the banks' business. The sources of risk which a bank must subject to stress tests must include market risk, if relevant. In addition, under BIPRU 7.1 firms are required to carry out regular stress tests of trading book exposures. The results of the trading book stress tests must be reviewed by senior management and reflected in the policies and limits the bank sets. Banks with permission to use internal models are subject to additional requirements to stress test market risk exposures, including a robust program of backtesting.</p> <p>AC1. The systems and controls for prudent valuation described in EC3 above require reporting lines for the department accountable for the valuation process that are clear and independent of the front office and ultimately lead to a main Board executive director. Banks are required to perform independent price verification, where market prices or model inputs are regularly verified for accuracy and independence. Where such verification is not possible (e.g., because independent pricing sources are not available), prudent valuation adjustments may be imposed. A bank with VaR model permission is required, at least once a year to conduct a review of the risk management process, including the accuracy of the valuation process, which must be done by suitably qualified staff independent of the area being reviewed.</p>
Assessment	Largely compliant
Comments	<p>The quantitative and qualitative rules are fully in place for banks' having policies and practices that accurately identify, measure, monitor and control market risk. Supervisors have appropriate power to deal with market risk issues and have the ability to do so. FSA staff demonstrated a high level of understanding and competence of market risk issues and ability to conduct effective supervision of market risk. The FSA has demonstrated the ability to conduct detailed in-depth reviews of market risk practices at banks where risk is higher. That, plus the more-normal higher-level supervisory reviews, means that market risk, and related controls in banks where it is identified as higher risk, is adequately understood by the FSA. However, practice in at least some of the banks and the FSA has some way to go in being more proactive in monitoring and assessing market risk in a detailed way, with more regular use of benchmarking reviews to provide a higher level of assurance that their risk assessment is accurate and that root causes of deficiencies are being dealt with. This is not a specific issue for market risk and relates to improvements necessary in the supervisory approach generally (see CP 19). The FSA is increasing resources and the frequency and depth of reviews is very much on the right path, as are developments in banks to deal with identified issues.</p> <p>The size and complexity of market risk positions in London is immense. Regardless</p>

	<p>of whether structural changes are imposed on how banks structure and capitalize these businesses, and regardless of changes in how they are funded, the FSA will need to maintain a high-quality in-depth supervisory approach. Given this, the FSA should review the adequacy of its resources in this area compared to the demands of ongoing stress testing and core prudential program, as well as demands from regular monitoring and thematic and more proactively designed deep-dive work. Such a review should also factor in the need for detailed follow up on selected remedial action plans of banks to ensure that they are really effective.</p>
<p>Principle 14.</p>	<p>Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
<p>Description</p>	<p>EC1. With the intention to overcome the serious shortcomings revealed as a consequence of the financial crisis, at the end of 2009, the FSA set out a new liquidity regime that applies to banks, building societies, branches of European Economic Area (EEA) and non-EEA banks (the so-called BIPRU 12 with its different sections). The new liquidity regime includes: adequate liquidity and self-sufficiency standards, systems and controls requirements, quantitative requirements based on banks being able to survive liquidity stresses of varying magnitude and duration, group-wide and cross-border management of liquidity standards, and reporting standards. Undrawn commitments, and off-balance sheet and on-balance sheet liabilities are taken into account as part of a bank's stress testing and this in turn determines the size of the liquidity asset buffer a firm believes it would need to hold to survive such stresses.</p> <p>The new regime was confirmed in a policy statement of October 2009. The regime was approved in December 2009 and banks were required to adjust or create appropriate risk management systems according to the new regime. Reporting requirements and individual liquidity assessments came into force in June 2010, cascading down the banking system starting with the largest firms. The FSA recently announced that it would be delaying the calibration of the liquidity regime until the Basel proposals for the introduction of minimum global liquidity standards are finalized. In the meantime, firms are expected to meet the new international standards by the proposed implementation date of 1 January 2015.</p> <p>The regime (in BIPRU12) requires a firm to have in place robust strategies, policies, processes and systems that enable it to identify measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intra-day. The rules require a firm's governing body to establish a risk tolerance that is appropriate for its business strategy. It also covers such matters as internal pricing of liquidity risk, management of collateral, funding diversification and managing liquidity across legal entities.</p> <p>To demonstrate compliance with the rules, firms will undertake a self assessment against the requirements (ILAS), at least annually. Supervisors assess the adequacy of the firm's liquidity risk management framework as part of the ARROW assessment or as part of a scheduled supervisory liquidity review process (SLRP). Supervisors will provide feedback on the results of their qualitative and quantitative assessment of the firm's ILAA/ILSA and Contingency Funding Plan (CFP) in a letter to the firm. That letter may specify explicit liquidity funding expectations or other liquidity-related expectations.</p>

Assessors reviewed the operation of the regime with supervisors and liquidity specialists. They also saw examples of the extensive and in-depth liquidity reporting by firms, liquidity DashBoard, supervisory liquidity scorecard, and examples of liquidity deep-dive reviews conducted by the FSA over the recent past on a proactive, cross-system basis. Initial desk top reviews were then backed up by limited on-site visits, which determined that the firms' self assessments were too optimistic. As a result, a strategy of deep-dive reviews was adopted. Deep-dive liquidity reviews typically take 3-4 people over 2-3months.

EC2. As noted above, the new liquidity rules impose requirements on Boards, including for an oversight role in seeing that processes are developed to monitor and control liquidity risk. Supervisors have assessed this aspect of the rules as part of the SLRP. This has included members of a firm's governing body having detailed discussions with their supervisor and other relevant personnel in the FSA.

The FSA has established Individual Liquidity Guidance with the purpose of ensuring that each bank has a sufficient amount and quality of liquidity resources to increase the likelihood of it surviving a severe liquidity stress event, having regard to its liquidity risk profile. This is known as the overall liquidity adequacy rule and firms are required to document their compliance with this rule as part of their internal liquidity assessment, which is also a key supervisory tool in the new design for demonstrating appropriate liquidity risk management. The FSA will assess the adequacy of banks' internal liquidity assessment through an established Supervisory Liquidity Review Process (SLRP), the outcome of which is to define an appropriate liquidity profile and level of liquidity resources for that firm. This process leads to commentary in the FSA's reporting letter to Boards and to discussion at that level. Liquidity positions of a number of banks have improved because of this process. Several major banks that the assessors met are on multi-year programs to reduce their structural exposure to wholesale funding and liquidity pressures. Initially, individual liquidity guidance was set on the basis of desk-top reviews of the bank's liquidity reports, and reviews of FSA-related stress testing. FSA staff advised that on average current liquidity guidance is likely below the new Basel standards and further below the buffers than they would ideally like, and is being phased in. More recent deep-dive SLRP reviews are permitting more tailored stress assumptions to be applied to individual banks' portfolios, with a consequent revision in the liquidity guidance. These reviews also permit verification of the adequacy of controls around liquidity. The program of deep-dives has not yet covered all of the very high-risk banks and has covered a number (but less than half) of the high-risk banks. The roll-out is expected to be finalized within several years.

EC3. BIPRU 12.3 and BIPRU 12.4 stipulate a number of requirements in relation to senior management oversight and the actions required of the firm's senior managers to monitor, control and limit liquidity risk. Specifically, BIPRU 12.3.4 requires a firm to have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor liquidity risk. A bank is required to document its compliance with these rules in their internal liquidity assessments and the supervisor will assess the extent of the firm's compliance with the rules as part of the ongoing supervisory relationship. Senior managers should expect to have detailed discussions with their supervisor and other relevant personnel in the FSA on their liquidity risk management strategies, policies and practices through follow-up on-site visits.

EC4. Funding needs represent a serious source of risk in the current U.K. banking system and world-wide. The crisis evidences U.K. banks' over reliance on short-term credit sensitive unsecured funding to fund illiquid assets. In the new liquidity regime a bank is required to ensure that it has in place a robust framework to project fully over an appropriate set of time horizons cash flows arising from assets, liabilities and off-balance sheet items. Banks are expected to develop methodologies for the identification, measurement, management and monitoring of funding positions. These methodologies must include current and projected material cash-flows in and arising from assets, liabilities, off-balance sheet items, including contingent liabilities and the possible impact of reputational risk. Banks have to document compliance with these rules in their internal liquidity assessments, which are part of the ongoing supervisory relationship.

EC5. In the new regime, the FSA requires banks to consider the potential impact of foreign currency mismatches in their overall risk management strategy, including how currency convertibility may be affected during times of stress. A bank must ensure that its strategies, policies, processes and systems in relation to liquidity risk enable it to identify, measure, manage and monitor its liquidity risk positions for all currencies in which the firm is active. The supervisor is also able to identify risks arising from foreign currency transformation through the new suite of liquidity returns. The key liquidity returns to note are FSA047, FSA048 and FSA054. FSA047 captures contractual daily flows out to three months and is designed to analyze survival periods and spot potential liquidity strains early. The liquidity returns, taken together with the information supervisors receive on the banks' analysis of their foreign currency exposures, should provide the supervisor with sufficient information to understand and monitor the foreign currency risks firms may be exposed to on a regular basis.

EC6. BIPRU 12.4.11 requires banks to have in place contingency funding plans, setting out adequate strategies and proper implementation measures to address possible liquidity shortfalls. These plans must be regularly tested, updated on the basis of the outcome of the mandatory stress tests required by the rules, and be reported to and approved by the bank's governing body, so that internal policies and processes can be adjusted accordingly. Principle 11 of the FSA Handbook requires a firm to deal with the FSA in an open and cooperative way and to disclose any appropriate information about the firm that the FSA would expect to be notified of.

Firms are required to submit their contingency funding plans to the FSA when they submit their ILAA or ILSA. The supervisor assesses the quality of the firm's contingency funding planning as part of the ongoing supervisory process or SLRP. The quality of a firm's CFP is one of the areas assessed in the liquidity scorecard and supervisors will provide feedback to the firm if shortcomings or deficiencies are found in a its CFP.

AC1. BIPRU 12.4.1 requires all firms to conduct appropriate stress tests on a regular basis to identify sources of potential liquidity strain, which includes any potential liquidity risk arising from its taking positions in foreign currencies. The frequency and scope of the stress testing should be proportionate to the nature, scale, and complexity of the firm's activities, as well as to the size of their liquidity exposures, but the expectation is that stress testing should be carried out no less frequently than annually.

	<p>AC2: There are a number of rules set out in BIPRU 12, which relate to funding diversification, market access, and the rollover of assets. In addition, a firm must ensure its liquidity resources contain an adequate buffer of high quality, unencumbered assets. The rules stipulate that firm can only include securities in its liquidity asset buffer which it realizes on a regular basis. The FSA assesses the adequacy of a firm's periodic realization policy and its implementation in practice.</p>
Assessment	Largely compliant
Comments	<p>As in many other countries, liquidity was given insufficient attention by firms and supervisors in advance of the crisis. As a result, considerable central bank liquidity support was required and a considerable part of that remains in place (though it is being worked down). The FSA has rightly put high priority on enhanced liquidity rules and supervision, parts of which were in advance of the international community. It is currently engaged in an intensive high-quality effort to ensure that banks maintain adequate liquidity resources, in terms of both amount and quality, to ensure there is no significant risk that it cannot meet its liabilities when they fall due.</p> <p>The new comprehensive liquidity regimen and supervisory program that the FSA has put in place recently, over time, will be a strong base for U.K. supervisors to assess banks' liquidity management strategies adequately, including prudent policies and processes to identify, measure, monitor and control liquidity risk. The program, as discussed at the time of the assessment, is leading edge in terms of liquidity assessment and the FSA is clearly using it very effectively to get results. Assessors have no issues with the broad content of the rules or the supervisory approach. In contrast with other risk areas, liquidity risk has a system-wide proactive program of in-depth reviews of risk measurement and management, and related governance.</p> <p>Assessors reviewed the roll-out program with FSA staff. While the program has rightly focused on the major banks in terms of more detailed reviews, there is some way to go on the next tier of high-impact firms. As well, the full deep-dive reviews (that also cover follow-up reviews related to remediation that may be needed at individual banks. More work is also needed to ensure the regime is producing the liquidity desired and that required under the new Basel rules. The FSA advised that its liquidity requirements were calibrated as an interim measure with regard to the need to phase in higher requirements. This is important, given the wholesale refinancing program needed by U.K. banks in the next 18–24 months, which many acknowledge as a key system risk. There is no doubt about the FSA's ability and clear intent to achieve full effective compliance with this principle, but implementation needs to make further progress.</p>
Principle 15.	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
Description	<p>EC1. The FSA Handbook requires banks to have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk via a set of proportionate general risk-management standards contained in sections SYSC 4.1.1R to 4.1.2R and SYSC 7.1.16R as well as operational risk-specific standards in section BIPRU 6 of the Handbook, proportionate for different approaches to operational risk (BIPRU 6.3 for the basic indicator approach; BIPRU 6.4 for the standardized approach; and, BIPRU 6.5 for the advanced measurement approach).</p>

There are also requirements that operational risk assessment and management systems must be subject to regular independent reviews. Since the introduction of the new rules based on the new European directives, the FSA also updated ARROW for operational risk, conducted operational risk surveys of the industry, and issued additional operational risk guidance to help the industry meet the operational risk requirements.

EC2. The approval and periodic reviews by banks' senior personnel of strategies and policies for taking up, managing, monitoring and mitigating the risks their banks are or might be exposed to are the general risk management standards imposed by the FSA Handbook (SYSC 7.1.4R). The operational risk-specific sections of the Handbook refer to the above standards as a mandatory requirement. Additionally, section SYSC 7.1.16R requires banks to define operational risk and to implement policies and processes to evaluate and manage operational risk exposures. The "Enhancing frameworks in the standardized approach to operational risk" guidance note further highlights the importance of the Board's role in ensuring that operational risk policies and processes are implemented effectively.

EC3. The FSA Handbook requires that banks implement policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high severity events (section SYSC 7.1.16R). As part of the ARROW assessments, the FSA supervisors are asked to verify that operational risk policies and processes are properly implemented. As part of the process of improving operational risk management and strengthening capital standards, the FSA undertook a survey of the operational risk frameworks being established by banks intending to use the Basic Indicator (BIA) or the Standardized (TSA) approaches. The questionnaire covered the banks' operational risk strategy, resources, governance framework, senior management review, policy, risk identification, assessment and reporting, loss data collection and analysis, and treatment of capital. The FSA has also invited representatives of a number of banks to participate in an expert group on operational risk policies and documentation, which is culminating in a guidance note to be published in mid-2011.

EC4. The FSA Handbook sections SYSC 4.1.6 and SYSC 4.1.7 require that banks must take reasonable steps to ensure continuity and regularity in the performance of their regulated activities. They must establish, implement and maintain adequate business continuity policies and employ appropriate and proportionate business continuity systems, resources and procedures. The ARROW framework has procedures to ensure firms' business continuity plans are adequately tested via conducting risk assessment visits. In addition to this firm-specific work undertaken by the line supervisors, the Resilience Team in the Financial Stability Division focuses on ensuring that the key participants in the financial sector are capable of responding collectively to major operational disruption. The two main tools it uses for this are its Market-wide Exercise and Resilience Benchmarking programs.

EC5. The FSA Handbook requires that banks must take reasonable care to establish and maintain such systems and controls as are appropriate to its business (section SYSC 3.1.1). In addition, section GENPRU 1.2.89 G, states that banks should satisfy themselves that their systems are sufficiently sound to support the effective management and, where applicable, the quantification of the risks. As part of the ARROW assessments, supervisors are asked to determine whether banks have

	<p>established appropriate information technology policies and processes that address areas such as information security and system development.</p> <p>EC6. The FSA requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions. The FSA use GABRIEL (Gathering Better Regulatory Information Electronically) as the online regulatory reporting system for the collection, validation and storage of regulatory data including operational risk data (report FSA007). As part of the SREP process, banks are asked to provide a wide range of operational risk information, including loss data, to the FSA supervisory teams. There is a program in place to address any current deficiencies in the data collection process (e.g., data quality and coverage)—CoRep.</p> <p>EC7. Although the FSA Handbook does not explicitly require incorporating legal risk management into operational risk management processes, the ARROW framework has legal risk as one of its risk elements, and that the FSA supervisors are expected to verify if legal risk is assessed and managed properly.</p> <p>EC8. The FSA determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The FSA Handbook (section SYSC 8) defines what constitutes outsourcing and the outsourcing risk and sets out requirements for firms to manage their outsourcing arrangements and the associated risks. As part of the ARROW assessments, the FSA supervisors verify that banks have strong outsourcing controls.</p> <p>AC1. All BIPRU firms are required to meet a set of proportionate general risk-management standards (contained in SYSC 4.1.1R to 4.1.2R and SYSC 7.1.16R), irrespective of the operational risk methodology adopted. As a consequence of the SYSC general risk management requirements, there should be no significant difference between the qualitative operational risk standards required of a large and complex TSA bank and those for a similarly large and complex AMA bank. The waiver approval process for an AMA bank is conducted by the FSA Prudential Risk Department. However, TSA banks have not had the benefit of a similar close and continuous process, and this factor, together with the findings of some ARROW assessments and firm visits, and some SREP submissions, has raised concerns about the qualitative standards adopted. The FSA decided to address the lack of any guidance on the appropriate components and form of an acceptable TSA/ASA framework by publishing additional guidance namely, the “Enhancing frameworks in the standardized approach to operational risk” guidance note, which was going through a public consultation process at the time of the assessment prior to finalization, which is expected shortly.</p>
Assessment	Compliant
Comments	<p>The U.K. supervisors have established a work program to conduct regular independent evaluations of a bank’s policies, processes and systems related to operational risk. In this work program, U.K. supervisors are encouraged to continue inviting banks to improve their approaches to operational risk management, particularly in those cases of large banking groups. U.K. supervisors are also encouraged to carefully monitor the risks that may stem from interconnected global markets and firms, on a solo and a group-wide level. The transition toward a new prudential architecture needs to be managed carefully to mitigate operational risks. As noted in the comments on CP 19, the FSA supervisory process is going through a</p>

	process of intensification, which will enhance effectiveness, including for operational risk. The roll-out of the core prudential program needs to be pursued.
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	<p>EC1. The FSA considers Interest Rate Risk in the Banking Book (“IRRBB”) to be a significant source of risk for a substantial number of banks within its supervisory remit (and including building societies), and it is considered as a distinct and specific component of the risk profile of a bank. The FSA considers IRRBB across the dimensions of: repricing risk; yield curve risk; basis risk; and optionality risk. Banks are also required to monitor their assumptions about customer behavior and how this might affect their evaluation of the level of IRRBB that they identify.</p> <p>The FSA requires banks’ governing body and senior management through the overall Pillar 2 rule GENPRU 1.2.30R to have in place sound, effective, and complete processes, strategies and systems to monitor IRRBB, in terms of both its financial resources and systems for determining the level of this risk type. The specific requirement for banks to undertake a periodic evaluation of their exposure to IRRBB at least annually is contained in BIPRU 2.3.12R, in terms of both the level and nature of the risks monitored, and the FSA monitors the compliance of banks during the course of the recently enhanced supervisory cycle. Assessment of the level of IRRBB in a bank must address both the risks to the economic value of the equity of the bank and those to earnings. Discussions with the FSA indicate that earnings at risk measures need more development in some banks.</p> <p>EC2. There are both high-level requirements for banks to have appropriate systems in place to monitor and manage IRRBB contained in SYSC 7.1.15R and more detailed ones specified in the overall Pillar 2 rule in relation to risk monitoring and the need for banks to maintain adequate capital for this risk type. The FSA monitors the compliance of banks during the course of the recently enhanced supervisory cycle, both by considering their evaluation of the level of IRRBB that banks are running, both in absolute terms and in relation to their peers. A model developed within the FSA allows supervisors to achieve consistency of evaluation of IRRBB both within banks over time and across banks. Banks need to develop and employ their own “fit for purpose” models in this area. However, the FSA has not developed a formal process for model evaluation and approval for IRRBB. The FSA is conducting some outlier analysis for smaller and mid-sized banks, though this is partially hampered by deficiencies in the regularly-reported data fields.</p> <p>EC3. BIPRU 2.3.7R requires banks to undertake a stress test of a sudden shift of +/- 200bps in the yield curve in order to assess their vulnerability; BIPRU 2.3.12R specifies that this is to be undertaken on a quarterly basis, and banks are required to notify the FSA if the economic value of the bank declines by more than 20percent of its financial resources due to that stress test. (This is the standard supervisory stress test outlined in current guidance for supervisors by both the BCBS, “Principles for the Management and Supervision of Interest Rate Risk” (2004), and CEBS, “Technical aspects of the management of interest rate risk arising from nontrading activities under the supervisory review process” (2006)) Additionally, the guidance contained in BIPRU 2.3.9G recommends that larger and/or more complex banks should evaluate their exposure to the distinct components of IRRBB (outlined in the overview above),</p>

	<p>and have appropriate modeling techniques to incorporate greater complexity (e.g., the incorporation of scenarios where underlying assumptions vary with the absolute level of interest rates).</p> <p>AC1. The FSA has the general power to obtain information from banks under section 165 of FSMA, and this also covers IRRBB and the results of banks' internal risk management and measurement systems in this area. At the time of the assessment, the FSA was considering the content of its current reporting requirements. As part of ARROW, the FSA additionally requires banks to prepare an ICAAP periodically and submit it to the FSA, both as part of their normal supervisory cycle and on request at other times; this covers the risks arising under IRRBB specifically (via the guidance provided in BIPRU 2.2.30G) and under the overall Pillar 2 rule GENPRU 1.2.30R and requires banks to assess the capital that they should hold to guard against adverse interest rate movements. Additionally, through rule BIPRU 2.3.7R, there is a specific requirement for banks to consider the impact of the standard supervisory shock on interest rates, explicitly in terms of the effect on capital resources.</p> <p>AC2. The FSA requires banks to identify the level of IRRBB that they are running. This is assessed against a model developed internally by the FSA with the aim of taking a consistent view across banks of their risk profiles.</p> <p>AC3. The FSA requires banks to take a forward-looking view in their ICAAPs of the interplay between their available capital resources and the capital requirements associated with their business lines. This is done (as part of ARROW) by requiring the bank to undertake a capital planning exercise over a time horizon of typically three to five years, incorporating scenarios representing future economic downturns (as outlined in GENPRU 1.242R and GENPRU 1.2.73G) and modeling the impact that such a deterioration might have on both their capital resources and the capital requirements. The ICAAP of the bank, including the capital planning exercise that leads to the derivation of the capital planning buffer, must then be agreed and signed-off by senior management and the Board, and is subject to the "use test" by which the FSA requires banks to use information generated as part of the outputs of the exercise to inform policies, processes and limits for all risk types, including interest rate risk.</p> <p>AC4. In general, and for all risk types, the FSA requires banks to have robust governance arrangements with well defined, transparent and consistent lines of responsibility, and effective processes to identify, manage, monitor, and report the risks it is or might be exposed to (this requirement is specified in SYSC 4.1.1R). The ARROW supervisory process seeks to confirm that there is clear independence of roles and responsibilities between risk managers and front-office personnel. Senior personnel within banks must also ensure compliance with their obligations under the regulatory regime as codified in the high-level requirements detailed in SYSC 4.3.1R. Looking forward, the FSA is issuing additional guidance (in SYSC), effective from May 1, 2011, on risk controls (encouraging FTSE-100 banks and insurers at a minimum to consider establishing a risk committee and appointing a chief risk officer, which emphasizes the independence and authority of this role). It expects to introduce a specific chief risk officer (controlled function) and other controlled functions in due course.</p>
Assessment	Compliant
Comments	The FSA should push ahead to revise regular reporting forms for smaller and mid-

	sized deposit takers so that it can do more complete outlier analysis.
Principle 17.	Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	<p>EC 1. The Companies Act 2006 establishes the responsibilities of directors who manage a company. Any bank which has a Premium Listing on the U.K. Official List is required under the FSA's Listing Rules to include a statement in its annual financial report of its compliance with the U.K. Corporate Governance Code (formerly the Combined Code), which has recently been revised by the Financial Reporting Council in the light of the financial crisis and in parallel to the "Walker Review," commissioned in February 2009 to review corporate governance in the U.K. banking sector after shortfalls evident from the crisis. The review makes recommendations on: the size, composition, qualification, functioning and performance evaluation of Boards of directors; the role of institutional shareholders; risk governance; and remuneration. Many of these recommendations are reflected in the updated Financial Reporting Council Corporate Governance Code which took effect from June 2010. In addition, the FSA's rules implementing recent changes to the EU's Fourth Company Law Directive require a slightly broader set of U.K. issuers to publish an annual corporate governance statement in which they must disclose compliance with any applicable corporate governance code and describe the main features of its internal control and risk management systems in relation to the financial reporting process.</p> <p>EC2. The FSA's requirements on banks' internal controls are adequate for the nature and scale of their business; it derives from EU Directives, in particular, the Banking Consolidation Directive (BCD) and the Markets in Financial Instruments Directive (MiFID). Since all banks are subject to BCD and most are also subject to MiFID, the FSA has implemented the management oversight, internal governance and systems and controls requirements in both directives in one set of rules, chapters 4-10 of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC). These chapters are known collectively as the Common Platform. These high level requirements in SYSC are incorporated in ARROW, which includes the newly established Supervisory Enhancement Program and Core Prudential Program, now applied to very high-impact firms. For banks carrying on investment business and holding client money or safe custody assets, an auditor is required to express an opinion as to whether the bank has maintained systems adequate to enable it to comply with the applicable chapters of the Client Assets Sourcebook (CASS) throughout the period, and that the bank was in compliance at the period end.</p> <p>EC3. The FSA requires banks (SYSC 4.3.1/2R), when allocating functions internally, to ensure that senior personnel (which could include its governing body and other persons who effectively direct the business) are responsible for ensuring that the bank complies with its regulatory obligations. The newly established Supervisory Enhancement Program is expected to facilitate the FSA assessment of banks' Board and senior management understanding of the underlying risks in their business.</p> <p>EC4. The FSA has the power to require changes in the composition of the Board and</p>

senior management to address any prudential concerns related to the satisfaction of these criteria. Following the financial crisis, the FSA has intensified the application of the Approved Persons Regime (which includes “fit and proper” assessments).

EC5. The FSA requires banks (SYSC chapter 5) to have a responsibility to ensure that the staff (and agents) they employ do their jobs properly, follow internal procedures, are competent for the tasks they are given, and are not given multiple tasks which might compromise their ability to act properly. In addition, a bank must monitor, and regularly evaluate, the adequacy of its systems, internal control mechanisms and arrangements established to meet the requirements concerning staff and take appropriate measures to address any deficiencies. The effectiveness of front, middle and back office functions may be included in the terms of reference of either regular on-site supervisory visits, specialist visits or via the use of skilled persons.

EC6. The FSA requires banks (SYSC 6.1) to establish a permanent, effective and independent compliance function and to appoint a compliance officer responsible for coordinating the various tasks associated with the bank’s compliance policies and procedures, and reporting to senior management.

EC7. The FSA requires banks (SYSC 6.2.1R) to establish an independent internal audit function separate from the other activities of the bank, where, given the nature, scale and complexity of its business, it is an appropriate and proportionate way of ensuring the bank maintains adequate and effective internal control mechanisms and arrangements. In practice, all U.K. banks have an internal audit function, either fully sourced by bank personnel or, if not, by a combination of internal and outsourced personnel.

EC8. The FSA expects a bank, in complying with SYSC 4.1.1R (see EC2) and SYSC 4.3.1/2R (see EC3) to ensure an internal audit function has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations; has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties; employs a methodology that identifies the material risks run by the bank; prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and has the authority to assess any outsourced functions. Later in 2011, the FSA expects to introduce a new controlled function (CF15, the internal audit function).

AC1. In respect of banks that are issuers with a Premium Listing in the United Kingdom, the FSA’s Listing Rule requires such issuers to include in their annual financial reports a statement of their compliance with the U.K. Corporate Governance Code. This would therefore include ‘comply or explain’ in respect of the Code’s Principles and Provisions in relation to non-executive directors (notably Main Principle A4). More generally, the FSA would expect a bank’s Board to contain a suitable number of experienced non-executive directors; the FSA will form a view on the appropriate number as part of its ongoing supervision. All non-executive directors have to be vetted and approved by the FSA as fit and proper (Controlled Function 2 under the Approved Persons Regime (see item 4).

	<p>AC2. Under SYSC 4.1.11G, it may be appropriate for a bank to form an audit committee, depending on the nature, scale and complexity of its business. The FSA would form a view on whether it is appropriate as part of its ongoing supervision. The FSA would expect the audit committee to monitor and review the internal audit function (where it is appropriate and proportionate for a bank to have both).</p> <p>AC3. The FSA would expect an audit committee to include non-executive directors in line with Code Provision 3.1 and would consider the appropriate number as part of its ongoing supervision. Later in 2011, the (non-executive) chair of the audit committee will be a position the FSA will specifically vet as part of its Approved Persons Regime (controlled function CF2d).</p> <p>AC4. Under Threshold Condition 5 (suitability), banks must continue to satisfy the FSA that they remain fit and proper to be authorized. Relevant matters in the FSA's determination include whether the bank conducts, or will conduct, its business with integrity and in compliance with proper standards and whether it has, or will have, a competent and prudent management. Failure by a bank to notify the FSA of any material adverse information would therefore call into question whether it has continued to meet this condition of its authorization. Under the FSA's Supervision Sourcebook (SUP) 10.13.16R, if a bank becomes aware of information which would reasonably be material to the assessment of an approved person's, or a candidate's, fitness and propriety, it must inform the FSA.</p>
Assessment	Compliant
Comments	<p>Banks' governance failures contributed internationally to excessive risk taking in the lead-up to the financial crisis. In the United Kingdom, the document: "A review of corporate governance in U.K. banks and other financial industry entities," commonly known as the "Walker Review," has set out the road map to address deficiencies in banks' governance, particularly in patterns of behavior more than in organization. The FSA is encouraged to complete the recommendations set out in the Walker Review to ensure Board and senior management involvement in the development of a safe and sound business model. The FSA is also encouraged to detect and correct short-term incentive structures that undermined good governance and encouraged excessive risk taking, in particular effectively aligning senior management pay with long-term risk-adjusted returns.</p>
Principle 18.	<p>Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.</p>
Description	<p>EC 1. The reduction of financial crime is one of the FSA's regulatory objectives, and a responsibility to tackle financial crime is built into the FSA's regulatory approach (ARROW), which targets its resources to supervise firms proportionately according to the level of risk they pose. Small firms are not subject to an individual specific risk assessment. The FATF, in its 2007 U.K. Mutual Evaluation Report, indicated that while the supervisory system was generally comprehensive for large firms, there was less adequate supervision for certain smaller firms. In these cases, the risk assessment and resulting level of supervision often relied too heavily on the size of the financial institutions and did not always adequately take AML/CFT risk into account. FATF also raised an apparent over reliance on interview-based visits without sample testing.</p>

EC 2. The FSA requires banks to put in place policies and procedures for countering the risk that they might be used to further financial crime (SYSC 6.1.1 R). Where a bank has knowledge, suspicion or reasonable grounds to know or suspect that it is being used to launder the proceeds of any crime, it has to report this to the U.K.'s FIU (Serious Organized Crime Agency). From 2007 to October 2010, FSA has published over 80 disciplinary sanctions concerning financial crime matters. This included seven findings in the banking sector, primarily for failures in systems and controls.

EC 3. Banks must deal with the FSA in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice (PRIN 2.1.1 (11) R). This implies that banks report to the FSA suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the bank.

EC 4. Banks are legally required to put in place and maintain policies and procedures to prevent and detect money-laundering and terrorist financing. These policies and procedures have to be communicated to relevant staff and must cover, among others, a bank's risk assessment and management, risk-sensitive customer due diligence and monitoring and record-keeping (Reg 20(1), MLRegs 2007). The FSA expects that banks' KYC management policies and processes are well documented, communicated to relevant staff, and integrated into the bank's risk management. Banks must document their KYC management policies, processes and risk profile in a way that allows the FSA to monitor banks' compliance with regulatory requirements.

EC 5. Banks which have, or propose to enter into, a correspondent banking relationship must apply enhanced due diligence measures to mitigate money laundering and terrorist financing risk. In line with EU policy and legislation, these enhanced due diligence requirements do not extend to respondents from EU and EEA jurisdictions. Banks are not prohibited from entering, or continuing, a correspondent banking relationship with banks that have inadequate controls against criminal activities or that are not effectively supervised, provided that they can demonstrate to the supervisor that they are equipped effectively to manage the increased money laundering and terrorist financing risk. Supervisors will satisfy themselves that banks comply with these requirements as part of their ongoing supervisory work and, where applicable, during dedicated thematic reviews (see EC6, below). For example, thematic work is currently underway, which examines banks' systems and controls in relation to high-risk customers, wire transfers and correspondent banking.

EC 6. The FSA applies a range of supervisory techniques ranging from desk-based reviews to onsite visits. Financial crime specialists provide support and technical advice to supervisors and conduct thematic reviews on specific financial crime-related topics. The FSA also applies its risk based approach to AML/CFT supervision. As a result, the FSA will not periodically review the financial crime systems and controls of all banks but instead focus its supervisory resources on those banks assessed as presenting a higher financial crime risk.

EC 7. The FSA has an extensive range of powers under FSMA to investigate and enforce breaches of banks' obligations in relation to financial crime. The FSA also

has investigation and enforcement powers under other financial crime-related legislation, including the Money Laundering Regulations 2007, the Transfer of Funds (Information on the Payer) Regulations 2007 and Schedule 7 of the Counter Terrorism Act 2008. Under each, the FSA may obtain information and documents and impose civil penalties or prosecute criminal offenses. The FSA is also the lead prosecutor for insider dealing and other market-related offenses. Under the Regulation of Investigatory Powers Act 2000, the FSA is able to: acquire data relating to communications; carry out covert surveillance; make use of covert human intelligence sources; and access electronic data protected by encryption or passwords, where necessary for the purpose of preventing or detecting crime.

EC 8. FSMA sets out the duties and powers of auditors as well as their authority to provide information to the FSA. (ss. 340–346). Section 165 gives the FSA the power to require banks to provide internal audit and compliance reports and s.166 allows the FSA to require firms to commission external “skilled persons” reports, copies of which have to be provided to the FSA. Banks must appoint a money laundering reporting officer (MLRO) (SYSC 6.3.9 R), who may also be the nominated officer under the Proceeds of Crime Act 2002. The FSA require banks to put in place adequate screening policies and processes to ensure high ethical and professional standards when hiring staff. The Money Laundering Regulations 2007 and the FSA’s Training and Competence Handbook require banks to conduct training programs for their staff on KYC and methods to detect criminal and suspicious activities. The FSA conducts thematic reviews on matters linked to financial crime. Such reviews generally involve visits to selected firms to assess best practices as well as areas where practices fall short of acceptable standards.

EC 9. The Regulations require banks to establish and maintain appropriate and risk-sensitive policies and procedures under which anyone in the organization to whom information or any other matter comes in the course of business, as a result of which he knows or suspects or has reasonable grounds for knowing or suspecting that a person is engaged in money laundering or terrorist financing, is required to report this to the nominated officer (Reg 20 (2)). The nominated officer must consider each report and determine whether it gives sufficient grounds for knowledge or suspicion of money laundering or terrorist financing. If it does, the nominated officer must submit a suspicious activity report (SAR) to either the U.K.’s FIU (SOCA) or the U.K.’s Asset Freezing Unit as soon as reasonably practicable (ss 330,331, POCA 2002; s 21A, Terrorism Act 2000).

EC 10. There is no explicit provision in U.K. legislation protecting those reporting suspicious activity so that a bank’s staff who reports suspicious activity in good faith may not be held liable in connection with submitting reports. However, legislation does contain protections: sections 337 and 338 of the Proceeds of Crime Act 2002 allow banks to disclose information that meets defined criteria; such disclosure will not breach any legal restriction on the disclosure of information (however, imposed) that would normally apply. The Terrorism Act 2000, s 21, similarly provides that any disclosure under section 21A does not breach any restriction on the disclosure of information (however imposed). The Data Protection Act 1998 further provides that personal data processed for the prevention or detection of crime, the apprehension or prosecution of offenders, or the assessment or collection of any tax or duty or of any imposition of a similar nature are exempt from the nondisclosure provisions of the Act (s.29 (3)).

	<p>EC 11. The Money Laundering Regulations 2007 require that supervisory authorities which, in the course of carrying out any of their functions, know or suspect that a person is or has engaged in money laundering or terrorist financing, must promptly inform SOCA (the U.K. FIU) (Reg 24 (2)). The FSA confirms that, in practice, it has an active working relationship with SOCA with regular exchange of information as well as active collaborative working. The Regulations also stipulate that any such disclosure is not to be taken to breach any restriction, however imposed, on the disclosure of information (s.24 (3)). Furthermore, FSMA (Disclosure of Confidential Information) Regulations 2001 allows the FSA to disclose confidential information to any person (including the FIU). The FSA has also entered into MoUs with a number of other domestic authorities. These MoUs are available through the FSA website.</p> <p>EC 12. Section 354 FSMA places a duty on the FSA to take such steps to cooperate with the relevant domestic and foreign financial sector supervisory authorities. Section 348 FSMA places restrictions on the disclosure of information defined as confidential, but section 349 FSMA provides for the creation of gateways to enable disclosure of information falling within the “confidential” definition. Section 34 of the Serious Organized Crime and Police Act allows the FSA to disclose any “confidential” information to SOCA.</p> <p>AC 1. The FSA has specialist staff to tackle financial crime at all stages of the regulatory process. It has an Enforcement and Financial Crime Division of over 500 staff. Just under 50 of these staff fulfill specialist Intelligence functions, supporting colleagues who assess the fitness and propriety of applicants for authorization or approval; helping to detect breaches and assisting in enforcement actions.</p>
Assessment	Compliant
Comments	<p>Overall, the FSA supervision of banks’ policies and processes to prevent the bank from being abused for criminal activities seems comprehensive and thorough. Nevertheless, the FSA’s risk-based supervisory approach means that in practice small institutions are not subject to an individual specific AML/CFT risk assessment. This may raise concerns about pockets of financial activities that receive less than adequate supervision. This is an issue also raised by the FATF evaluators. Assessors discussed with the FSA the FATF concern of excessive reliance on interview-based visits without sample testing. The FSA is changing its approach to a more intrusive supervision. In particular, further supervisory work is needed to ensure that financial institutions require their branches and subsidiary undertakings located in a non-EEA state to apply, to the extent permitted by the law of that state, measures at least equivalent to those set out in the AML Regulations with regard to customer due diligence measures, ongoing monitoring and record-keeping. These deficiencies in supervisory practices are related to the discussion of Principles 19 and 20.</p>
Principle 19.	<p>Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.</p>
Description	<p>In theory, the FSA takes a risk-based approach to bank supervision (<i>SUP 1.3.1</i>), adjusting supervisory intensity according to the risks the firm presents to their statutory objectives (<i>SUP 1.3.7</i>) by using ARROW as its core model. In the 1st step: The FSA assesses firms in terms of their impact (the scale of the effect that the firm’s risks would have on consumers and the market if they were to crystallize, assessed</p>

on the basis of a range of indicators as a proxy for relative size within the sector and the likelihood of the particular issue occurring in the firm). The framework used to assess the firm or group risk level (the Advanced Risk-Responsive Operating framework – ARROW) looks at vertical risks (from a firm—or group-specific perspective) as well as ‘horizontal’ or ‘thematic’ risks (those that cut across several firms or the market as a whole). This gives a ranking, a scale expressed in letters: H, MH, ML, L where H is high, L low and M medium impacts. A new category: VHIFs (very high-impact firms) has been created after the crisis and there are 8 firms in that category. This was because the ARROW scores for all of these firms were well beyond the previous bands. Currently for banks there are a number of banks in each category. Recently, there have been 35-50 banks in the high-impact category.

The group of systemically important deposit-taking banks designated VHIFs are subject to enhanced supervisory scrutiny under the Core Prudential Program. A firm is categorized as a VHIF following agreement by the Executive Committee, a structure at the FSA that discusses and makes decisions on the main strategic and operational issues.

The 2nd step in the supervisory planning is the use of these filters to determine the intensity of supervisory approach to be applied:

For **Very-high, Medium-high and High-impact firms**, the FSA coordinates its supervisory work through a relationship manager, who carries out a regular risk assessment (on a cycle of one to four years) and determines a risk mitigation program to address the risks identified. The precise volume and type of work undertaken depends on the size and riskiness of the firm concerned. But as low firms could receive no attention, the FSA has put a minimum threshold called “baseline monitoring activities,” which are undertaken for all firms regardless of their impact scores (*SUP 1.3.11*). The work done encompasses an analysis of the firm’s financial and other returns, and a checking of compliance with the requirements. Breaches and other indicators of risk may be followed up by the supervisory team. Recently, the supervisory cycle for very high and high-impact firms (including timing of a full ARROW assessment) was moved from three to two years.

For **Very-High and High-Impact Firms**, the FSA applies a more intensive monitoring regime (called ‘close and continuous’). This is essentially a planned schedule of meetings with the firm throughout the regulatory period and also includes a request for standard firm MI. This allows the supervisory team to meet the firm’s senior management and control functions regularly. Where possible, the FSA centralizes the supervision of all of the firms within a group, in a single team to make the work and the supervisory response consistent. When appropriate (for example, if the group has an integrated management and/or control structure) the FSA will produce a combined ARROW risk assessment and risk mitigation program covering all the firms in a group.

If a firm is assessed as **low impact**, it does not have a specific risk assessment or risk mitigation program. These firms are monitored by a combination of baseline monitoring, action in response to risks identified by this information, thematic exercises to monitor compliance standards in a sector, and work as part of sector-wide reviews. Low risk firms will not have regular on-site visits and are usually required to send regulatory reports only twice a year.

After the crisis, the FSA has put in place a more intensive and intrusive approach to supervision in an enhanced approach of existing programs (e.g., close and continuous supervision) and workstreams (e.g., the Core Prudential Program). And as a result of the higher level of risk across the banking sector, all banks (except some foreign branches and individual firms within groups) currently are rated at least medium-low (ML) and above and therefore subject to a relationship-managed supervisory approach.

The following templates describe in one table the present regime:

Impact	Relationship managed?	Reg period	Supervisory approach
L	No	Not applicable	Baseline monitoring and thematic
ML	Yes	At least 4 years	ARROW light (reduced assessment)
MH	Yes	At least 3 years	Full ARROW (standard assessment)
H	Yes	At least 2 years	Full ARROW plus close and continuous (minimum standard of regular meetings)
VH	Yes	At least 2 years	Full ARROW plus close and continuous and core program (greater use of specialist resource and in-depth reviews)

EC1. ARROW is the core “system” to develop and maintain a thorough understanding of the risk profile of banks. The ARROW risk process is as follows.

Step 1 : the use of ARROW: ARROW, the central risk model, uses the notion of supervisory cycle that is per se correct; this cycle varies depending on the bank (from 1 to 4 years), that is to say on the risk profile for which the ARROW diagnostic remains valid. Very high-impact firms and a range of other firms are on a two-year cycle.

Risk assessments of banks

Step 2: Once during the cycle, a complete risk assessment is done. This risk assessment will have a number of phases: planning (which will include an information request of firm MI such as current business plan/strategy documents, group and organizational structure charts, latest financial statements, last Board meeting papers and minutes, Audit Committee papers, internal audit plan and reports, and compliance monitoring program/reports); discovery; and, evaluation and communication.

Step 3: It culminates in reporting the results to the firm in an ARROW letter (a follow-up letter) and a risk mitigation program (RMP) that sets out the results of the formal validation of the ARROW risk assessment. For the remainder of the regulatory period, the firm is subject to ongoing monitoring.

In ARROW, all banks are assessed on the basis of the following risk and control

	<p>factors:</p> <ul style="list-style-type: none"> • Environmental risk (economic, legislative & political, competitive and capital markets environment); • Business model risks and controls (customers, products and markets, business process, and prudential); <p>Oversight and governance risks and controls (management, governance and culture).</p> <p>The traditional risk categorization (credit, market, operational, IRRBB, etc.) is included in this framework under business and environmental risks.</p> <p>Step 4: Using this model, the FSA records and “measures” the risk in relation to the assessed firm. The impact and probability scores that the FSA attributes to these risks and issues will relate purely to the effect the individual firm has on the FSA’s statutory objectives.</p> <p>Depending on the firm’s impact and probability ratings, the supervisory approach adopted will fall into various categories noted above, with higher rated firms being prioritized in terms of resource allocation:</p> <p>Ongoing assessment and mitigation</p> <p>Step 5: The results of the risk assessment itself will (in the vast majority of cases) also lead to further actions over the course of the regulatory period – a risk mitigation program (RMP) – directed toward specific issues as identified during the periodic risk assessment. Any such extra work is carried out in a ‘follow-up phase.’</p> <p>There are two possible methods used for the ongoing monitoring of firms: baseline monitoring and close and continuous. The decision on approach is based on the firm’s impact.</p> <p>Baseline monitoring – this is undertaken for all firms. It involves analyzing a firm’s financial (e.g., capital, liquidity and large-exposures) and nonfinancial (e.g., complaints data, annual controllers and close-links reports) returns, and checking compliance with notification requirements. Breaches and other indicators of risk may be followed up by a supervisor. Issues that come to light are assessed and recorded on the FSA’s database for firm risk assessments as and when they arise, and dealt with according to the risk they pose, in exactly the same way as issues identified during a periodic risk assessment. For small firms, a case team will perform any follow-up needed.</p> <p>Close and continuous (C&C) supervision – for high-impact firms (HIFs) and very high-impact firms (VHIFs) only. The FSA applies a closer monitoring regime, which means that supervisors are in regular contact with the firm, undertaking structured ongoing assessment. In addition to baseline monitoring activities, HIFs and VHIFs subject to C&C have a planned schedule of visits to the firm throughout the regulatory period. This allows the supervisory team to meet the firm’s senior management and control functions regularly. As with baseline monitoring, issues may come to light during their</p>
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	<p>C&C work.</p> <p>The Risk Mitigation Program RMP that results from the SREP risk assessment, or from subsequent monitoring throughout the regulatory period, will contain specific actions for each issue raised. The level and type of work undertaken in response to each issue within a firm is determined by the combination of impact and probability.</p> <p>Assessors discussed with supervisors the use of the ARROW framework and saw examples of the impact and probability ratings, and how they had moved over the past few years for very high-impact firms. They also discussed the framework with the FSA senior risk manager who is the 'owner' of the ARROW process. Senior staff agreed that the ARROW framework is used more as a resource allocation model than a risk assessment model. As an example currently the framework does not discriminate well among the high or very-high-impact banks. There are minimal criteria to assist staff in knowing how to rate something in the various ARROW categories. The framework deliberately has minimal links to criteria such as BCBS sound practice documents that might help supervisors plan and make assessments. FSA staff advised this was deliberate in order to avoid a 'checklist' mentality. There are few forward-looking components in the ARROW system.</p> <p>Specialist staff and senior management can pre-specify risk ratings for various business lines, with supervisors having the discretion to vary the individual bank scores from those pre-specified if they explain the reason for the deviation. These sub-sector profiles are used to give supervisors a starting point for their assessment, encourage consistency of scoring across the ARROW model and give senior management an opportunity to inform the supervisor of their view of the typical score for a particular sub-sector of firms. Supervisors reported that the ability for sector specialists to pre-specify risk ratings tended to reduce usefulness.</p> <p>The ARROW instruction manuals for staff are voluminous and the system appears quite complex.</p> <p>Assessors did not observe that specialists uniformly thought that part of the output of their reviews was input into updated risk ratings. However, the FSA has recently introduced a scorecard for specialists to use when they do firm-specific work and this is assisting in the integration of this work into the supervisory process more generally. Assessors reviewed the financial soundness (probability) ratings for the current VHI banks over the previous five years. These ratings are one of the main sub-component ratings and encompass assessments of risk management and controls relative to inherent risk and financial cushions such as capital and liquidity. This was to obtain a high-level view of the responsiveness of the rating system. Examination of the probability ratings for financial soundness for the VHI banks over the past five years showed that the ratings for a number of banks tended to follow rather than lead developments.</p> <p>Staff that assessors met understood at a high level the major risks in their banks. However, assessors share the view of the FSA that the level of assurance around these judgments is not at the desired level for a system that is as complex and major and global as is the U.K. system. The United Kingdom is starting to implement the core prudential program for the eight VHI banks to deal with this issue. It involves much more proactive in-depth reviews and cross-system theme reviews. The</p>
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modules for capital and liquidity have been rolled out but the modules related to greater in-depth understanding of the risks inherent in banks business plans and the modules related to risk management, ERM and risk governance are at a very early stage. The plan is to roll those out sequentially.

The goal is to complete the CPP cycle for all the VHI banks in the next 18–24 months before the start of the next ARROW reviews. Then the results can be taken into account in the ARROW assessment. That will become more of a roll up of all supervisory themes and specialist work than it is today.

The CPP has not been rolled out for the wider range of high-impact banks, but will be in future. Specific plans in this regard are not yet in place. Nor is there a formal resource assessment of what will be required.

Assessors observed that, in discussion with staff, the sheer complexity of the ARROW framework appears to make it hard to explain risk ratings. It is also not clear that ARROW reporting highlights the most important risks.

Assessors reviewed the FSA approach to deep-dive and theme (peer) reviews. They also examined examples of these reviews. The frequency of these reviews—both deep-dives and thematic reviews—appears low and staff confirmed that they have tended to be reactive, rather than proactive. This is changing.

Monitoring of banks occurs in regular meetings between FSA staff and bank management, including reviews of bank management information (MI) packs.

The FSA approach to the CPP roll-out is mostly module by module, yet there are links between modules (e.g., risk management and governance can only be assessed in relation to the inherent risks in the business). In discussion, FSA staff recognizes this, but that aspect of CPP roll out is unlikely to be fully dealt with in this initial two-year phase.

Lastly, while the various programs (the supervisory enhancement program and the Core Prudential program) are technically part of the ARROW framework, it was unclear whether they were fully integrated. Assessors reviewed examples of the 18-24 month forward planning chart of supervision activities of major banks. This chart includes various work streams and all of these are reviewed by management regularly for consistency and general approach. The charts include mandatory work (such as six monthly head of division—HOD reviews, ARROW assessments), roll out of the Core Prudential Program, thematic work driven by senior management and specialists (e.g., liquidity detailed reviews), work driven by bank plans (e.g., reviews of models for capital purposes), and specific work more closely related to material risks identified in the supervisory process. FSA staff confirmed that resource availability was one of the main drivers for the timing and scheduling of work. It also appeared that in-depth reviews of higher risk areas identified for the individual banks seemed to be fitted into other work streams and their timing, or be covered under the more general close and continuous supervision/monitoring program.

EC 2 Supervisors have access to a range of data, analytical tools and services that enable them to assess sector-wide trends and risks. Key among these are:

Core Prudential Program (CPP) ‘deep-dives.’ According to the FSA, the CPP “was introduced after the crisis as an assurance program to enhance the FSA’s existing risk architecture for very high-impact firms. It has been designed to enhance its approach to prudential supervision of the major U.K. banks. This rolling assurance program is based on in-depth structured work (‘deep-dives’) and aims to address earlier the big picture risks. These **deep-dives cover five modules** – *Business Model Analysis, Capital, Liquidity, Risk and Governance* – and involve narrow specialist testing of these specific issues in a firm.” *However, for the time being, practically there are deep-dives only in capital and liquidity for some of the banking groups (20 percent) and it will take time to fully cover all of them.*

Simultaneous system-wide stress tests provide a view of levels of risk within the banking system as a whole. This is undertaken by firms’ use of a common scenario to gauge the system-wide impacts of particular stress events for financial stability purposes. This exercise ties in with macro-prudential analysis that also focuses on gauging the systemic impacts of stress events. *These stress-tests, requiring fewer resources, are more common today.*

Market view analysis (MVA), which comprises weekly reports that summarize trends in market sentiment (focused on for its role in driving banks’ behavior), equity and credit research, rating actions, investor views and market price indicators. Analyst conclusions and recommendations, as well as rating actions, are examined critically and inconsistencies in market indicators are highlighted.

Peer group analysis, which provides a comparative analysis of the results of large U.K. and foreign banks. Supervisors also receive peer group analysis of credit characteristics of high-impact banking firms, a process resulting in an Intrinsic Credit Rating (ICR) being assigned to the firm, which aims to measure, on a relative basis, the distance of a banking firm from likely regulatory intervention and/or state support, i.e. its intrinsic business and financial strength. FSA banking sector specialists also hold Peer Review Days with senior management from Supervision to consider peer analysis of risks relating to banks’ business models, controls, capital and liquidity. Peer Review Days provide an opportunity for the supervisors to examine their firms in relation to their peers and for all meeting attendees to challenge each other on the risks facing the firms and the adequacy of the mitigation plans in place. The discussions enable the prioritization of issues for follow-up by supervisors and ensure greater consistency of impact and probability scores. The methodology on peer groups has not been discussed with the assessors. The mission has not examined the way the peer groups were made. What is described here under ICR is indeed interesting but it is not a traditional supervisory peer group analysis of findings on risk and risk management and mitigants, as would be found in many other G-10/20 countries’ supervisory process.

Business model and financial analysis: covers three sub-sectors—retail and commercial banking, wholesale and investment banking, and building societies/mortgage lenders. It aims to assess the sustainability and risk characteristics of banking firms’ business model (“BM”) as an essential starting point in monitoring the firms’ prudential risk and potential conduct risk as part of the supervisory process. A key goal of this assessment is to identify and name outliers – and thus flag early-warning indicators – with respect to BM sustainability, growth and diversification strategies, risk-taking appetite, asset mix and quality, funding and liquidity patterns, and the quality and level of capital (including potential internal

	<p>capital misallocations).</p> <p>Sub-sector issues (SSIs). SSIs are prioritized issues that typically would not be regarded as ‘business as usual.’ They aim to focus supervisory work in firms, by clearly articulating specific risks that are recognized by senior management as being significant and topical for each type of firm being risk assessed; integrate the outputs of horizontal work and the contribution of specialists on particular issues into firm supervision to facilitate knowledge sharing; provide perspective and encourage consistency of approach between ARROW firm risk assessments by offering suggested discovery and mitigation work; and provide a feedback mechanism to inform risk owners and senior management of how and to what extent the issues have been mitigated in individual firms.</p> <p>Banking sector scorecard: supervisors are required to undertake a minimum level of review of the regulatory returns information submitted by banks. The scorecard displays a number of measures and calculations, allowing supervisors to carry out peer analysis on the individual categories, and is reviewed quarterly for solo/unconsolidated firms and half-yearly for consolidated groups.</p> <p>Banking sector risks on the FSA Risk DashBoard (a risk log for managing high-level thematic and internal FSA risks), where risks and their implications are described and progress on mitigation plans attached to the individual risks or groups of risks is monitored.</p> <p>Regulatory returns: Permissions, the nature of the firm, and the firm’s size determine the type of return required by the FSA and the frequency of its preparation. Data available to supervisors for analysis include a solvency statement, income statement, large exposures, daily flows, funding concentration and currency analysis, and are submitted on an annual to daily basis according to the nature of the return. Trends across peer groups—and by extension, high-risk or outlier firms—can be also identified using the Business Intelligence (BI) tool. As seen in CP 17, the GABRIEL Data base is less important to the FSA than would be the case in other G-10/20 countries. The FSA has adopted significant ad-hoc reporting for major banks. In some cases, the data are then migrated into general returns.</p> <p>Firm MI: The aggregate risk presented by each departmental risk portfolio is reviewed monthly to identify trends in risk. This includes a focus on commonalities in risk identification and type to inform future risk assessments under the ARROW process. In addition to this analysis, firm MI also identifies outliers from a risk perspective, including the intensity of mitigation effort and resources applied to individual firms relative to their peers. Market data (e.g., CDS prices) are also used to complement supervisory-generated data and regulatory returns analysis conclusions. Such analysis is presented at divisional risk committees, and then a higher-level analysis is presented at a Business Unit and Executive Risk Committee level.</p> <p>The various pieces of monitoring are clear and understandable. However, the various monitoring functions and analysis are coming from various sources—explicit monitoring groups, specialist risk divisions, supervision monitoring with banks, among others. While there are processes to bring this together, the overall approach appears complex with various pieces covering different parts of sectors, and being based inherently on different data sources. The risk is that a profusion of analysis and data sources could (a) generate conflicting messages (b) confuse the very analysts who are supposed to be assessing the institutions, and lead to silos of data and analysis</p>
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with insufficient sharing across units and possible insufficient roll out of data collected for VHI banks to other high-impact banks for whom it might be relevant in risk assessment..

EC 3: importance and scope of the risks in individual banks.

The FSA firm and group risk assessment model uses the ARROW risk process, its initial assessment and the follow-up work it leads to. The supervisory work is prioritized based on the results of these assessments using the 3 levels of ARROWS (full ARROW vs. ARROW Light; Baseline vs. C&C monitoring).

The results of the ARROW risk assessment allow supervisors to compare their firm against its peers or sub-sector 'modal' and to set out supervisory work for the remainder of the regulatory period accordingly. Head of Department Reviews, for banks subject to close and continuous C&C supervision, are also key to prioritizing supervisory activities according to developments in the firm's risk profile.

The FSA uses a structured panel process for agreeing to and prioritizing supervisory work in a cycle and for verifying overall ratings and findings and the supervisory letter and follow-up remedial action plan that goes to the bank's Board of Directors. Assessors reviewed several examples of the end-to-end panel process, from planning through to reporting on analysis and supervisory work done, to reporting to the bank board and senior management. The head of the major groups division usually chairs the panel for major banks, with members of the panel including another head of department the supervisory team and specialists involved. There does not appear to be a formal process to compare results across major banks for consistency, though the panel pack includes some high-level peer comparator material. The Managing Directors of Supervision and Risk would not normally attend or chair panels. Directors of supervision chair all VHIF and HIF panels, and Risk is represented on all panels, but at a less senior level.

The letter to Boards is usually 10-15 pages long, with a similar amount in annexes. They contain the risk rating information—impact and components of the probability rating, as well as the remedial action plan (RMP). The FSA has recently organized RMP plan items by importance to better communicate with the Board. Typical RMPs that assessors saw for big banks had 20-30 items summarized in the RMP table.

Review of several packs demonstrated what appeared to be important inconsistencies in the messages between what was reported in the supporting material that went to the panel, the risk ratings given to the Board, the comments in the Board letter, and the presentation by the FSA team to the Board. In addition, it appears that certain important items may not show up in the letter to the Board, but may be the subject of separate conversations between the supervisors and certain Board members such as the chair of the Risk Committee.

Assessors explored the extent to which skilled person reports under section 166 of FSMA were an effective supplement to supervisory resources. These are commissioned by banks at the direction of the FSA to investigate selected control or process or risk measurement issues, These can be done by banks' auditors as well as by other experts. The FSA sets the terms and approves the final report, but the review is paid for by the bank. Based on assessors' research on raw data provided by the FSA, the number of S166 reports related to prudential issues across time in 2008,

2009 and 2010 has been: 6, 13 and 23 respectively. Most of the commissioned S 166 reports have been on small institutions, financial advisors, mortgage lenders, brokers, asset managers, and custodians advising and arranging intermediaries.

The range of cost is from £10K to £1.1 million for a large bank. For banks, the average cost is around £0.3 million to £0.5 million. The topics are mainly reviews of governance, selling practices, risk management frameworks, customer detriments and assessments on the quality of systems and controls. There have been eight S166 reports on the quality of the supervisory return in 3 years, but there has been no apparent commissioned work on the quality of the credit portfolios or on IRB or AMA.

Though increasing in number year after year (from 6 to 23 for banks), the commissioned prudential work under section 166 does not represent a realistic answer currently to the lack of supervisory in-depth reviews. As evidenced by the average price paid by banks to auditors at market price, the tasks performed are rather small (representing on average 3 persons work for one month for banks).

	2008	2009	2010	Average cost in 2010
BANKS	6	13	23	£ 415k with a range from £30k to £1,100k
Building Societies	1	3	1	
TOTAL	7	16	24	

EC 4: compliance with prudential regulations

Firm regulatory returns (See SUP 16.12.5 and 16.12.6 and EC 2 above for bank returns the FSA receives) can be viewed and analyzed by supervisors on an ongoing basis.

The FSA Banking Sector Scorecard provides supervisors with a high-level summary of key information for defined analysis areas for a firm or group over eight time periods. The summaries highlight the areas most important to bank supervisors: Profitability, Capital Adequacy, Balance Sheet, Regulatory Capital, Credit Risk, Market Risk, and Asset Quality.

Supervisors and the Prudential Risk Division work together to carry out capital and liquidity assessments of individual firms as per the EU Capital Requirements Directive (CRD) and (to varying degrees) the 2009 FSA Handbook amendments for liquidity standards.

The FSA reliance on firm MI is useful as it allows supervisors to see the bank the way management does; it inherently bases its analysis on data that each bank provides to the FSA in the manner it likes—because that is the way the bank is able to produce the data. This can hinder the ability to compare across banks in making supervisory judgments. As an example of the issue, there was a major debate between the FSA and industry in 2009 with respect to whether liquidity data needs could be satisfied by firms' own data or whether it had to comply with supervisory standards.

	<p>Industry arguments were that they did not and could not manage their liquidity profile on the basis of contractual maturities but needed many behavioral assumptions. If this argument is valid, then neither industry data alone nor FSA prescribed data could provide a complete picture of industry risks and create the ability to undertake peer review—both would be needed. But regulatory reporting is not necessarily an internal tool in banks and the lack of it will hamper the FSA's efficiency to monitor liquidity and make comparisons across banks.</p> <p>EC 5: notification of the FSA of any substantive changes</p> <p>Principle 11 of the FSA's Principles for Business requires firms to deal with regulators in an open and cooperative way and to disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice. Principle 11 applies to unregulated activities as well as regulated activities and takes into account the activities of other members of a group.</p> <p>Compliance with Principle 11 includes notifying the FSA orally or in writing (at an early stage and before making any internal or external commitments) of:</p> <ul style="list-style-type: none"> • any proposed restructuring, reorganization or business expansion which could have a significant impact on the firm's risk profile or resources; and • any significant failure in the firm's systems and controls, including those reported to the firm by its auditors. <p>Following notification, the bank may be granted a waiver of rules that no longer apply or become subject to additional rules/requirements for new activities. Implementation of the Principle depends on banks' willingness to disclose information without much opportunity to double check compliance. Discussions with the staff on practices have reassured assessors that the Principle is being implemented.</p> <p>EC 6 The supervisor has an adequate information system:</p> <p>In addition to the Banking Scorecard and Banking Sector peer group analysis tools, supervisors are able to monitor and analyze prudential information through business intelligence (BI) alerts and stress testing results.</p> <p>The Alerts and Risk Indicators (ARI) system automatically identifies rule breaches or potential risks <i>based on data submitted by firms</i>. ARI runs approximately 160 rules against the FSA's Amalgamated Regulatory Data Information System (TARDIS), Retail Mediation Activities (RMA) data items, Complaints returns and Product Sales Data. The rules are made up of approximately 60 alert rules (which are rule breaches) and 100 risk indicator rules (for example, conduct of business issues, or levels of complaints reported). All Alerts and Risk Indicators are accessible by supervisors.</p> <p>Supervisors also receive the results of firm and system-wide stress tests. In addition to evaluating the results of firms' stress tests, the FSA runs its own stress tests on a regular basis for particular firms and uses these to assess a firm's ability to continue to comply with minimum specified capital levels throughout a stress period.</p> <p>The ongoing information system remains basic when compared with other major</p>
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	<p>jurisdictions familiar to the FSAP team. As a result the system is supplemented extensively by processing requests based on a relatively high proportion of individual bank MI data and specialized information from groups of banks. This in part relates to supervisory reporting issues assessed in CP 21. While the FSA has considerable monitoring tools, it does not appear to have an organized early warning system</p> <p>AC 1 The supervisor employs a well defined methodology designed to establish a forward-looking view:</p> <p>As described by the FSA, the impact is on the “consumers and the market,” instead of banks—a prudential supervision is above all centered on banks not on customers.</p> <p>See EC2 and EC6 for details of data and analysis available to supervisors to establish a forward-looking view on the risk profile of banks.</p> <p>The environmental risk scores and narratives in the ARROW firm assessment provide a ‘point in time’ view of the environmental risk the bank faces – made up of economic, legislative and political, capital markets and competitive risk – but also factor in and provide analysis of upcoming or potential future risks.</p> <p>The FSA’s Banking Sector Risk Group is made up of senior staff in the banking supervision divisions, along with senior representatives from policy areas and the risk division. The risk group acts as the principal cross-FSA group responsible for the identification and monitoring of risks facing the banking sector, with one of its principle areas of focus being the identification of new and emerging risks.</p> <p>Senior management is also provided with further forward-looking analysis that is communicated to bank supervisors. This includes updates of a set of regulatory stress points (low-probability, high-impact events of relevance to the FSA’s statutory objectives); stress tests on the “Watchlist” firms (see <i>Principle 20, EC5</i>) and analysis of firm-level MI.</p>
Assessment	MNC Materially noncompliant
Comments	<p>In all supervisory systems, CP 19 is one of the most important. It considers whether the supervisors adequately consider various risks and banks’ controls and management capability, and produce focused information and assessments, backed up by evidence that can be used to intervene effectively using the variety of tools available. It requires demonstration of a <u>thorough</u> understanding of the operations of banks and banking groups. The FSA possesses all the tools necessary. There are examples of very good supervisory work, in a difficult environment, but these are not consistent. However, the assessors’ review has determined that there are serious weaknesses in terms of the depth of reviews, bringing together various processes and forming a coherent view, linking supervisory assessments to the risk model, a risk model that does not produce adequate discrimination or forward-looking assessments, and issues regarding communication of a clear supervisory view to individual banks.</p> <p>The FSA itself determined that the previous system was not adequate, as demonstrated by the crisis experience. Deficiencies in achieving a thorough understanding were serious. The major retooling required has started with the core prudential program (CPP) and other initiatives in the supervision and specialist spheres. But this is a multi-year task, and the more-detailed, proactive reviews of the modules related to risks inherent in banks’ businesses, and the quality of their risk</p>

management and governance are at the initial stage of roll-out and so could not be assessed. The FSA has come as far as possible in the time since the crisis. While the FSA has commendably increased resources, the full nature of the resource issues and personnel policies that may be required cannot be fully known at this stage. While the deficiencies assessors saw are understandable at this stage of the roll-out of a new methodology, sustained, hands-on, leadership and management will be required to ensure that the multi-year improvement program remains on track and delivers the desired results. Other matters, such as the new macro-prudential overlay, that have been announced, if not adequately resourced, risk drawing attention away from core micro-prudential work on inherent risk, quality of risk measurement, risk management and risk governance.

There are a number of other indicators of potential issues. There are no clearly identified groups for 'on-site' supervision (which need not be resident in banks). In addition, based on data prepared for the reorganization, the number of staff in banking supervision is around 600, which as indicated in CP 1 appears low, given the size and complexity of the U.K. system (though the quality and experience of available resources matters as much as the actual number of staff). Most, if not all, G-10/20 countries that assessors are aware of would have considerably more staff devoted to detailed reviews (i.e. 'on-site' type work). These are often specialist resources involved in assessment of major risk categories, including reviewing selected credit files to assess whether banks' risk rating systems are operating as they should. The culture and skill set of this sort of staff can be a helpful adjunct to other specialist and regular supervisory staff in assessing risk and risk management capabilities.

Are S166 reports and "deep-dives" possible proxies to onsite examinations?

What is called the S166 process, (the use of an external specialist), though useful, is not extensive enough currently to be a substitute for a proactive on-site deep-dive process, with regular cross-system reviews to do peer analysis. It cannot be seen in its current form as equivalent to an on-site examination. Even if S166 reports were ramped up (which may be a useful interim measure) it would be preferable for supervisory staff to carry out more of the detailed reviews. This would give them a fuller knowledge of the bank and would be more useful in linking review findings to broader risk management and governance themes and root causes.

Most deep-dives that have been done also seem to involve a relatively small number of people for relatively short timeframes, so it is unclear how they can deliver the desired level of reasonable assurance. Deep-dives that are equivalent to those done in other major countries are done by the FSA, though far less frequently, and when they do occur, add value to uncovering risk management and governance issues. The number of detailed deep-dives should be increased, as planned by the FSA.

And, as elsewhere, there is room, as recognized by the FSA, to better integrate specialist activities within the supervisory program.

In addition, based on the documents transmitted to the assessors, the only really consistent proactive deep-dives in risk areas currently seem to be focused on liquidity where—though the analysis relies mainly on banks' MIS, hence on information given by banks themselves—the bulk of information collected is important and probably allows for a real deep look and accurate assessment.

The FSA has decided to use more and more deep-dives in the future. This is certainly the direction to go. However, for the time being, the number of cases remains small and it is hard to say that that deep-dives are a key feature in the present FSA landscape.

Besides, the current roll-out plan for the CPP does not adequately take account of linkages between modules. This important conceptual point should be given due attention in the future.

The FSA approach to supervisory letters (“ARROW follow-up letters”) is also likely to dilute their effectiveness, as confirmed to assessors by banks. Progress has been made in clarifying messages to boards, ensuring that attention is drawn to the most important findings, and better linking supervisory findings and ratings to the supervisory letter and board presentation. But examples reviewed by assessors suggest there is more room to improve. Also the fact that some major review findings are communicated separately and perhaps only to certain persons (without being included in an overall summary communication at board/CEO level) leaves room for misunderstanding. The FSA has recently instituted regular contact between the most senior FSA staff and CEOs of major banks, during which time supervisory messages are conveyed. While this process can be effective, there is merit in ensuring that Boards of these banks are also aware of all major issues through a regular focused supervisory letter. Availability of more peer analysis would also be a powerful motivator to Boards and senior management to improve. Clarity of the major concerns and what the bank is expected to do would help.

While the FSA has enhanced the level of its representation at the close-out meetings with Boards there is room to improve on this in the future. That would also allow more senior people to help ensure the appropriate focus of the message.

Revamping ARROW would seem to need to be part of the retooling required so that it addresses the deficiencies identified in this assessment such as being more discriminating (the score given by Arrow is questionable and its sensitivity across time is an issue) and forward looking. It is also desirable to revisit the decision to have very little guidance on criteria for making rating judgments. The current approach is minimalist, does not refer to criteria in various available guidance, and risks not giving sufficient help to staff, many of whom are new. Also, assessments in ARROW may be overly tilted toward financial variables, and that may increase as a macro-prudential overlay is added. In addition, the risks to the reputation of the supervisory and regulatory system are not fully correlated with its size—credibility and confidence can suffer with smaller failures if they are perceived as having been a surprise to the regulator or the regulator was not adequately equipped to deal with them well. The supervisory coverage model for banks needs to take this into account.

Senior FSA management recognized the need to improve the existing supervisory framework and has therefore committed much more time to oversight over the key risks in meeting the FSA regulatory objectives. Major issues and decisions are escalated by supervisory teams through a watchlist process for consideration by the FSA Senior Executive team. This essentially amounts to a high-level judgmental overlay on the supervisory process. The FSA has also introduced a regular and direct contact program between the most senior FSA management and the CEOs of the U.K.’s largest firms. All major supervisory judgments are communicated both by this

	<p>senior management team as well as the lead supervisors. The FSA believes that this approach has been broadly successful in identifying potential major issues in the recent past. However, it is not a sustainable substitute for the necessary enhancements and carries risks, as the FSA itself recognizes.</p> <p>The overhaul of the supervisory process that has started should include a comprehensive multi-year program for enhanced supervision including more in-depth reviews and a desired coverage model that is more frequent and proactive. This should include the Core Prudential Program and its extension in part or in total to a wider range of banks, with specific timetables. It should also include improvements in internal processes to ensure that specialist and supervision input is effectively integrated and that there is more-effective bringing together of communication of all key messages to banks, including at the board level. Sustainable oversight processes should be designed to ensure that senior management is able to effectively monitor whether the ‘intensive and intrusive’ behavior on the ground is consistent with what is desired.</p>
<p>Principle 20.</p>	<p>Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.</p>
<p>Description</p>	<p>In its self-assessment on this CP the FSA does not present onsite and offsite roles at the FSA. The FSA does not view its process as being organized in that manner. Instead it presents at length the use of its risk core model ARROW and how it is used for off-site supervision.</p> <p>ARROW is the core system at the FSA; it is used to assess a bank’s risk level, which will determine the intensity of supervision that the bank should receive. It also organizes the off-site work and the relations with banks including contacts with bank management.</p> <p>As a result, all firms with a risk level of medium low and above are relationship-managed; all those that fall below this risk level are supervised using a “distilled and nonrelationship-managed” version of the ARROW framework, “which focuses principally on prudential risks (with conduct issues considered through analysis of complaints data)”; it is “returns-based and focuses on specific issues in a firm (rather than undertaking a firm-wide supervisory assessment).”</p> <p>After that decision, the FSA uses other approaches to provide enhanced supervision (CPP, deep-dives, use of different tools such as stress-tests) and a greater focus on High and very High-impact banks. These are in effect and in part ‘on-site’ tools in the language of the CP, and are assessed from that perspective. Some risks are more closely examined: capital adequacy, liquidity, and more so now, market risks. Some kind of horizontal sector analysis is also in place.</p> <p>However, this CP is mainly about “the right mix of on-site and off-site supervision.”</p> <p>In its answer, the FSA presents the visits to banks during the ARROW assessment as “on-site.” The deep-dives and section 166 (skilled person)s reports are also part of the regime.</p> <p>EC 1: an appropriate mix of on-site and off-site supervision. In its answer the FSA notes that the “FSA policies and processes set out a combination of on-site and off-</p>

site supervision to assess the level of risk the firm poses to the FSA's statutory objectives and the mitigation plans in place to address any risks/issues identified by the supervisor."

Then the FSA describes what the ARROW process is and the Close and Continuous supervision for high-impact firms or groups. If this concept entails more contacts with the banks, it is not what is called on-site elsewhere. On-site takes time and it also requires skilled persons with a specific profile (like inspectors) that specialists, quants or off-site supervisors do not usually have.

Implicitly relying on external auditors for assessment of the quality of the portfolios, the provisioning and for more technical validation (models and operational risk for example) is accepting to take a risk on the lack of quality, because there may be inadequate control of the work undertaken externally.

Our experience shows that the differences in understanding an institution between short visits, long visits, and on-site complete examinations are usually very important. This is due to the difference of duration, techniques, even culture. Only the third process (i.e. real onsite) can give enough assurance. It remains to be seen if more regular and deeper "deep-dives" can offer the same quality.

Short of building some kind of on-site function, the prudential supervision risks remaining unbalanced.

EC 2: planning and executing on-site and off-site activities. The supervisor has indeed a consistent and robust framework (ARROW) for planning and executing off-site activities. But only two risks have been more intensively assessed to date (Capital and liquidity) and not the others (interest rate, currency, and above all credit, market, operational risks). Moreover, what the FSA calls "on-site" is not the commonly accepted notion.

EC 3: On-site work

1. *Independent verification of Corporate Governance:* Corporate governance is assessed as part of the ARROW process (ARROW II Supervisors' Guidance Manual), and receives particular focus in high-impact firms, where additional evaluation takes place through, for example, annual meetings with the Board. In addition, the FSA has the power to commission skilled person (i.e. auditor) reports under s.166 of FSMA. The scope of these reports is determined by the FSA and there is ongoing project management to ensure the end product meets its desired objectives.

Though most of the work is done offsite by the persons in charge, the contacts with the banks are, in the context of large banks, now sufficient.

2. *Assurance that the information provided by banks is reliable:* In addition to the industry and firm-specific knowledge that supervisors draw on to assess the information they receive from firms, guidance is provided on how to analyze the data provided in a firm's regulatory returns (Supervisors' Guide to Regulatory Returns: Banking Sector) NB. However, guidance and analysis tools for new liquidity reporting

standards are still in development.

The FSA's prudential risk specialists also lead quarterly/semi-annual assessments of whether firms' internal models meet appropriate standards, with follow-up meetings and reviews. These assessments focus on firms' market risk models (CAD2/VAR approval), counterparty risk models (IMM) and credit risk models (AIRB).

As indicated in the next CP, the GABRIEL system lies on the lighter range of what exists elsewhere. Of course the FSA can collect more information, drawing on the banks' MIS, and does so.

Though it is a faster and less costly approach, the risks are twofold (i) difficulty in comparing and storing inconsistent data across firms; and (ii) concerns regarding the quality of the data transmitted.

Additional information: The FSA is indeed empowered to request data from banks throughout the regulatory period (SUP2). The data can be analyzed on a firm or thematic basis either directly or via external auditors.

Monitor banks follow-up on supervisory concerns: done through ARROW.

With ARROW, the FSA has technically an adequate framework and the only issues are possible forbearance and operational risk failure. However, assessors reviewed the operation of the framework at a high level. It does not appear to adequately discriminate among larger banks, nor does it have much of a forward-looking component. There is little guidance as to how to make rating judgments, and assessors were told that this is deliberate to avoid a check box mentality.

So there is no link to the suite of domestic and international guidance available on sound practices. Description of rating categories is minimal.

While check box thinking is to be avoided, more guidance could be necessary given the number of new staff.

EC 4 off-site work

Monitoring: Throughout the regulatory period, supervisors monitor firm returns and requested MI as well as market information.

However, in view of the lightness of the call reports and their inadequate quality—as recognized by banks and by the FSA—the analysis does not go as far as would be desirable.

Follow-up on matters requiring further attention: In its answers and the discussion with the assessors, the FSA has pointed out the Close and Continuous approach to supervision, which enables supervisors and specialists to monitor risks as they develop and to carry out analysis to guide subsequent supervisory activities. Supervisors indeed hold regular meetings throughout the regulatory period (often monthly) with the firm's market, credit and liquidity risk experts. This approach also leads to the identification of issues relevant to all banks or banking sub-sectors, which are also evaluated to determine the broader supervisory approach. Sub-sector issues, horizontal work, and the Core Prudential Program are approaches used to

fulfill this requirement.

Determination of the priorities and scope of on-site work: The firm/group risk profile as determined by the ARROW assessment (based on a combination of prudential indicators and supervisory/specialist judgment) dictates the priorities and scope of on-site work. (See EC 2). The FSA's prudential risk specialists also produce a monthly note that consolidates important/priority issues that have arisen in a number of firms, enabling supervisors to be aware of and act on market-wide issues appropriately and proportionately. However, if what is indicated is correct, it falls short of mentioning that part of the prudential risks are too lightly treated (cf. Credit risk, provisioning)

EC5: Sufficiently frequent contacts. Except for asset quality where there is a huge gap, the FSA has a framework in place that is correct. For higher impact firms that are subject to close and continuous supervision, the supervisor maintains regular contact with Board members, non-executive directors, Audit Committee and senior and middle management (for example as part of the annual strategy meeting, NEDs' meetings and audit reviews) to monitor developments in the various risk elements of the ARROW risk assessment. The only potential issue is the hierarchical level of the staff and the quality of the staff as sometimes they are too new at the FSA to be effective. The FSA will inform the firm's senior management of any concerns they have relating either to: levels of risks in the firm or issues that are relevant to a wider population of firms.

EC6. Quality of the Board and management seen on and offsite. The FSA monitors this effectively under Condition 5 of FSMA (COND 2.5), and if necessary challenges the quality of a bank's Board and management. On-site assessment of the quality of Board and management is undertaken as part of the Management, Governance and Oversight element of the ARROW risk process. But, unless visits are considered as equivalent to an on-site examination, a part of the review is missing. However, for this specific aspect, the work can be done off-site. As indicated by the FSA, "The Core Prudential Program for very high-impact firms is also developing a module on Governance, which is made up of a structured methodology; a formal, ongoing program of reviews to assess effectiveness of governance; more in-depth work; an emphasis on effectiveness; use of case studies; and knowledge sharing." This module is not yet implemented, nor are its links to other modules.

Use of in-depth reviews of key risk areas, including Board oversight, does occur, but this is not usually proactive and appears not to be part of a comprehensive strategy at this point. These reviews would allow better verification of how senior management and the Board are operating in practice.

EC7. Evaluates the work of the bank's internal audit function. The FSA conducts this assessment. Assessors did not focus on the details of the FSA's process in this area.

EC8. Communicates to the bank the findings. Following a firm visit (and after the validation process) a close-out meeting will be held with the firm's key senior staff, including the CEO, in which supervisors will present their initial conclusions and indicate the content of the RMP. The firm will also receive an ARROW Letter and appendices (including an RMP) addressed to the firm's Board of Directors. Together, these documents summarize the FSA's 'point-in-time' evaluation of the key issues and associated mitigation in the RMP plus any planned further assessment work, any

	<p>specific assessment work, and the expected timing of the next risk assessment. Where a capital and/or liquidity adequacy assessment is undertaken at the same time as the ARROW risk assessment, the firm’s individual capital and liquidity guidance (ICG and ILG) is also communicated in this letter. This communication is conducted satisfactorily, but could be strengthened. However, it would be useful to think of a more homogeneous form for follow-up letters which could also be more centered on their audience (CEOs).</p> <p>ARROW letters do not currently uniformly roll up all of the supervisory work in one place for Board communication. Some items coming out of separate theme or deep-dive reviews may be communicated separately and may be communicated to a few Board members (e.g., through the chair of the risk committee), rather than in a written communication to the full Board or committee. Nor is there clear coherence in the FSA Board presentations or in FSA ARROW letters that assessors reviewed, between the risk ratings disclosed to the firm, the supervisory findings and the major points raised with the Board for priority remediation. The FSA has now changed so that it categorizes points made in the remediation plan in terms of importance in the attachments to Board letters. The FSA’s plan is to make the ARROW letter a summary of all supervisory work, but moving to that model will occur for VHIFs over the next 18-24 months, and subsequently for H impact firms.</p> <p>While more senior FSA personnel than previously attend Board level wrap-up meetings, it is rare for the head of supervision or head of risk, or the FSA CEO or Chair to attend those meetings at major banks, or to review the material going to the Board. Banks that assessors met indicated some variation in the clarity of FSA communication of key issues, but most reported that it was increased from a few years ago.</p> <p>AC1. The supervisor meets periodically with senior management and the Board. The supervisor meets indeed periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit.</p> <p>For higher impact firms that are subject to close and continuous supervision, the supervisor maintains regular contact with Board members, non-executive directors, Audit Committee and senior and middle management (for example as part of the annual strategy meeting, NEDs’ meetings and audit reviews) to monitor developments in the various risk elements of the ARROW risk assessment.</p> <p>Following a firm visit (and after the validation process), a close-out meeting will be held with the firm’s key senior staff, including the CEO, in which supervisors will present their initial conclusions and indicate the content of the RMP. The firm will also receive an ARROW Letter and appendices (including an RMP) addressed to the firm’s Board of Directors. Together, these documents summarize the FSA’s ‘point-in-time’ evaluation of the key issues and associated mitigation in the RMP plus any planned further assessment work, any specific assessment work, and the expected timing of the next risk assessment. For major banks the FSA also prepares a presentation of key findings for the Board meeting. The material in EC8 above notes several aspects of how these meetings are structured and attendance.</p>
Assessment	Largely compliant
Comments	The “largely compliant” rating given must be read in conjunction with the “materially noncompliant” rating given to CP 19.

	<p>As seen in the previous CP 19 analysis, the two supplementary approaches that are the “s166” and the “deep-dives” cannot be really seen as an on-site supervision system with transaction testing, even on a select basis. Even if the deep-dives become more the rule, the qualifications of a real team of examiners and the work effectively done on site during several weeks or months have little commonality with much of the current practice of visits of just a few days, without the possibility to conduct serious checks on-site. The quality assurance provided is not comparable. The move toward more deep-dives, which is, however, the right answer—short of real onsite—is today, proportionally not yet sufficient to permit one to say that deep-dives are a sufficient approximation of an on-site function; nor, either, with the outsourcing made through external auditors (the S 166 scheme).</p> <p>There is also an opportunity, as indicated in the assessment of CP 19, to better focus the supervisory letters to banks’ Boards of directors. They should cover all material matters from the supervisory cycle, regardless of how they arose, better indicate which issues are the most important, and ensure the messages in the letter, the ratings communicated, and the RMP are clearly aligned. While the FSA has moved to increase the level of its representation at Board meetings with major banks, there is room to further enhance it. That would also allow senior staff to be sure that they are satisfied with the clarity of the FSA message going to these firms.</p>
<p>Principle 21.</p>	<p>Supervisory reporting. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.</p>
<p>Description</p>	<p>EC 1: The supervisor has the power to require banks to submit information. Technically, the FSA, through its database, collects data, on a solo and consolidated basis. The reporting requirements (which are contained within the handbook under SUP 16) are indeed part of the FSA's approach, but a small part only as the focus is more on compliance with processes and rules in place in banks than a financial/economic analysis based on data collected from banks.</p> <p>The reporting requirements, however, respect all the requirements dictated under Basel, Capital Requirements Directive, and U.K. legislation and cover prudential and accounting information at, usually, a low level of detail. However, the quality of the information received is often questioned within and outside the FSA. This also explains the light use of quantitative data. Hence there is a dialectic interaction between the supervisory approach, the construction and use of the Risk Model (ARROW) and the central database.</p> <p>EC 2 instructions that clearly describe the accounting standards. General valuation rules, which also apply to reporting, are laid out in GENPRU 1.3. These are based on international IFRS and U.K. GAAP accounting standards, with certain specific adjustments which apply to regulatory reporting, which are set out in GENPRU 1.3.36.</p> <p>Each reporting form (data item) also has reporting instructions and this includes an instruction relating to Valuation e.g., for FSA001 “firms should follow their normal accounting practice.” See details in CR 22.</p> <p>The instruction to fill in the data are expressed in SUP 16 but the number of arithmetic controls , as checked from this document, is very low, the number of logical</p>

controls extremely low and the number of likelihood controls apparently non-existent. This has an impact on quality assurance and the use of supervisory reporting.

EC 3: valuation rules that are consistent. The FSA Handbook includes specific rules on recognition and valuation of assets, liabilities, exposures, equity and income statement items set in GENPRU 1.3.

“A bank must establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates (GENPRU 1.3.13(2)).” Such systems and controls must include at least (a) documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month-end and ad-hoc verification procedures; and (b) reporting lines for the department accountable for the valuation process that are: (i) clear and independent of the front office; and (ii) ultimately to a main Board executive director (GENPRU 1.2.13(3)). So the FSA puts the onus on banks and external auditors, though it could verify and contest some results through “deep-dives” or through S 166 reports.

Trading book positions are subject to prudent valuation rules as specified in GENPRU 1.3.14 R to GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification, Adjustments or reserves). These are mainly based on IFRS rules, and the U.K. GAAP rules used by some smaller entities are close to IFRS rules.

EC 4: adequate frequency. The frequency of standard regulatory information required from banks is set out in SUP 16.12.6. Frequencies seem commensurate with the nature of the information requested; for some data the frequency is specified in Directives, e.g., group data being more complex to compile is collected less frequently (usually half-yearly) than firm level data (usually quarterly). Some data items also have reporting thresholds so that they are only required from firms with significant business in that area e.g., FSA005 Market Risk. Monthly, rather than quarterly, capital data (FSA003) are required from those banks with large market risk as these requirements are deemed to be commensurate with BIPRU 730k investment firms, which are subject to an EU Directive to monitor their capital on a monthly basis.

Some data such as on “Large Exposures,” and interest rates, are effectively used. It is also expected that for the new liquidity ratios, the data expected to come in the Database will be used. But, as already indicated, the FSA relies more than most supervisors on banks’ MIS. This technique presents the advantage of not imposing on banks the need to build and maintain large systems “only for a prudential supervisory purpose”—and hopefully of better quality as they are banks’ data—but the disadvantage is that the system is not tested on site and there is little consistency between banks, as each bank uses its own MIS.

EC 5: meaningful comparisons. Reporting dates and frequencies are all calculated from a firm’s Accounting Reference Date. Therefore all entities in a group will report at the same date and periods. The same suite of reporting forms are completed by all banks and, where applicable, by the banking group.

This requirement is respected, at a low level however, as the scarcity of data of the call report system remains a constraint, and the use of banks’ MIS data hampers

comparisons.

EC 6: the power to request and receive any relevant information

This power exists. The overarching rule that gives the supervisor the power to request any relevant information it deems necessary is laid out in FSMA (section 165). The FSA prefers to ask banks to draw on their own MIS than to impose a fixed regulatory new template.

This approach is effectively used as needed, given the paucity of data collected through the normal central reporting. It is fair to say than a customary “cost/benefit” analysis gives easier channels to industry pressures to limit reporting.

The financial and banking crisis has of course pushed the FSA to request more external data from banks, especially the largest, including internal management information. For the time being, the domains are still limited to liquidity and capital adequacy. But also could be used in the future to provide information on the quality of loan portfolios in the same way, in conjunction with the COREP part included in the central base as a reference framework.

EC 7: full access to all bank records As indicated in its self-assessment and discussed with the staff, the FSA has full access to a bank’s Board, management, staff and records (see section 165 of FSMA) to collect data and to conduct investigations (under sections 167 and 170 of FSMA).

Moreover, failure to provide information requested by the FSA without reasonable excuse, or knowingly providing false or misleading information to the FSA constitutes a “criminal offense.” Furthermore, destroying, concealing, falsifying or otherwise disposing of a document which is or may be relevant for an investigation will constitute a criminal offense where a person was aware of or suspected that the FSA was likely to conduct any such investigation. Besides the FSA may apply for a warrant to enter the premises of a bank and obtain documents or information of a specified kind, where it suspects that such a requirement would not be complied with or the documents or information would be removed, tampered with or destroyed (section 176 of FSMA). Any person who intentionally obstructs the exercise of any rights conferred by a warrant will be guilty of an offense. This demonstrates a very strong enforcement capacity.

EC 8 timely monitoring. The FSA has in place both systematic and manual processes to monitor timely collection of data and automatic systems similar to supervisors in other countries. Systems exist (TARDIS, DMT) to monitor delays. They hold the firm information including the electronic reports that firms are expected to submit. These systems also record the remittance period and frequency for each report. When a return is submitted late, there is an alert system that will flag this up. There is a dedicated data monitoring team (DMT) that monitors both the electronic reports and any paper returns that firms are due to submit. Using a combination of the alert system and manual controls for monitoring paper returns, they are able to see which firms have submitted data late and as it is FSA policy to charge firms that submit their returns late, the DMT will issue these fines and warnings.

In addition to systematic validations on the data to check that the data have been provided and any cross-validations are correct, the prudential risk department and

supervisors run analytics and statistics on the data to assess the validity and adequacy of the data. Where they feel the data are incorrect, they will ask for supplementary data. Where a firm has persistently misreported and it is felt that they are in breach of their obligations, the enforcement team will do further investigations and can issue unlimited fines for serious infringements.

The requirement on firms to submit specified data and the schedule, in terms of frequency and deadlines, are laid out as Rules in SUP 16 of the FSA Handbook. SUP 15.6 sets out the standards around accuracy, completeness and timeliness that firms must meet. If a firm does not meet these requirements, they can be subject to fines or in more serious cases referred to the Enforcement department for investigation and appropriate action/penalties.

There is an ongoing process for identifying any late data submission and penalties for late reporting are regularly applied. If there is significant doubt about the accuracy of data supplied, under FSMA supervisors can request a “report by skilled person” to investigate in detail. At any time supervisors can require firms to resubmit data where errors have been uncovered, either by the supervisor or by the firms themselves. Again this does happen on a regular basis. SUP 15.6.4 places a requirement on firms to supply correct information if they become aware that the information they supplied was false, misleading or inaccurate.

This system is similar to those existing in other supervisory authorities.

EC 9: The FSA has produced a “Banking sector guide” to review regulatory returns. This Guide is mandatory and banking supervisors must follow it. It sets out the minimum level of review a supervisor is required to undertake.

In addition, the FSA undertakes peer review of regulatory data which can highlight anomalies for investigation, and there is the power under FSMA (section 166) to call in external experts to undertake a review. This, however, is more a “potential weapon” than a real one as, following an inquiry by the assessors, the number of reports asked in this domain appears to be only one in three years.

However, thematic reviews, where the regulatory data from a sample of firms are checked off site for completeness and accuracy, are undertaken periodically.

Reliability and accuracy of reporting may also be investigated off site as part of the regular ARROW assessment of a firm but banks may provide answers to any concerns raised.

EC 10: external experts. The FSA has the power to commission external experts called “skilled persons” that produce, onsite, reports under section 166 of the Financial Services and Markets Act. The scope of these reports is determined by the FSA and there is ongoing project management to ensure the report meets its desired objectives. The number of 166 engagements has been 23 for banks and one for building societies in 2010, which was increased from a lower number in previous years.

EC 11: prompt reaction from external experts. This is the case, but skilled experts are commissioned for a very specific task and do not perform a general overhaul.

	There is indeed always an end deliverable which summarizes the skilled person's findings on the topic related to its commission. During the onsite mission, there is also a regular communication throughout the process to ensure any material issues discovered are brought to the FSA's attention on a timely basis.
Assessment	Largely Compliant
Comments	<p>Technically, the FSA complies largely with this CP, but most of the time (with some exceptions in EC 7 for example) at a rather low level of completeness, effectiveness and efficiency. The Largely Compliant rating given here must, however, be read in conjunction with CP 7 and 19 rated MNC; CP 21 can be seen as one of the causes of the MNC rating given to CP 8 and 19.</p> <p>The paucity of data collected by the FSA has important implications on the building of its central risk model (ARROW) where the amount of hard data is extremely limited and on the construction of supervisory tools such as EWS (Early Warning System) that are still missing. Indeed, this is consistent with the past supervisory approach, which focused more on the conduct of business, compliance with rules and processes than on direct financial analysis or detailed analysis of portfolios. Though the FSA—in its new enhanced supervision for large banks—requests and uses more data from banks, the move toward a more quantitative approach remains timid.</p> <p>However, as a cultural tradition, the FSA does not rely much on data; indeed its collection of data can be seen, compared with peer supervisors, as very light. The FSA prefers to rely on banks' MIS and to ask banks to perform analysis on their own data though most of them are often qualitative (for instance on liquidity). Accounting data in banks are reviewed by external auditors, no credit registers or balance-sheet or credit bureau has been developed internally. Within the new planned reorganization, the FSA could have a complete reappraisal of its use of financial and prudential qualitative data. Even if understandable, the present very low use of quantitative data has important implications on the risk model and even on the supervisory approach and tools.</p>
Principle 22.	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	<p>EC1: All U.K. incorporated banks and branches of non-EEA banks are subject to the provisions of the Handbook in SYSC (Chapter 3.1). Banks are required to capture and record accurately and on a timely basis every transaction and commitment which the bank enters into and provide details as appropriate for each transaction and commitment. In addition SYSC 3.2.20R states that “A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system....” The FSA has powers to enforce these requirements and to fine banks for late and inaccurate supervisory returns. For U.K. incorporated companies, further accounting record requirements are set out in the Companies Act 2006.</p> <p>EC2: All U.K. banks must be externally audited (SUP 3.3.2R) and published accounts must bear an opinion by the external auditor as to the completeness and accuracy of the financial statements. If there were a failure to comply with the relevant accounting standards, the external auditor would qualify the opinion. In addition, external auditors have a statutory duty to inform the FSA whether any concerns of material significance have arisen during the course of their work (FSMA Sections 342(5) and 343(5) and SUP 3.8.10).</p>

EC3: Banks are expected to follow generally accepted accounting standards unless a different treatment is specified by, or agreed with, the FSA (SUP 16, Annex 25G). This includes specific rules on recognition and valuation of assets, liabilities, exposures, equity and income statement items (GENPRU 1.3). A bank must establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates (GENPRU 1.3.13(2)).

EC4: The Auditing Practices Board (APB), which is a part of the Financial Reporting Council (FRC), sets U.K. auditing standards, which are based on international standards with additional U.K. requirements. In addition, under section 340(3) of FSMA the FSA can impose rules on auditors in respect of regulated firms. All U.K. banks must appoint an auditor (SUP 3.3.2R). The Companies Act 2006 section 495 requires that the auditor's report (which is required with the accounts) must state clearly whether, in the auditor's opinion, the accounts give a true and fair view and have been properly prepared in accordance with the relevant financial reporting framework (IFRS or U.K.GAAP).

EC5: U.K. audits are required to follow International Standards on Auditing (ISAs) (United Kingdom and Ireland) issued by the Auditing Practices Board (APB), which are, in essence, international standards on auditing with U.K. add-ons. ISAs (United Kingdom and Ireland) are a body of auditing standards that are designed to support the basis of the auditor's reasonable assurance opinion. As such, compliance with ISAs (United Kingdom and Ireland) include specific standards that cover the loan portfolio, loan loss reserves, nonperforming assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.

EC6: If the FSA had concerns over the abilities of a bank's external auditors, it can: request management to change the audit firm; refer that auditor to the Accountancy and Actuarial Discipline Board (AADB) and the auditor's professional body; or potentially, under section 345(1) of FSMA, disqualify an auditor if it appears to the FSA that the auditor 'has failed to comply with a duty imposed on him under [FSMA].' The FSA prohibits banks from using disqualified auditors (SUP, 3.4.5R).

EC7: All U.K. banks must appoint an auditor (SUP 3.3.2R). The Companies Act 2006 (section 495) requires that the auditor's report (which is required with the accounts) must state clearly whether, in the auditor's opinion, the accounts give a true and fair view and have been properly prepared in accordance with the relevant financial reporting framework (IFRS or U.K.GAAP). The auditor must follow auditing standards issued by the Auditing Practices Board, ISAs (United Kingdom and Ireland), which essentially are international auditing standards with additional local legal requirements, for example the duty to report to the regulator.

EC8: The accounts referred to above (in EC 7) must be produced and filed for each annual period. The accounts form part of the annual report, which must include a directors' report that sets out a business review (Companies Act 2006 section 417). In addition, for banks which have equities admitted to trading on a regulated market there is a requirement to publish: an annual report, a half yearly financial report, and an Interim Management Statement that can be in narrative form. Slightly less onerous requirements apply where only debt securities are admitted.

EC9: Annual reports for unlisted banks contain, amongst other things, a fair review of the company's business and a description of the principal risks and uncertainties facing the company. The review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business. Annual reports for listed banks include (among other requirements) audited financial statements and a management report that sets out a fair review of the business and the principal risks and uncertainties, consistent with the size and complexity of the business (DTR 4.1); half yearly financial reports include (among other requirements) (i) condensed financial statements prepared in accordance with IFRS (IAS 34); and (ii) an interim management report that sets out an indication of the important events that have occurred in the first half of the year and which have had a material effect on the financial position or performance (DTR 4.2); interim Management Statements provide: (i) an explanation of material events and transactions that have taken place during the period and their impact on financial position; and (ii) a general description of the financial position and performance during the relevant period. Further, listed banks which have financial instruments admitted to trading on a regulated market are subject to rules under which, subject to certain conditions, they are required to disclose as soon as possible "inside information which directly concerns the [bank]..." (DTR 2.2). There is a recognition that there may be a legitimate interest to delay disclosing inside information concerning the provision of liquidity support by the BoE or by another central bank to it or to a member of the same group (DTR 2.5.5A).

EC10: The U.K. has effective review and enforcement mechanisms designed to confirm compliance with disclosure standards. Where annual accounts do not comply with the requirements of the Companies Act 2006, every director who knew that they did not comply, or was reckless, and who failed to take reasonable steps to secure compliance, commits an offense. (Companies Act 2006, section 414). The Financial Reporting Review Panel (the U.K.'s independent regulator responsible for corporate reporting and governance), seeks to ensure that the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 2006 and applicable accounting standards.

EC11. The FSA's Financial Risk Outlook includes selected aggregate data on the banking system. The BoE publishes a range of monetary and financial statistics in relation to banking. Monetary statistics are collected by the BoE from banks and building societies operating in the United Kingdom, which together make up the Monetary Financial Institutions sector.

AC1. As a lesson learned from the failure of the bank Northern Rock, the FSA has established periodic meetings with external audit firms to discuss issues of common interest relating to bank operations. The FSA's Supervisory Enhancement Program requires supervisors of high-impact banks to meet with the auditors of their firms at least annually. In addition, the FSA meets in bilateral meetings with financial services audit partners for the Big 6 audit firms.

AC2. Under the FSMA 2000 (Communications by Auditors) Regulations 2001, auditors have a legal duty to report to the FSA certain contraventions, or possible contraventions, of rules and legislation and other matters that they reasonably believe are or may be of material significance to the FSA. FSMA (Sections 342(3) and 343(5))

	<p>provides that no duty to which the auditor is subject shall be contravened when a disclosure is made to the FSA. This is provided the disclosure is done in good faith and the auditor reasonably believes the information or opinion is relevant to any function of the FSA.</p> <p>AC3. The APB has rules regarding rotation of audit engagement partners for listed companies (under the APB's Ethical Standard 3 (Revised) Long association with the audit engagement). For unlisted companies, these rules require the auditor to carefully consider the need for audit engagement partner rotation. There are no requirements for the rotation of audit firms.</p> <p>AC4. The U.K. banks that have financial instruments admitted to trading on a regulated market must disclose information in periodic reports and at other times where disclosure of 'inside information' is required. In addition, the FSA has encouraged the U.K.'s largest banks through the British Bankers' Association to develop and apply a Financial Reporting Disclosure Code (the BBA Code) that sets out 5 key principles for disclosures. The BBA Code also includes a commitment for these banks to meet with the FSA (as part of their reporting preparations in advance of each interim and annual reporting period) to discuss areas of interest relevant to disclosures for that reporting period.</p> <p>AC5. Under section 165 of FSMA, the FSA has the power to access the supervised firm's documents, including, for example, any reports from the auditor to the firm. For public interest audits (which includes all U.K. listed companies), the Audit Inspection Unit (AIU) of the financial reporting council (FRC) is responsible for the review of the audit work and as part of this it has the right of access to the auditors' working papers for this purpose. For other audits, the auditor's 'Recognised Supervisory Body' is responsible for the review of the audit work and has the right of access to the auditors' working papers. However, the supervisor does not have a right of access to audit working papers.</p>
Assessment	Compliant
Comments	<p>The U.K. public authorities should consider enhancing the information disclosed by banks, promoting comparability, relevance, reliability and timeliness of the information. A useful tool in this regard would be the regular public disclosure by the supervisor of nonconfidential firm-level prudential returns, such as balance sheet and income statement, loans and investments (sectoral information), asset quality (past-dues, nonperforming loans, charge offs), funding structure, capital structure, and off-balance sheet exposures.</p> <p>Recently, the FRC and the FSA have expressed some concerns about the quality of audits, including such matters as the need for more professional skepticism. The FSA has commenced more regular in depth discussions with audit firms. It is developing a more comprehensive strategy for engaging with auditors on a regular basis to share concerns and identify where the FSA could better lever its relationship with auditors to assist the FSA in meeting its goals – this should continue. The FSA should also continue to develop the extent of its engagement with auditors through more detailed discussions with auditors. This would enable the FSA to understand and confirm it is comfortable with the nature and scope of work supporting audit assurance in key areas that the FSA is implicitly heavily reliant on, such as credit impairment and provisioning, and model and mark- to-market valuation.</p>

	<p>If the FSA were to share with auditors those areas it is concerned about in advance of audits, this could also help auditors focus on things that would enhance the effectiveness of the audit and would indirectly be of benefit to the FSA.</p>
<p>Principle 23.</p>	<p>Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.</p>
<p>Description</p>	<p>The FSA has the legal powers under FSMA, to take an appropriate range of remedial actions against banks and to impose penalties up to and including revocation of a bank’s authorization.</p> <p>As described in its self-assessment, “these powers are used to address problems such as the failure to meet FSMA threshold conditions. The tools available to supervisors include written communications with bank management to actions that involve restricting a firm’s activities, e.g., withdrawing a firm’s permissions to carry out certain regulated activities (s. 45) or disciplinary measures such as fines or public censure (s. 205). The FSA’s powers may be implemented with immediate effect or within a specified timeframe (ss. 45, 53(3)) as appropriate. Sections 380 and 382 enable the FSA to apply to court for injunctions to restrain a person from any conduct that would put it in breach of any FSMA requirement, or for an order that pays compensation or takes other remedial action where such a breach has occurred. (EG 9; DEPP 6.6.1G – 6.6.5G))3.</p> <p>The logic of the FSA is to start from the FSMA threshold conditions that set requirements for firm authorization. Those thresholds, if triggered, will generally require action in all cases of noncompliance that come to the FSA’s attention, and that cannot be resolved through the normal use of supervisory tools.</p> <p>The FSA does not generally appoint investigators in such cases. Instead, “firms are first given an opportunity to correct the failure through remedial actions”. If the firm does not take the necessary remedial action in due time, the FSA will consider whether its permission to carry out regulated business should be varied and/or cancelled. It is the OIVOP scheme. However, there may be cases where the FSA considers that a formal investigation into a threshold condition or other concern is appropriate. Hence, the FSA has the ability, where appropriate, to revoke the banking license.</p> <p>More precisely, where a firm or person has failed to comply with FSMA requirements, the rules, or other relevant legislation, the FSA may feel it appropriate to deal with this without the need for formal disciplinary or other enforcement action. The proactive supervision and monitoring of firms, and an open and cooperative relationship between firms and their supervisors, will, in some cases where a contravention has taken place, lead the FSA to decide against taking formal further disciplinary action. However, in those cases, the FSA will expect the firm to act promptly in taking the necessary remedial action agreed with its supervisors to deal with the FSA’s concerns. If the firm does not do this, the FSA may take disciplinary or other enforcement action in respect of the original contravention.</p> <p>Hence, the tools exist and are in line with similar supervision elsewhere. The issue is to determine if the action imposed is rapid and strong enough.</p> <p>EC 1 Supervisory concerns are addressed. During its ARROW assessment and now</p>

during its continuous supervision, the FSA maintains lines of communications open with the firm's management at all levels. It also holds key meetings during the evaluation phase of the ARROW risk assessment; and holds a close-out meeting, which follows the validation process and both presents the FSA's initial conclusions and indicates the contents of the risk mitigation program (RMP) to the firm's senior management.

Follow-up letter: The results of the risk assessment are formally communicated to the firm in an "ARROW Letter" following formal validation of the assessment. During the rest of the regulatory period (until the next re-assessment), the firm is subject to ongoing monitoring and any further planned meetings or visits to monitor progress against the Risk mitigation Programs or RMP should be set out in the ARROW Letter.

The findings of FSA individual capital and liquidity adequacy standards (ICAS and ILAS) assessments and notification of the firm's individual capital and liquidity guidelines – the amount and quality of capital that at that point in time and after taking account of the firm's risk profile (GENPRU 1.2.26R) – are set out in a specific follow-up letter that is sent to the firm either as part of the ARROW process, or as a separate assessment.

Assessors reviewed documents that showed that the framework is compliant with general practice.

EC 2 orderly resolution of a problem bank situation. As indicated by the FSA: "The FSA is responsible for determining that a banking institution is failing, or is likely to fail, to satisfy its threshold conditions (as set out in FSMA, s. 41 and the Banking Act 2009, s. 7) and that it is not reasonably likely that action will be taken by or in respect of the institution that will enable the institution to meet those conditions."

The FSA would thus be responsible for the authorization of a bridge bank and ongoing supervision of institutions in the SRR (Banking Act 2009, s. 7).

EC 3 The supervisor has available an appropriate range of supervisory tools. Indeed, the FSA has the legal powers, under FSMA (s 41, COND), to take an appropriate range of remedial actions against and impose penalties on banks. The range of tools is applied in relation to the gravity of the situation.

The tools available to supervisors range from making recommendations for remedial action, to giving guidance and imposing individual requirements to actions that involve restricting a firm's activities, e.g., withdrawing a firm's permissions to carry out certain regulated activities or own initiative variation of permission (OIVOP, FSMA s. 45; SUP 7.2; SUP 7.3; DEPP 2) or disciplinary measures such as fines or public censure (FSMA s. 205; SUP 1.4.6).

The FSA's powers may be implemented with immediate effect or within a specified timeframe (Section 45, 53(3)) as appropriate.

The FSA can use the Courts' powers to enforce its action. Sections 380 and 382 of FSMA enable the FSA to apply to the court for injunctions to restrain a person from any conduct that would put it in breach of any FSMA requirement, or for an order that pays compensation or takes other remedial action where such a breach has occurred.

How, in practice, would a remedial action related to a control or risk management breakdown be carried out given threshold conditions?

- The FSA would normally respond to a control or risk management concern in a firm by issuing a letter to the firm asking them to take steps to remedy the relevant matter.
- Depending on the circumstances, it may also take account of the issue in setting Pillar 2 individual capital guidance for the firm. The FSA may also use its information gathering powers to further ascertain the nature of the issue. For example, it might require the firm to appoint an expert to review the relevant issue, using the FSA's power under Section 166 FSMA.
- In most cases, this is sufficient to persuade the firm to address the issue. If the issue was not resolved, the FSA could use the OIVOP power (in the case of a firm with a Part IV permission – i.e., a U.K. firm, an EEA firm with a top up or a third country firm). In the case of an inwardly passporting EEA firm, the FSA could in principle use its equivalent power under Part XIII of FSMA - although in most cases, responsibility for systems and controls would be reserved to the home state regulator, and it would therefore be normal for them to address the issue.
- The grounds for using the OIVOP would be either or both of: (i) the failings were sufficiently serious that the firm no longer meets threshold conditions; or (ii) that it is in the interests of consumers or financial stability to require the firm to take action. The second ground may be particularly useful where the problem is material, but not so serious that it calls into question compliance with threshold conditions.
- Where the grounds for using the OIVOP are met, the FSA has a flexible power to impose a requirement on the firm that is best suited to address its concern.
- If appropriate, there may be other tools open to the U.K. supervisors. For example, taking enforcement action against individual approved persons who were responsible for the problem.

EC4 supervisor has available a broad range of possible measures. The supervisor has available the range of possible measures described above. The assessors have seen some cases to gain a better understanding of the process.

FSMA Part XIV (ss. 205-211) sets out the disciplinary measures available to the FSA. These measures have been enhanced in the 2010 Financial Services Act 2010. Key among these measures are the FSA's ability to require firms to increase their regulatory capital to reflect an increased risk profile; its ability to vary permissions (OIVOP); and its right to levy fines/penalties against firms or suspend a firm's activities (its powers were enhanced under the Financial Services Act 2010,) or issue public censure.

One of the possible issues is: "How often do big or small firms fail to meet the remedial action plan and face more serious consequences?"

A good proportion of cases which are referred to the Enforcement division are a result of, either a firm failing to fully implement a formal remedial action plan, or a firm failing to address issues of concern which have been raised but where no formal supervisory remedial action plan had been proposed.

However, the FSA cannot provide a precise number of how often big or small firms fail to meet remedial action plans and subsequently are subject to other enforcement actions. This is because the FSA does not have a centralized system to record this type of information.

The assessors have examined three examples of remedial action plans or risk mitigation program agreed by the FSA Supervisors with a firm, and the closure records on two issues.

A remedial action plan agreed by the Enforcement Division of the FSA frequently focuses on how the firm will compensate consumers who may have suffered a financial loss as a result of the firm's breach. Such plans usually cover the following areas:

- (a) A review by the firm of its records to identify which customers might potentially have been caused detriment by the firm's noncompliant conduct and therefore could be eligible for redress.
- (b) Customer contact: unless the firm can identify from its records that a customer should be automatically compensated, it should be required to write to identified customers to give those customers a chance to have their sale reviewed and, where appropriate, receive redress. For example, the following Final Notice sets out the agreed customer contact letter in the EGG case, see:
<http://www.fsa.gov.uk/pubs/final/egg.pdf> .
- (c) Assessment of whether redress is required: how the firm will determine whether customers are eligible to receive redress.
- (d) Calculation and payment of redress: how appropriate redress should be determined and then paid to customers.
- (e) An agreed timeframe for all of the above.
- (f) Monitoring of all of the above. This will either be done by FSA Supervision or via the appointment of a Skilled Person or other third party.

EC 5 The supervisor has the power to take measures. The FSA is indeed empowered to intervene to prevent a firm's capital levels from falling below the minimum levels set out in its capital resources requirement (BIPRU 2.2; GENPRU 2.1).

The supervisory review and evaluation process (SREP) enables the FSA to review the firm (or group) capital position as per its internal capital adequacy assessment process (ICAAP) and to require the firm to take necessary actions at an early stage to address any failure to meet requirements set out as per GENPRU 2.1 specifications (BIPRU 2.2.9(3)).

Where the amount or quality of capital which the FSA considers a firm should hold to meet the overall financial adequacy rule or as a capital planning buffer is not the same as that which results from a firm's ICAAP, the FSA usually expects to discuss any such difference with the firm.

Where necessary, the FSA may consider the use of its powers under section 166 of FSMA to assist in such circumstances (BIPRU 2.1.12C) – though the assessors have not been able to find a single case of S 166 action. If the firm disputes the FSA's findings and the two are unable to come to an agreement (as per BIPRU 2.2.13; 2.2.14), the FSA may invoke its OIVOP powers (FSMA, s. 45) to vary the firm's Part IV permissions.

After review, the assessors believe that the capital adequacy review is a domain where the FSA has put resources and that the tools and procedures are in place to permit the FSA to intervene.

It remains to be seen if the action is sufficiently proactive and forward-looking to be intrusive in time. The new change of culture has just started and will take time to be fully prevalent.

EC 6 The supervisor applies penalties and sanctions not only to the bank but to individuals. The sanctions outlined in EC4 above can also be applied to individual approved persons within a firm, especially those performing a significant influence function (SIFs) (COND 2.5; PS 10/15 "Effective Corporate Governance – Significant influence controlled functions and the Walker Review")

The FSA is empowered to apply penalties and sanctions to approved persons within the firm for breaches of FSMA (FSMA, Part XIV – Disciplinary Measures, Part V – Performance of Regulated Activities – ss. 56, 63; 64; DEPP 6.5B, 6.5C, 6.6.3). The Financial Services Act 2010 has increased the FSA's ability to take action against individuals by removing the restriction on imposing a penalty and withdrawing an individual's authorization/permissions at the same time (FSMA, s. 206, s. 33).

Though sanctions, such as fines, are more often taken against nonbanks, the FSA has these powers also for individuals.

AC 1 The FSA's statutory objectives (market confidence, financial stability, consumer protection and the reduction of financial crime) and its duty to follow principles of good governance (FSMA, s. 7) require supervisors to take corrective actions in an appropriate and timely manner. A good FSA governance in this area is also encouraged by the fact that the Treasury is empowered (FSMA, s.14) to arrange independent inquiries should it consider the FSA to have failed to appropriately address risks in the financial system.

Though the FSA, as described below, has these powers, the recent crisis put a legitimate suspicion on the effectiveness and efficiency of the prompt corrective action. A vast program of internal remediation, however, has been launched these last two years, but even though it will take time to be fully effective, the discussion with the staff permits the consideration that this AC is fulfilled.

AC 2 power to take remedial actions. The FSA is empowered under FSMA to vary or

	<p>cancel Part IV permissions (ss. 44-48) and to prohibit specific regulated activities in a firm (ss. 56-71). So it has those powers (perhaps with some exception in the case of complex groups under a Bank Holding Company).</p> <p>AC 3. n/a – as the FSA is an integrated regulator</p>
Assessment	Compliant
Comments	<p>The FSA has all the tools available and has evidenced an ability to use them. Over time, the addition of financial stability to the regulatory objectives may further enhance the use of these tools. The FSA move to more proactive use of tools would be aided by having a more formal early intervention framework. That should include, how the FSA and the resolution authority coordinate to ensure as smooth an operation of the regime as possible. As in other jurisdictions, the ability to judge when no other solutions other than resolution are likely (as is required in the FSA's invoking of the threshold conditions) is difficult. However, the authorities should review their recent experience with invoking the threshold conditions to ensure that how they are worded does not impede appropriate action.</p>
Principle 24.	<p>Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.</p>
Description	<p>EC1: The FSA carries out consolidated supervision as derived from the European Directives, namely the Capital Requirements Directive (CRD) and the Financial Conglomerates Directive. These requirements are contained within the FSA Handbook. Consolidated requirements for Banking/Investment firm groups are set out in BIPRU 8. Financial Conglomerates (group requirements) are located in GENPRU 3.2.</p> <p>The supervisor receives periodic notifications regarding the firm's 'close links' as defined in the FSMA. The firm is also required to submit a group organization chart. These provide the supervisor with a comprehensive overview of the firm's group structure, which in most cases is wider than the regulated consolidation group.</p> <p>As part of the Pillar 2 framework, supervisors carry out a Supervisory Review and Evaluation Process (SREP) Within this, the supervisor is required to take into consideration the group structure and any group risks arising from membership to this group. This includes consideration given to the different entities that are included within the consolidation group and the risks that arise from them, so as to ensure that the group holds capital proportionate to these risks. This requires a comprehensive understanding of the different business lines that the firm and its consolidation group partake in.</p> <p>Through these processes supervisors familiarize themselves with the overall structure of the group. Recovery and resolution planning, which has started for all major groups, is also helping in this regard. The FSA also has a number of information gathering powers that can be applied to include any entity in a firm's group, including unregulated entities. These information powers also extend to entities which may not necessarily be included within the consolidation group that is supervised by the FSA. These are set out in Sections 165 and 166 in FSMA, which require the provision of information and requirement of a skilled person's report.</p> <p>EC2: Prudential requirements that are supervised on a consolidated basis include: consolidated capital requirements and consolidated capital resources calculations (as per Basel II); liquidity management and support, systems and control requirements, sound governance and risk management, risk concentrations, intra-group transactions</p>

on a group wide basis.

A financial conglomerate must additionally ensure it has sound reporting and accounting procedures for identifying, measuring, monitoring and controlling intra-group transactions and risk concentrations. These group requirements cover all entities in the consolidation group including unregulated entities and entities outside the United Kingdom.

The consolidation group for these purposes under FSA rules includes the U.K. regulated entities. It will then extend up to the highest level parent institution or parent holding company in the United Kingdom or another EEA member state, if there aren't any other EEA regulated entities). If there are other EEA regulated entities, then there is a U.K. consolidated group and an EEA consolidated group where the consolidated supervisor is somewhere else in the EEA.

However, FSA powers to take supervisory actions or remedial powers under FSMA are targeted at the regulated entities that fall within the consolidated group. The FSA does not have clear, direct powers over the parent holding companies.

Therefore the FSA imposes consolidated obligations by acting through the U.K. regulated entities. For example, the U.K. regulated entities are required to cause the unregulated U.K. holding company to report on a consolidated basis and may be required to cause the unregulated holding company to take certain actions.

The U.K. government is currently consulting on extending the FSA powers over unregulated holding companies. This will help to provide the supervisor with enhanced powers in order to direct the holding company, if desirable to do so for the purposes of achieving statutory objectives. The changes are regarded as potentially complex as they interact with issues of whether and how the statutory SRR can be extended to holding companies and nonbank firms in such corporate groups.

FSA staff report that they generally receive cooperation from corporate groups in complying with the current FSA approach but that it is not ideal and can be awkward in some cases (e.g., when the U.K. regulated entity in the group is small relative to the non-U.K. regulated entity over which the FSA has no direct control).

EC3: As noted previously, consolidated supervision (e.g., within the ARROW or SREP) involves the consideration of all group risks and intra-group exposures. The supervisor will also be looking to detect and address instances of multiple gearing (i.e. use of same capital resources more than once in the same group), leveraging (i.e. upgrading the quality of capital within a group), contagion (i.e. the risk that an occurrence in one entity may adversely affect another entity, e.g., through financial or reputational linkages) and risks from shared services (e.g., risks emanating from the sharing of market infrastructure).

Group risk will then be reflected within group capital requirements, with the firm required to hold resources on both a solo and group basis proportionate to the risks posed by the group.

EC4/6: As noted previously, the supervisor has the ability to express various requirements on a group basis but does not have formal powers to impose those prudential standards at the unregulated holding company level. Nor does the supervisor have the formal power to limit the range of activities that the consolidated

group may engage in. However, in a range of cases, the FSA can use its powers at the regulated bank level to achieve necessary results. The FSA requires senior management to be fit and proper and subject to such requirements as are included within the Approved Persons regime. Where individuals at the parent entity level exert significant influence over the regulated firm, they are included in the requirements and approval process. In major banking groups, there are often the same individuals sitting on the bank Board as on the Board of the regulated holding company.

EC5: As noted in CP 1 and CP 25, the FSA does have arrangements with other relevant supervisors to receive information on the risk management and financial condition of the group members.

EC7: As part of the ARROW framework and business as usual relationship management, supervisors will assess management and governance within the firm so as to ensure that management within the firm maintains proper oversight of the firm and its wider group including activities conducted in other entities. This includes assessment of policies and processes of internal management and control. This will also be assessed as part of operational risk within the SREP process.

EC8: The European directives implemented in the United Kingdom require that supervisors ensure there are no legal impediments to access and availability of information from and between entities that fall within the scope of consolidated supervision, whether the entities are regulated or unregulated.

Management, governance and internal control are all part of group requirements and will therefore include all entities within the scope of the group including those which are located in foreign jurisdictions. Supervisors will be aware of the adequacy of group information from the close and continuous process and other reviews.

EC9: The current FSA approach is designed to allow supervisors to properly assess the risks posed to the bank as a result of its membership to the group, and as such will be able to apply its full range of powers at the regulated entity. This would include powers to: disallow unsuitable persons from controlling the regulated entity, ring-fence assets, impose requirements on the regulated entity to take specific actions or to refrain from acting in a particular way, and take specific actions as may be appropriate in the circumstances.

EC10: Overseas regulated and certain unregulated entities are included within the scope of consolidation as set out above. The focus in the supervisory process on the adequacy of group oversight of local entities is commensurate with the risks and materiality of foreign activities.

AC1: While the FSA has limited redress authority over unregulated parent entities its powers of information gathering do extend to these entities, and affiliated entities, and are used in practice.

AC2: There are a number of different equivalence assessments undertaken by the FSA in assessing the quality of supervision undertaken in overseas jurisdictions. This includes Home Country Supervisory Assessments.

AC3: Through the use of supervisory colleges, the FSA will be in close contact with other relevant competent authorities who supervise the entities that are material entities within a group or part of the same group as the firm. The level of interaction between the FSA and other relevant competent authorities will be commensurate with the risk profile of the group/firms concerned. The relationship management team also has the ability to visit foreign operations that are material to the firm/group that they

	regulate. In practice this is done, but desired frequency can be affected by resource considerations.
Assessment	Largely compliant
Comments	<p>The lack of direct legal powers over the parent holding company in a banking group is an issue. The FSA has used the powers it does have to deal with issues as fully as it can. While staff reports no issues to date in ongoing supervision, it is not clear that the regime has been tested. The lack of powers has led to issues in approvals, where the holding company was acquiring an entity that was not regulated in the United Kingdom (so that the transaction was not reviewable under normal FSA procedures from the point of view of ownership of the target company).</p> <p>The authorities should address this legislative deficiency as quickly as possible. If necessary to expedite this, authorities should de-couple the issue of extending FSA powers to bank holding companies from the holding company resolution issues, which are understandably complex.</p> <p>SIVs were issues in the crisis. There is far less activity in this area and FSA staff indicated that they would be highly reluctant to allow capital relief for such vehicles. Accounting rules have also been tightened so that there is far less likelihood of de-consolidation of these vehicles. The FSA should satisfy itself that it has processes to identify if such off-balance sheet activities start to be revived.</p> <p>The more intrusive supervisory style being adopted may necessitate more on-site visits and in depth reviews at select foreign operations of U.K. banks, than have been performed to date. Issues of how effective the governance, risk management and control environment works in a major cross-border group, and issues of how resolvable such a group is may also necessitate that work. The FSA should be sure it allocates adequate resources for that purpose.</p> <p>The FSA should also review its resources for direct supervision of foreign operations to make sure they are sufficient.</p>
Principle 25.	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	EC1. The FSA's policy is to exchange information with foreign supervisors that may be relevant to either supervisor. For supervisory colleges, this provides a ready-network for sharing such information. The FSA is still developing contacts with other supervisors to ensure that appropriate information is shared in a timely and proportionate manner and to ensure that this is maintained through both times of calm and crisis. The FSA recognizes the importance of delivering effective supervision of cross-border firms and the importance of home and host supervisors working in tandem to deliver this. The FSA is actively engaged in the work of the FSB, Basel Committee and the amendments to the Capital Requirements Directive. The FSA recognizes, however, that achieving strong relationships will take time and they are still developing them. The FSA is working to ensure that the views of other supervisors are appropriately integrated into their domestic supervisory framework. Assessors discussed with FSA staff situations where information sharing was not as adequate as they and/or other countries would like. Assessors and the authorities understand that there are limits to the ability of the United Kingdom as home supervisor to satisfy all

host countries' needs. Banks that assessors talked to generally reported that colleges were useful, but agreed they had more further to go.

EC2. The FSA's policy is to identify all the foreign supervisors involved in the supervision of the relevant international banks and engage with them under the home/host framework. For the five largest U.K. banks, the FSA has established supervisory colleges that include the key foreign supervisors that supervise systemic entities and, in some cases, those supervisors for whom the group is systemic to their national financial system. For non-U.K. banks that are important to the U.K. market or where the U.K. entity is systemic to the firm, the FSA participates. At this stage, many of these colleges are new and still developing their role. The FSA objective, in line with the Basel guidance and CRD requirements, is that these college networks will promote the timely exchange of information, discuss supervisory plans and identify opportunities for joint work, share analysis of potential macroeconomic vulnerabilities to or from the banking group, and agree how supervisors would work together in different situations.

EC3. In terms of information provided as home supervisor to host supervisors, the relationship with EEA supervisors is determined by the CRD requirements and the new requirement to agree a joint risk assessment and capital adequacy decision with other EEA supervisors annually from 2011. Where U.K. banks have operations outside the EEA, the FSA agrees on significant non-EEA entities with host supervisors (this will determine the extent of the involvement of the host in the following tasks and the extent of the information they should be provided with), and communicates its overall supervisory view of the banking group and the key messages from the risk assessment of the firm. The Home Country Supervisory Assessment applies to these relationships.

EC4. In terms of the information provided as host supervisor to home supervisors, the relationship with EEA supervisors is, again, determined by the CRD requirements and the new requirement to agree a joint risk assessment and capital adequacy decision with other EEA supervisors annually from 2011. Regardless of the parent country, the FSA agrees on the significance of the U.K. entity with the home supervisor. Where the banking activities are operated through an EEA branch, a non-EEA branch or a subsidiary of an overseas group, the FSA will often send the ARROW letter (the communication the FSA sent to a bank as a result of an ARROW assessment) to the relevant supervisor. The ARROW letter includes the type of information described above and should set out the length of the next regulatory period. The FSA, as a host supervisor, will inform the home supervisor when the cross-border operation is material to the bank or banking group and financial sector of the United Kingdom. The Home Country Supervisory Assessments apply in these relationships.

EC5. The FSA's policy is that all banks (both U.K. incorporated and overseas banks operating in the United Kingdom) are subject to the same prudential requirements. For EEA banks, the U.K. system operates in a way such that it complies with EU Law and in particular with Directive 2006/48/EC. This broadly means that responsibilities allocated to the United Kingdom in relation to an incoming EEA bank branch are more limited on the basis that the home state has responsibility under the Directive for prudential, inspection and regulatory reporting requirements. Similarly, monitoring and reporting requirements are more limited in relation to EEA banks conducting cross-border services business only rather than from a branch established in the United Kingdom. For banks from non-EEA jurisdictions, the FSA's policy is to require them to set up subsidiaries in the United Kingdom except when the FSA is satisfied that the

firm will be subject to prudential regulation by its home state supervisor that is broadly equivalent to that provided for in the FSA Handbook and the applicable EEA prudential sectoral legislation. If the latter, the FSA's policy is to place reliance on the home supervisor for those aspects of supervision.

For this purpose, the FSA carries out three types of third country assessments:

(i) Home country supervisory assessments: this is a broad 'reliance' assessment that covers the regulatory regime, resources and competence of supervisors (banking, securities, and insurance) in non-EEA jurisdictions to determine the degree to which the FSA can "rely" on their work when undertaking a risk assessment or implementing a risk mitigation program; (ii) Third Country Groups Equivalence Assessments: this is an 'equivalence' assessment that allows the FSA to identify whether a banking/investment group or conglomerate (Third Country Group/s) is subject to the provisions in the Capital Requirements Directive (CRD) or Financial Conglomerates Directive (FCD), respectively; and determine whether the Third Country Group, of which the U.K. firm is a member, is subject to equivalent consolidated supervision in its home jurisdiction; or consider what alternative supervisory measures, if any, may be appropriate for a Third Country Group that is not subject to equivalent consolidated supervision. (iii) Liquidity assessments: to establish whether the liquidity regime of EEA and non-EEA supervisors is broadly equivalent to the FSA Handbook (BIPRU 12); and the level of liquid assets a firm is required to hold to allow it to survive a liquidity stress.

EC6. The FSA's policy is to seek views from the home supervisor when assessing the application of an overseas bank wishing to establish a branch or subsidiary. In the case of a bank incorporated outside of the EEA seeking to establish a branch in the United Kingdom, the FSA would make a Home Country Supervisory Assessment as described above. In the case of a bank incorporated outside of the EEA seeking to establish a banking subsidiary in the United Kingdom, the FSA would make a Home Country Supervisory Assessment as described above. In the case of branches of EEA banks, as outlined in Principle 3 of the Handbook of Rules and Guidance, the FSA does not authorize branches of EEA banks; rather the FSA is notified by the home supervisor that it consents to the establishment of such a branch. In this situation, no assessment of the effectiveness of the global consolidated supervision of the home state supervisor is undertaken as the home state's regime is based on the same EU legislation as the United Kingdom.

EC7. The FSA's approach is to give home country supervisors on-site access to local offices and subsidiaries. There are requirements for the FSA, acting as home supervisor, to inform the host supervisor of intended visits to local offices and subsidiaries of banking groups but these only apply in relation to EEA banks. However, the FSA tends more broadly to inform host supervisors of such visits in the context of the enhanced home/host approach to supervision of banking groups. The home/host policy is stated in ARROW, in particular, chapter 5 of the Reference manual, chapters 7-8 of the ARROW toolkit and Policy Card: Home/host.

EC8. The FSA's policy does not allow 'shell banks' or 'booking offices' to be established or continue to operate in the United Kingdom (section 16 Money Laundering Regulations 2007). The FSA's approach in this area has been recognized by the Financial Action Task Force (FATF) in the Mutual Evaluation Follow-up Report (December 2009).

	<p>EC9. FSA staff understands that there is no overall requirement for the FSA to consult the other supervisor if it were necessary to adopt remedial action based on the information provided by the other supervisor. However, the FSA does tend to do this in the context of the enhanced home/host approach to supervision.</p> <p>AC1. The FSA's policy is to establish a communication strategy with all EEA supervisors and significant third country supervisors depending on the size and complexity of the relevant bank/banking group in times of crises. However, this has been sometimes difficult to deliver in practice, in particular in times of crisis.</p>
Assessment	Largely compliant
Comments	<p>Effective group-wide supervision, particularly of systemically important financial institutions where institution-specific cooperation agreements between relevant home and host authorities will be needed, and progress in international recovery and resolution plans require effective home/host information sharing and cooperation. In addition, the central role of the United Kingdom in the global financial system makes it paramount to reach the highest standards on home-host relationships and in the assessment of the quality of home and host country supervision. The importance of branches in London of EEA banks (where the FSA powers only relate to liquidity under European rules) emphasizes the need for high quality interaction between the United Kingdom as host and the home country supervisor. Also, given the nature of the London market, the United Kingdom will be privy to much potentially useful information relevant to foreign supervisors. To take fully into account the specific situation of the U.K. in the global financial market, and experience during the crisis, the FSA is in the process of enhancing effective relationships with foreign home and host supervisors, through bilateral relationships and in the area of supervisory colleges. Given the evidence of progress so far in these efforts, the assessors concur with FSA staff that this principle should be assessed as largely compliant at this stage.</p>