Financial Services Authority

Financial Risk Outlook 2010

Delivering financial stability

Delivering market confidence

Delivering consumer protection

Delivering a reduction of financial crime

Financial Services Authority
Financial Risk Outlook
2010

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Foreword

Since the publication of last year's Financial Risk Outlook, the immediate financial crisis has subsided, equity and credit market prices have recovered, and most major economies came out of recession in the last quarter of 2009. But this stabilisation and recovery was only possible because of the public policy response to the crisis – bank recapitalisations, public debt guarantees, exceptional central bank liquidity support, quantitative easing and the reduction of policy interest rates to historically low levels. Moreover, despite these measures, most developed economies including the UK suffered a severe recession in 2009; recovery is only gradual, and vulnerabilities created by the build up of leverage in the pre-crisis years still remain.

Fundamental reforms to global financial regulation are now being designed. These will entail significant increases in capital requirements to above pre-crisis levels, with particularly significant increases against risky trading activity, and tighter liquidity requirements which will restrain risky maturity transformation. Banks will be required to build up counter-cyclical capital buffers in good times so that they are available for drawdown in periods of stress. These reforms will create a sounder financial system for the future. Their introduction, however, will create challenges for banks and building societies, particularly when combined with the withdrawal of exceptional funding and liquidity support.

Sections A and B describe the prudential risk management challenges for banks, building societies and insurance companies created by the combination of the macroeconomic environment, the changing regulatory regime, and the future withdrawal of funding and liquidity support.

Section A sets out the *Macroeconomic background and outlook*. It focuses in particular on the challenges created by the need for some households and companies (particularly in commercial real estate) to deleverage from high pre-crisis levels of indebtedness. It describes the base case assumption of a gradual low inflation recovery, but also possible alternative scenarios which would pose different challenges for specific consumer segments and firms.

Section B considers the implications of this outlook for *Financial stability and prudential risks and issues*. In the banking sector, the FSA's interim capital regime has already driven a major increase in capital ratios to above pre-crisis levels, but banks and building societies will need to build up capital further to meet future global requirements. Stress tests now play a crucial role in assessing capital adequacy and *Section B* sets out the new macroeconomic parameters that the FSA will be requiring firms to use in capital stress tests during 2010. In addition, the transition to more sustainable patterns of funding and liquidity will be particularly challenging. In the insurance sector, meanwhile, immediate crisis-driven challenges (for instance, relating to very high credit spreads) have receded, but some specific recession-induced risks remain.

Slowly developing risks, such as increases in longevity, need to be monitored carefully. The introduction of the Solvency II regime will require major changes in capital adequacy measurement and risk management which should help mitigate some of these risks and strengthen the sector.

Section C sets out the challenges around *Market risks and issues*. Some of these derived directly from the crisis and the required regulatory response. Major reform to over-the-counter (OTC) derivative markets are, for instance, now being introduced to reduce counterparty risks through the creation of central counterparty (CCP) clearing systems. But many of the risks with which the FSA is concerned, and which market participants and infrastructure providers need to manage, are either ongoing (such as, the issue of market abuse) or reflect developments which are independent of the macroeconomic cycle (such as, the fragmentation of equity market liquidity through the development of new trading platforms, high frequency trading and OTC markets).

Similarly in *Section D*, which addresses retail conduct of business issues, some of the risks which the FSA and the industry need to watch carefully are accentuated by today's specific economic circumstances. Very low interest rates, for example, can accentuate the danger that consumers may be susceptible to apparently yield-enhancing structured products whose risks they do not fully understand. But many of the risks on which *Section D* focuses are rooted in enduring features of retail financial services markets, such as asymmetries of information between producers and consumers, and business models which entail cross-subsidies between loss-making core products and very high margin related products. The FSA is increasingly shifting to an approach to conduct risk analysis which aims to identify these underlying drivers of potential risk, and to an approach to conduct policy which will allow intervention at earlier stages in the product design and marketing process, rather than focusing solely on sales processes and customer redress when detriment does arise.

Published alongside the main Financial Risk Outlook is a series of Sector Digests which considers in more detail trends and risks in specific sectors: the banking sector, the insurance sector, the retail intermediaries sector and the asset management sector.

The analysis which lies behind the Financial Risk Outlook helps inform how the FSA sets priorities and deploys its resources. Our Business Plan, which will be published next week, describes those priorities and the resulting resource requirements.

Macroeconomic background and outlook

Following the largest post-war contraction in global economic growth, most countries are now showing signs of recovery. Fiscal and monetary policy support has limited the depth and duration of the global recession, but in many countries this has come at the cost of rising public debt. In the UK, the effect of the recession on unemployment and residential property prices has not been as severe as the fall in GDP and the experience of previous recessions might suggest. Given the subdued inflation outlook the Bank of England has used conventional and unconventional monetary policy measures to stimulate the economy. However, leverage remains high in the household sector and in parts of the non-financial corporate sector. The economic outlook will be shaped by the speed with which deleveraging takes place in these sectors.

Global economic background and outlook

Global economic background

Most developed economies fared worse than emerging markets in the global recession…

In 2009, the global economy experienced its largest post-war contraction in GDP. The financial crisis highlighted the interdependency of financial markets and the real economy. Developed economies suffered large falls in GDP. In some cases this was due to previous dependence on credit-financed growth (for example, the UK, US and Spain). In other cases it reflected falling exports, as global demand declined (for example, Japan and Germany). Some emerging markets were less affected, partly because of the robustness of their trade with each other and particularly China.

Table A1: Key global economic indicators

		2008[a] y-on-y	2009[e] y-on-y	2010[f] y-on-y	2011[f] y-on-y
Real GDP (annual average % change)	World output	3.0	-0.8	3.9	4.3
	US	0.4	-2.4[a]	2.7	2.4
	UK	0.5	-5.0[a]	1.3	2.7
	Japan	-1.2	-5.1[a]	1.7	2.2
	Germany	1.0	-4.9[a]	1.5	1.9
	Spain	0.9	-3.6[a]	-0.6	0.9
	Euro area	0.7	-3.5[a]	1.0	1.6
	China	9.6	8.7	10.0	9.7
	India	6.3	5.7[a]	7.7	7.8
	Russia	5.6	-9.0	3.6	3.4
	Brazil	5.1	-0.4	4.7	3.7
	Advanced economies	0.5	-3.2	2.1	2.4
	Emerging and developing economies	6.1	2.1	6.0	6.3
Consumer Price Index (annual average % change)	Advanced economies	3.4	0.1	1.3	1.5
	Emerging and developing economies	9.2	5.2	6.2	4.6
Oil (annual average)	Price in US$	97	62	76	82

Source: IMF World Economic Outlook, January 2010 update
Note: 'Oil' is a simple average of prices of Brent, Dubai, and West Texas Intermediate crude oil; a - actual, updated by FSA where new data is available; e - IMF estimate; f - IMF forecast.

...and in 2010 face growing concerns about public finances.

Monetary and fiscal policy interventions around the world have eased the economic downturn in the short term. However, efforts to support domestic financial systems and stimulate local economies have led to significant deterioration in public finances across many developed and some developing countries. Governments now face considerable pressure to improve their fiscal positions. This necessary process of fiscal consolidation is likely to depress consumer expenditure. Events in Greece in early 2010 have highlighted the instability that can arise from concerns around the sustainability of rising sovereign debt levels. Furthermore, aggregate private sector indebtedness is still high in a number of developed countries and deleveraging will bring significant risks.

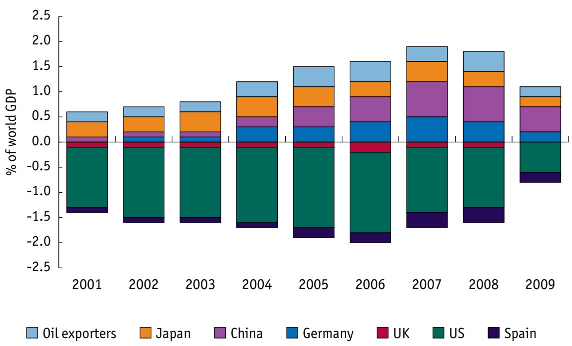
Global imbalances

The growth of significant global imbalances (see *Chart A1*) was a key contributing factor to the financial crisis. In the decade to 2007, large current account surpluses accumulated in many Asian and oil-exporting countries, while fiscal and current account deficits grew in the US, the UK and parts of the Euro area. These global imbalances were an important factor behind the low level of real risk-free interest rates, plentiful global liquidity and the bubble in mortgage-backed securities. The bursting of this bubble triggered the financial crisis.

Global imbalances have narrowed, but could still be a major threat to the global economy.

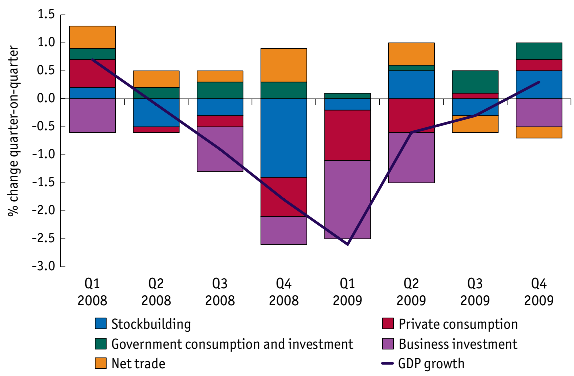
Global imbalances narrowed during 2009, mainly due to contracting demand in the largest 'debtor' countries associated with the economic downturn. A sustainable global recovery will require a further rebalancing, with 'creditor' economies expanding domestic demand in order to drive global economic growth. Doing so will allow governments and households in the 'debtor' countries to reduce their indebtedness without triggering a renewed global downturn. However, failure to address excessive leverage could restore pre-recession imbalances, and re-inflate the asset bubbles that triggered the crisis.

Chart A1: Global current account balances



Source: IMF, International Financial Statistics

Chart A2: Contributions to real UK GDP growth



Source: ONS
Note: The contribution of government investment to GDP in Q4 2009 is estimated at 0%. Stockbuilding includes alignment adjustment.

Global economic outlook

At the beginning of 2009, world trade reduced dramatically through a combination of contracting import demand and reduced availability of trade credit (see *Chart A4*). Both trade and international capital flows have now begun to stabilise. However, they remain vulnerable to renewed global risk aversion which could arise from a sharp correction in asset prices, or overly rapid withdrawal of government support in one of the major economies.

The International Monetary Fund (IMF) expects economic growth in the developed economies to recover over the next couple of years, but remain weak. Many developed countries will be constrained by high public and private indebtedness, still fragile financial sectors and high unemployment (which will constrain domestic demand). Meanwhile emerging markets, which are not so heavily indebted, are expected to grow more strongly (see *Table A1*).

UK economic background and outlook

UK economic background

Government support, low interest rates and trade have helped the UK through the recession.

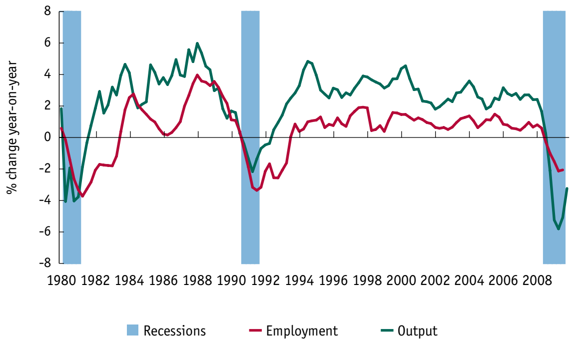
In 2009, the UK economy experienced its largest annual contraction in GDP since the Second World War. The contraction in GDP was driven by declines in private consumption and business investment (see *Chart A2*). Within net trade, exports have fallen less than imports for much of the recession and together they have contributed positively to GDP. The impact of the recession on households and companies – through unemployment and corporate and household distress – has not been as severe as the contraction in GDP might suggest. Fiscal policy action has supported household and corporate income. This has been reinforced by accommodative monetary policy, including quantitative easing and low policy interest rates. Low interest rates have helped reduce the cost of servicing debt, boosting the disposable income of indebted households and companies and helping to stabilise property markets.

The decline in employment has been less severe than might have been expected.

Despite the contraction in output being greater than that experienced in the 1980s and 1990s recessions, the decline in employment has been smaller (as shown in *Chart A3*). In previous recessions, the falling demand led employers to lay off workers. But in this recession, many employers appear to have sought alternatives to redundancies, including pay freezes, voluntary pay cuts, reducing the number of hours worked and leaving vacancies unfilled. To some extent, the lower fall in employment may therefore reflect a more flexible labour market. However, labour productivity has fallen and corporate earnings growth has been weak. Unless the economy continues to recover it may be that greater falls in employment have been delayed rather than avoided.[1]

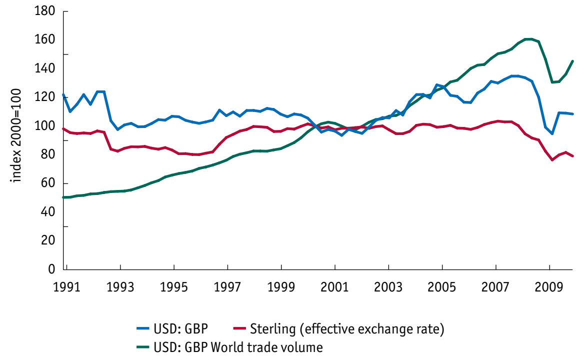
1 *Inflation Report*, Bank of England, February 2010.

Chart A3: Employment and output in past recessions



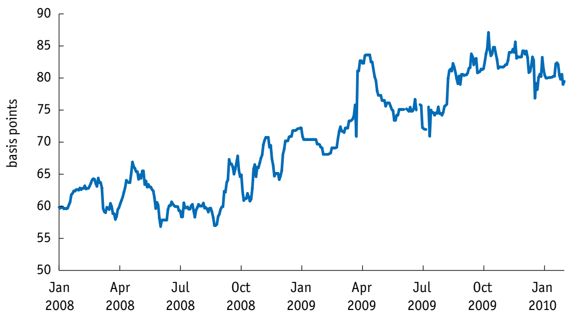
Source: ONS
Note: Recessions are defined as two or more successive quarters of contraction in GDP, ending when growth resumes.

Chart A4: Sterling exchange rates and world trade volume (indices)



Source: Bank of England, CPB World Trade Monitor

Chart A5: Sterling normalised implied volatility (five year, five years forward)



Source: Bloomberg

World trade could provide the impetus for UK recovery…

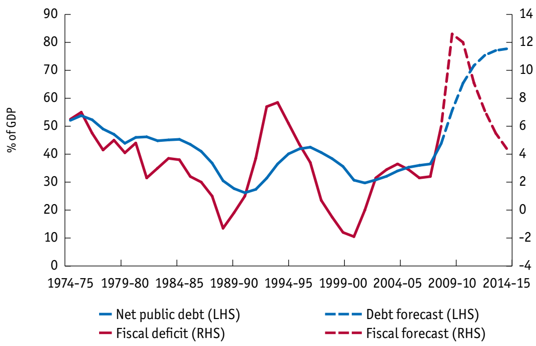
Against the background of recession and extensive government and monetary support, sterling has depreciated. Between 2007 and 2009 sterling lost 20% of its value (on a trade-weighted basis, shown in *Chart A4*). Depreciation is expected to support UK net trade. However, the extent of the boost to UK economic growth from trade will depend on the strength of the global recovery and the ability of UK companies to take advantage by switching towards production of exported goods and services.

UK GDP levels stabilised in the second half of 2009 (see *Chart A2*) underpinned by monetary and fiscal support and the depreciation of sterling. But the future path of economic growth is highly uncertain. Key factors that will influence future growth include: whether global demand will rebalance; how the UK economic recovery can be sustained while households, government and parts of the corporate sector reduce debt levels; and the robustness of the financial sector.

…but the UK economic outlook is still highly uncertain.

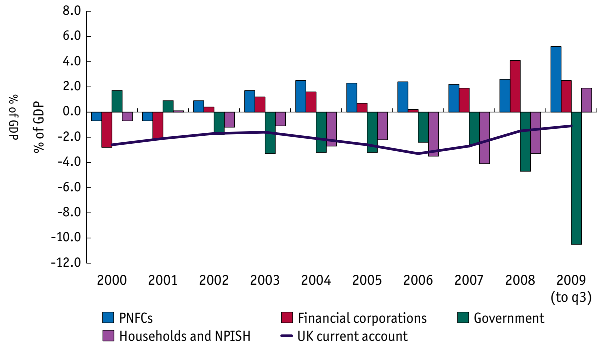
Uncertainty over the economic outlook is difficult to measure, but one market-based indicator is the high level of implied volatility on options to enter into five-year sterling interest rate swaps in five years' time (see *Chart A5*). This indicator captures uncertainty about the future path of sterling interest rates over the medium term and reflects a wider atmosphere of reduced certainty. We next consider the positions of the UK public, household and corporate sectors in turn.

Chart A6: UK fiscal deficit and public debt



Source: HM Treasury Pre-Budget Report, December 2009

Chart A7: UK net lending and borrowing by sector



Source: ONS
Note: Net lending is the net amount a sector has available to finance other sectors, directly or indirectly. It is the balancing item in the capital account: (net saving plus capital transfers receivable minus capital transfers payable) minus (the value of acquisitions less disposals of non-financial assets, less consumption of fixed capital). Negative net lending may also be described as 'net borrowing'.

UK public sector

The stock of UK public debt is rising.

UK public debt has risen in relation to GDP in response to the global economic crisis (see *Chart A6*). The annual public deficit is expected to rise further to more than 12% of GDP in the 2009/10 fiscal year. The high deficit has been driven by both rising expenditure (such as, income support) and falling receipts (particularly, lower corporation tax and stamp duty). However, the deficit is expected to fall back in subsequent years and net debt is forecast to peak below 80% of GDP in 2014/15. While fiscal consolidation is essential, it needs to take place at an appropriate pace over time. A lack of fiscal consolidation could damage investor confidence and raise long-term interest rates. Too rapid consolidation could damage private demand and delay economic recovery.

Substantial fiscal stimulus in 2009, combined with the cyclical impact of the recession on public finances, means that the government has increasingly become a net borrower from other sectors of the economy (see *Chart A7*). At the same time, the household sector returned to surplus in the first three quarters of 2009 as households reduced consumption. This was a sudden reversal of the trend towards accumulation of debt within the household sector in the years preceding the financial crisis. But the change in the government's position meant that the UK economy overall continued to be a net borrower from overseas. A smooth deleveraging process therefore depends on continuing foreign capital inflows.

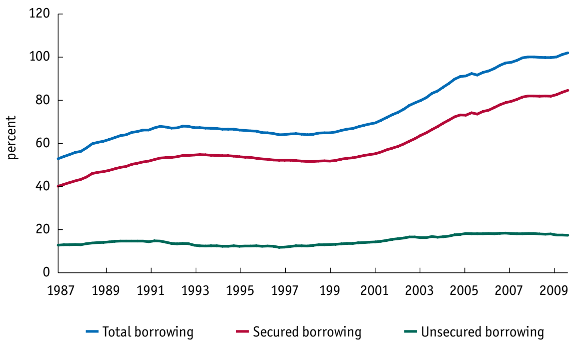
UK household sector

Pre-crisis accumulation of household debt was closely associated with rising house prices.

Household indebtedness increased significantly in the run up to the financial crisis, rising from 73% of GDP at the end of 2001 to 100% of GDP at the end of 2007 (see *Chart A8a*). The majority of this increase was in the form of residential mortgage borrowing, underpinned by rising property prices, macroeconomic stability and reduced credit standards among many lenders. In the initial phase of the housing boom between 2000 and 2004, debt-servicing costs remained low as nominal interest rates fell. Between 2005 and 2008, weak household income growth combined with rising debt levels and higher interest rates, contributed to slowly increasing household debt burdens. But the continued boom in house prices and availability of mortgage debt to refinance existing loans at higher multiples of debt-to-income allowed many households to take on even more debt, including higher-risk groups that had not previously had access to credit.

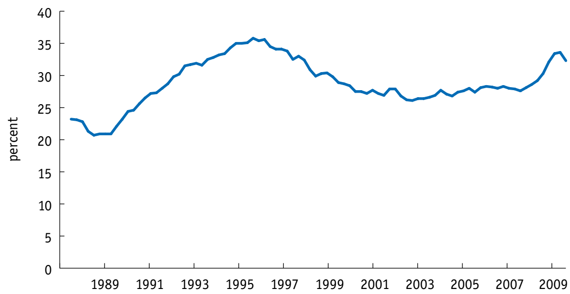
Chart A8: Measures of household leverage

Chart A8a: Household debt as a percentage of GDP



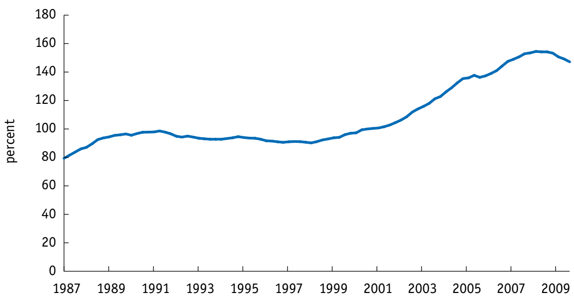
Source: ONS

Chart A8b: Household secured debt as a percentage of housing stock value



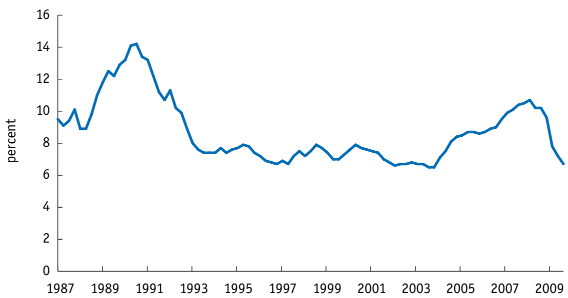
Source: ONS

Chart A8c: Household debt as a percentage of post-tax income



Source: ONS

Chart A8d: Household debt payments as a percentage of post-tax income

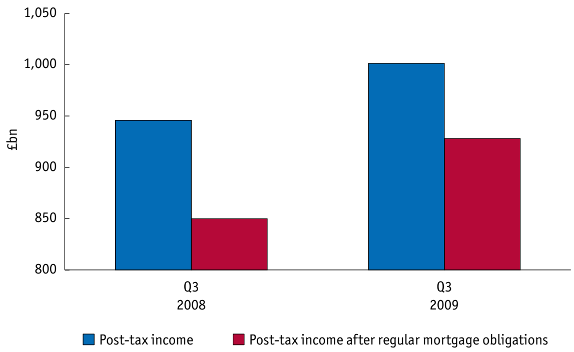


Source: ONS

Very low interest rates have reduced the burden of household debt.

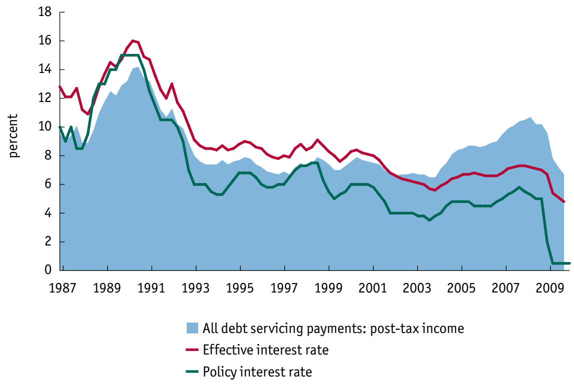
The reduction in interest rates has played an important role in stabilising the household sector and limiting the effects of the recession (see *Charts A9 and A10*). The reduction in the Bank of England Bank Rate to historically low levels fed through into lower mortgage rates for the majority of borrowers (see *Chart A11*), thereby reducing homeowners' debt-servicing levels. In September 2009, aggregate household interest and principal mortgage payments were £20 billion lower than in September 2008. However, the high level of debt income has left many households vulnerable to property price, income and interest rate shocks.

Chart A9: Cash benefit to households of lower interest rates



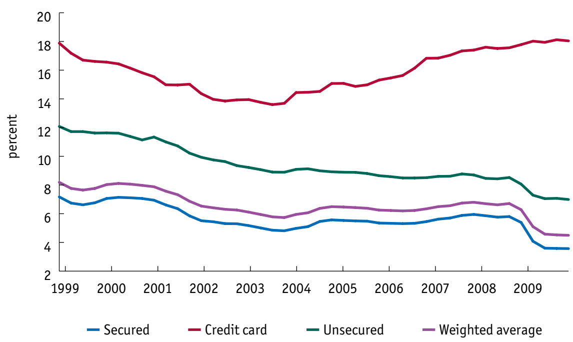
Source: ONS

Chart A10: Policy interest rates and household debt burden



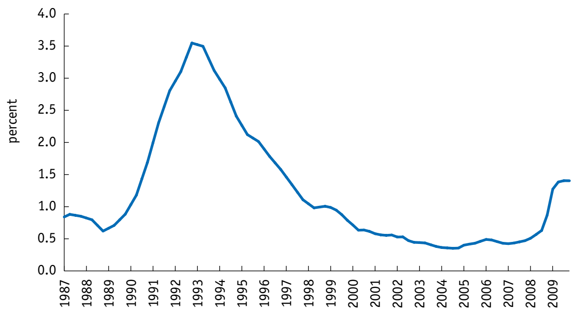
Source: ONS

Chart A11: Household interest rates by debt type



Source: Bank of England

Chart A12: Quarterly arrears as a percentage of loans



Source: CML

There has been a sharp rise in the household savings rate.

Although mortgage interest rates have fallen, some unsecured rates, especially on credit card debt, have actually increased because of the tightening of credit conditions and increased riskiness of these loans. Perhaps because of the low level of interest rates on secured debt, the rise in the savings rate has taken the form of increased pension contributions and investments in equities, rather than debt repayment. Where deleveraging has taken place, it has been concentrated in repayments of more-expensive unsecured debt (see *Chart A8a*). The fact that borrowers have not taken the opportunity of low interest costs to increase their principal payments on secured debt could reflect a wish to keep liquid savings available, because of concerns about unemployment or falling incomes. No doubt some households will be taking advantage of being able to get a higher deposit or saving rate than they are paying on their secured debt. And for the minority of highly indebted consumers, they may simply not be able to afford to increase their secured debt repayments. These issues are explored again in *Section D*.

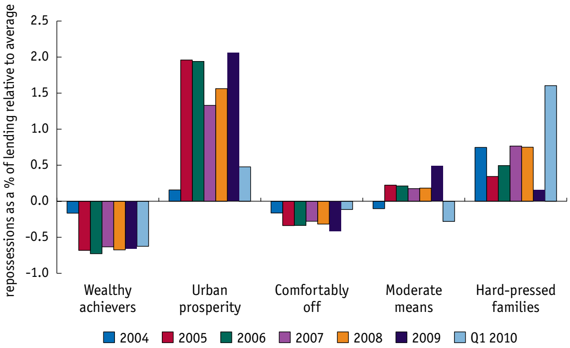
Arrears and repossessions have so far been lower than generally anticipated and experienced in the 1990s recession (see *Chart A12*). Low interest rates and lower-than-forecast unemployment have meant that fewer households have fallen into default on mortgage repayments, as income gearing has remained low, meaning that the burden of debt servicing costs has fallen relative to household income.

Household arrears have been concentrated in highly-indebted groups.

In the 1990s recession, arrears and repossessions were spread across large numbers of households affected by the high interest rates. By contrast, in this downturn they have so far been concentrated in particular geo-demographic groups, such as the hard-pressed 'credit-hungry' families and 'urban prosperity', and characterised by higher-risk lending practices, such as self certification of income and very high lending multiples (See *Chart A13*).[2] *Table A2* shows how both the type of mortgage arrangement (particularly self-certification) and loan-to-value ratios are important determinants of default rates.

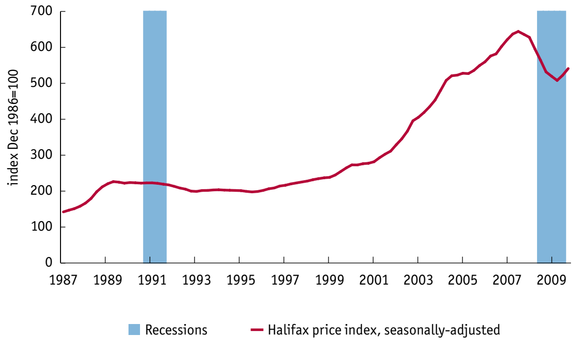
2 Hard-pressed 'credit-hungry' families are defined as less affluent families who rely on credit to fund their lifestyle. 'Urban prosperity' are young people in the early stages of establishing careers and possibly renting their homes.

Chart A13: Geo-demographic profile of mortgage repossession



Source: FSA, CACI
Note: This chart shows mortgage possessions relative to an estimate of the distribution of mortgage assets by geo-demographic group. Numbers greater than zero suggest a greater prevalence of repossession than that implied by the groups' holdings of mortgages.

Chart A14: House prices and recessions



Source: ONS; Halifax
Note: Recessions are defined as two or more successive quarters of contraction in GDP, ending when growth resumes.

Table A2: Default rates by loan-to-value and mortgage type

Loan-to-value ratio	Buy-to-let	Credit-impaired	Other	Self-cert	Standard	All types
Under 0.5	0.51	3.97	0.40	1.02	0.40	0.46
Between 0.5 and 7.5	0.74	5.93	0.65	1.76	0.75	0.86
Between 0.7 and 0.9	2.08	7.57	1.30	3.42	1.24	1.65
Between 0.9 and 0.95	8.13	8.56	1.98	5.26	2.56	2.62
Between 0.95 and 1	6.33	8.97	2.38	9.24	2.50	2.66
Greater than 1	3.40	16.52	1.70	6.44	5.83	4.74
ALL LTV BANDS	**1.58**	**6.44**	**0.88**	**2.97**	**1.08**	**1.21**

Source: FSA
Note: the default rates shown in each cell are weighted by the number of accounts in each firm, of each type or in each LTV band, as appropriate. Data is based on the ten largest mortgage lenders by mortgage type and LTV at origination during 2008.

Households remain vulnerable to income or interest rate shocks.

Even during the benign economic conditions experienced in the lead up to the recession, borrowers that had over-extended themselves and faced financial constraints dominated the profile of mortgage repossessions. During the recession, the number of highly-indebted borrowers unable to maintain high debt-servicing costs has increased, due to their over-reliance on credit to service their debts. Specialist lenders that extended mortgage credit to those who had previously not had access to the mortgage market, and those who purchased mortgage books from these lenders, have to date been most affected by rising arrears and repossessions.

It is possible that this trend will continue for some time. However, any future significant rise in unemployment, widespread loss of income or material increase in interest rates could affect a wider group of homeowners. As the economy begins to recover, interest rates may return to more normal levels, increasing the cost of debt before household incomes have recovered fully. Such income or debt-cost shocks could yet trigger a more disorderly deleveraging process through higher arrears and repossessions.

The residential property market has begun to stabilise, but is still subject to medium- and longer-term risks.

Residential property prices have also not fallen by as much as expected at the onset of the financial crisis. By the beginning of 2009, property prices had experienced significant falls of 19% from their peak in mid-2007 (see *Chart A14*). But the market now appears to have stabilised, with prices rising in the second half of 2009. This has helped to limit the number of mortgage holders in arrears, and households have not experienced the negative wealth effect that would be implied by an even larger fall in property prices.

Chart A15: Gross new mortgage lending

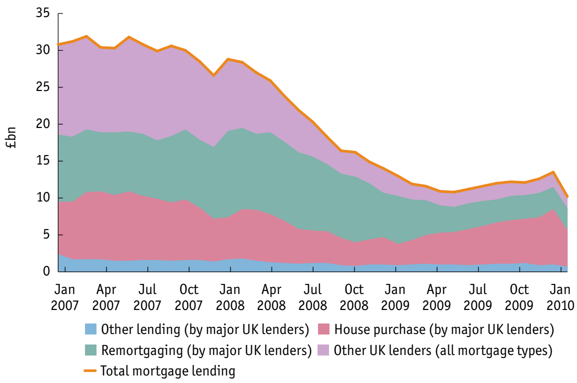
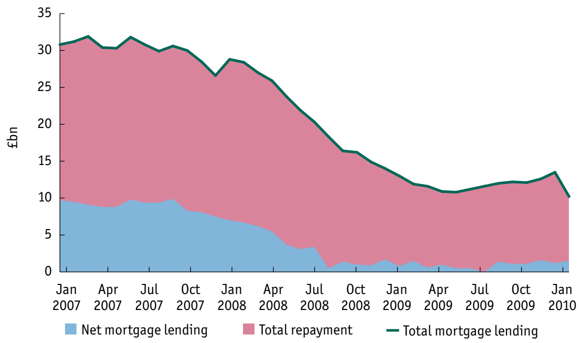


Chart A16: Net and gross mortgage lending



Source: Bank of England
Note: [Chart A15] For major UK lenders (Banco Santander, Barclays, HSBC, Lloyds Banking Group, Nationwide and Royal Bank of Scotland) the pre-2009 split of gross lending data is estimated using loan approval values for house purchase, remortgaging and other advances. Lending Panel data is used in 2009 as reported by the major UK mortgage lenders. Data for major UK lenders include both sterling and foreign currency lending, total mortgage lending and other lenders data include sterling lending. All are expressed in sterling terms. Seasonally adjusted. [Chart 16] Data cover sterling lending and are seasonally adjusted.

Lending for house purchase has picked up…

While demand, including from first-time buyers, has remained relatively strong, the supply of properties has been low as homeowners have been reluctant to sell when their property has lost value. Lenders have also often avoided repossessing properties and releasing them onto the market, through forbearance for households in financial difficulty or by holding onto repossessed properties to avoid forced sales. In the medium term, residential property prices will depend on: the underlying supply of housing to meet demand; affordability for owner-occupiers, determined primarily by income and the level of interest rates; and affordability for buy-to-let investors, determined primarily by rental yields and the level of interest rates.

…but remortgaging activity remains low.

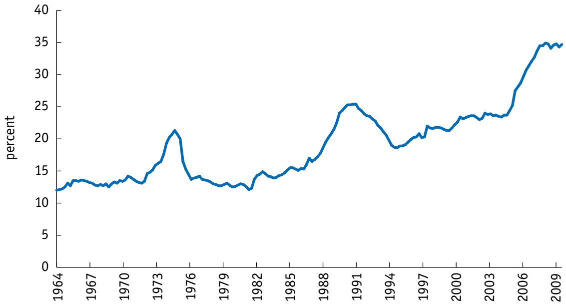
Gross new mortgage lending remains below pre-crisis levels but much of this fall has been due to the decline in remortgaging activity. The fall in property prices has left many households unable or unwilling to withdraw equity from their homes, resulting in a decline in the demand for remortgaging. Net mortgage lending (gross lending after repayments) has remained positive, so that the level of household secured debt has actually continued to rise (see *Charts A15 and A16*). Combined with slow growth in nominal GDP, this explains why household leverage (debt relative to GDP, see *Chart A8a*) has not yet fallen.

UK non-financial corporate sector

Indebtedness relative to GDP also increased steadily in the non-financial corporate sector over the past thirty years, although to a lesser extent than in the household sector. By March 2009, non-financial corporate debt had reached around 34% of GDP (see *Chart A17a*). Since 2000 borrowing has also risen steadily in relation to the market value of corporate assets and gross operating surplus (see *Charts A17b and A17c*).

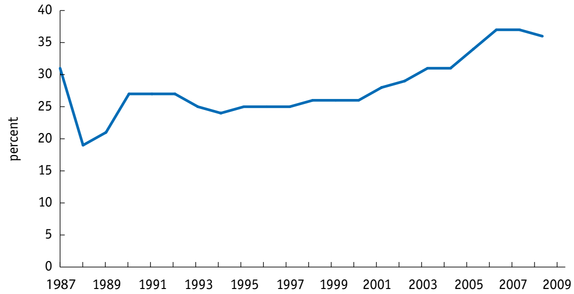
Chart A17: Measures of corporate sector leverage

Chart A17a: UK non-financial corporate sector bank loans as a percentage of GDP



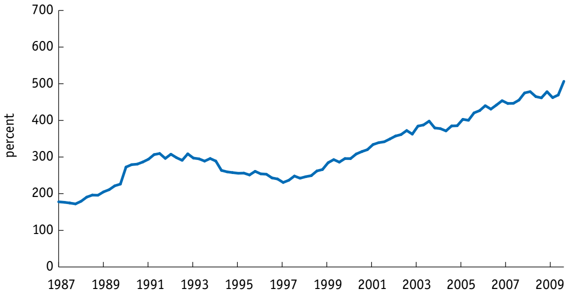
Source: Bank of England, ONS

Chart A17b: UK non-financial corporate sector debt (securities and loans) as a percentage of assets



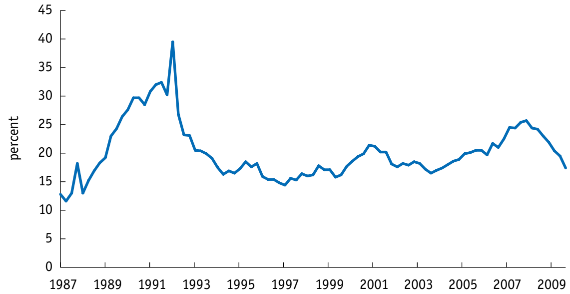
Source: Bank of England, ONS

Chart A17c: UK non-financial corporate sector liabilities (long- and short-term loans and securities) as a percentage of gross operating surplus



Source: Bank of England, ONS

Chart A17d: UK non-financial corporate total debt interest as a percentage of gross operating surplus



Source: Bank of England, ONS

Non-financial corporate indebtedness also increased before the crisis…

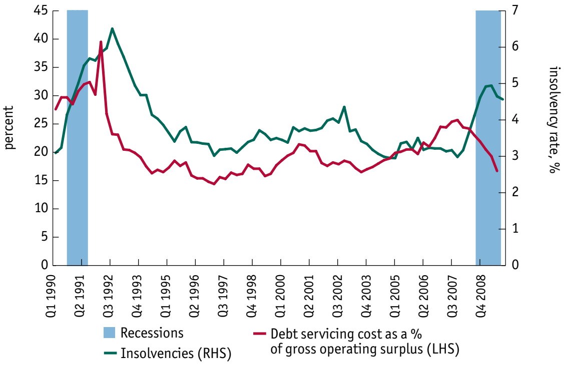
As for households, low nominal interest rates kept non-financial corporate debt servicing costs low between 2000 and 2004. These costs then rose steadily between 2004 and 2008. Since the financial crisis, the initial tightening of credit conditions has been more than offset by the loosening of monetary policy, particularly for larger, creditworthy firms (see *Chart A17d*). Insolvencies have not been as high as forecast, which has meant that the impact on the real economy has been less severe than expected (see *Chart A18*). Overall, company liquidations have been lower than in the previous recession, when businesses faced high interest rates and a stronger exchange rate.

…but was concentrated in commercial property companies.

Growth in leverage over the past decade has not taken place evenly across the non-financial corporate sector, but has been concentrated primarily in commercial property companies and companies that were subject to leveraged buy-outs. Continued investment in and demand for commercial property drove expectations of further price appreciation and higher leverage than seen in other non-financial companies (see *Chart A19*).

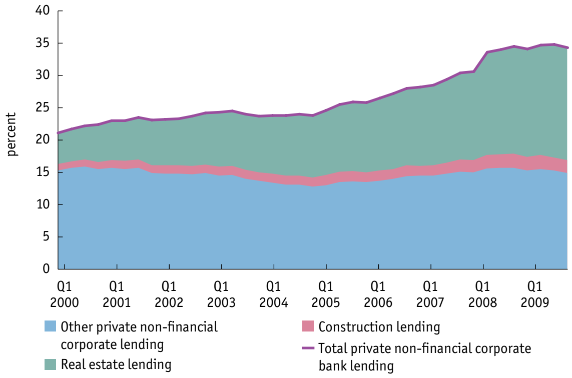
Lending to the commercial property sector rose from around 20% of total non-financial corporate lending in 2000, to around 40% at the peak of the market in mid-2007. Contractual commitments to provide new funds at different stages of commercial property development have meant that lending continued to increase even as the market collapsed, reaching around half of overall bank lending to non-financial companies by 2009.

Chart A18: Businesses' debt burdens and insolvencies



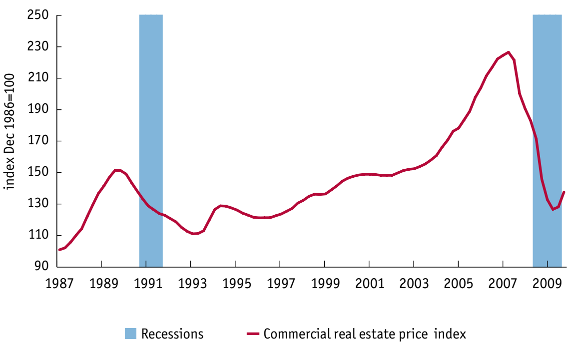
Source: ONS; Insolvency Service; Department for Business, Innovation and Skills
Note: Recessions are defined as two or more successive quarters of contraction in GDP, ending when growth resumes. Insolvency rates are for England and Wales, calculated using insolvency numbers and total number of active companies at the start of each year.

Chart A19: UK non-financial corporate bank debt by sector as a percentage of GDP



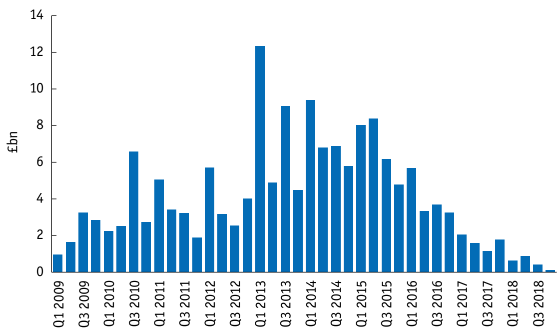
Source: Bank of England
Note: Part of the increase in real estate lending may be due to re-categorisation of corporate lending following sale and lease-back of properties and PFI (public finance initiative) lending, but we do not think these elements are large enough to change the overall picture. Break in series from Q1 2008 due to inclusion of building society data. Sterling borrowing only.

Chart A20: Commercial real estate prices and recessions



Source: ONS, IPD
Note: Recessions are defined as two or more successive quarters of contraction in GDP, ending when growth resumes.

Chart A21: Maturity profile of leveraged loans for leveraged buy-outs



Source: Dealogic

Commercial property firms face considerable pressures.

Commercial property companies currently face both balance sheet and cash flow pressures. Property prices have fallen sharply from their peak in mid-2007, although prices of prime properties have recovered recently (see *Chart A20*). These falls have severely reduced commercial property companies' assets and the collateral underpinning their borrowing.

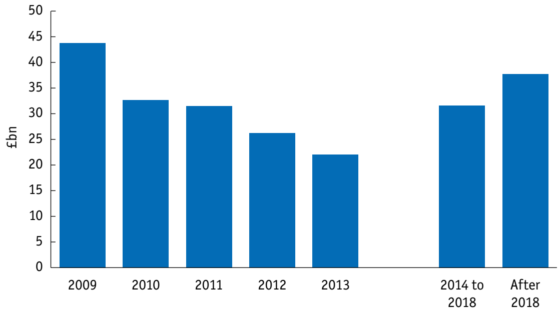
Negative equity could reduce future access to credit and the ability to roll-over existing debt, as well as exposing banks to higher losses following defaults. In addition, vacancies, which increased from 9% to 12.6% in the year to October 2009, and falling rents have reduced gross income, which has affected companies' ability to service debts.[3]

Refinancing challenges lie ahead for commercial property and LBO-funded companies.

Around £160 billion of UK commercial property debt will mature over the next five years, including both bank borrowing and commercial mortgage-backed securities (see *Charts A21 and A22*). During the recession, many commercial property companies were supported by forbearance, in the form of loan extensions and waived breaches of loan-to-value covenants. But banks could decide not to renew debts as they expire, and refinancing of maturing commercial mortgage-backed securities will be especially difficult. This could force liquidations and release commercial properties onto the market, possibly triggering further price falls. Leveraged loans to UK companies that were subject to buy-outs also face a maturity 'hump' and present similar refinancing challenges to the banks in this sector.

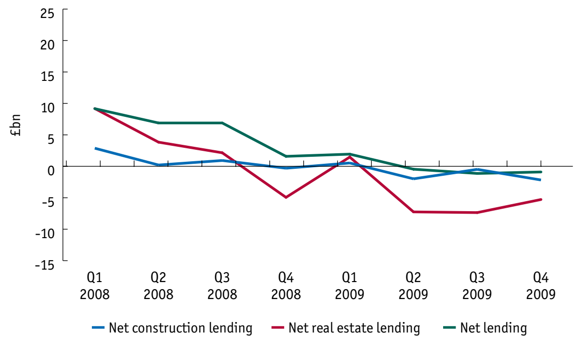
3 *Financial Stability Report*, Bank of England, December 2009.

Chart A22: Maturity profile of senior commercial real estate debt at end-2008



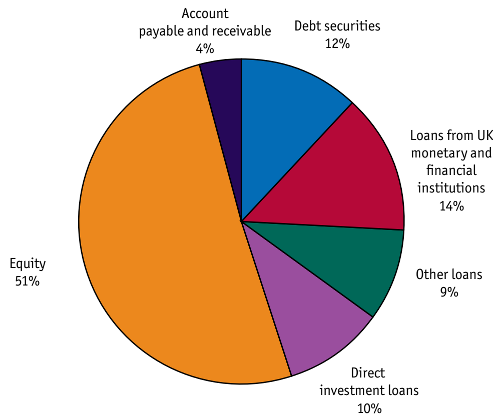
Source: De Montfort UK Commercial Property Lending Market report, 2008 year-end

Chart A23: Net new lending to UK non-financial corporates



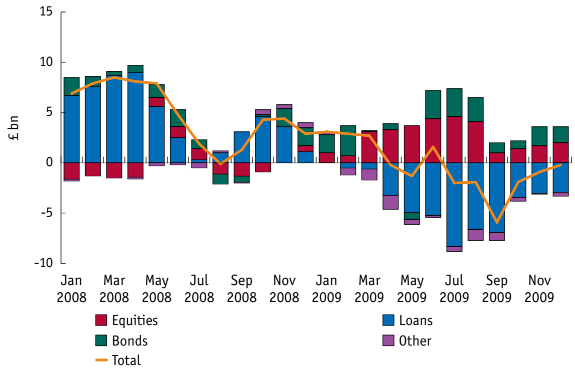
Source: Bank of England
Note: Adjusted for revisions by individual institutions, which are included in debt levels data (as used in *Chart A19*). Sterling lending, non-seasonally adjusted.

Chart A24: UK non-financial corporate liabilities (Q3 2009)



Source: ONS

Chart A25: UK non-financial corporate net finance raised



Source: Bank of England
Note: Funds raised by PNFCs from UK monetary financial institutions and capital markets. Data cover funds raised in both sterling and foreign currency, expressed in sterling terms. Loans are seasonally adjusted. Bond, equity and other are non seasonally adjusted.

Bank borrowing for non-commercial property sectors is contracting.

Unlike the household sector, and consistent with the experience of previous recessions, lending to non-financial corporates has turned negative (see *Chart A23*). Whereas bank borrowing had often been the lowest-cost form of corporate finance before the recession, the cost and availability of bank lending has since tightened markedly. However, the impact of the reduction in lending has varied across the corporate sector; lending to commercial property companies has fallen less, reflecting further drawdown of existing facilities.

Bank borrowing in aggregate (excluding direct investment loans) is only a third of total financing for the non-financial corporate sector and many larger companies have switched their borrowing to bond markets (see *Charts A24 and A25*). At the same time, many listed companies have issued equity in order to reduce leverage.[4] Small and medium-sized enterprises (SMEs) remain more dependent on bank lending and they have been put under the most pressure. Looking forward, it seems unlikely that the availability and cost of bank financing will ease much in the near term.

UK economic outlook

UK economy is expected to grow in 2010...

Domestic and global GDP levels have stabilised and are showing signs of recovery. However, the exact path of the UK's recovery is still uncertain and will be influenced by the way in which vulnerabilities present in the government, household, corporate and financial sectors unfold, as well as the path of the global economy. Our central scenario, based on a consensus of the main private sector forecasting institutions, is for UK economic growth to accelerate steadily throughout 2010. Household spending and

4 *Inflation Report*, Bank of England, February 2010.

Table A3: Consensus forecasts

	2009[a] Average	2010[f] Average	2011[f] Average
GDP growth (real % change, annual)	-5.0	1.4	2.2
Household consumption (real % change, annual)	-3.1	0.5	1.6
Gross fixed investment (real % change, annual)	-14.6	-0.8	2.8
Other GDP* (real % change, annual)	-2.3	6.4	3.7
Unemployment (claimant count, % of workforce)	4.7	5.4	5.4
CPI (% change over year)	2.2	2.6	1.7

Source: Consensus economics, a digest of international economic forecasts February 2010, ONS
Note: a - actual, updated by FSA where new data is available; f - Consensus forecast; *Other includes net trade and government consumption and is derived from GDP, household consumption and investment forecasts.

business investment will stabilise, but weaknesses will persist. This scenario places the UK economy on a 'V'-shaped growth path, but depends on external demand as the principal driver of recovery.

...but there remain downside risks...

In this base case scenario it should be possible to combine sustained, steady economic recovery with fiscal consolidation and gradual deleveraging by households and parts of the non-financial corporate sector. But continuing high leverage will, for a number of years, leave many households and companies more vulnerable to any economic shocks that lead to higher interest rates or falling income. This will mean continued high risks for financial firms.

Alternative scenarios

...which are explored in our three alternative scenarios.

Recent experience has shown the importance of considering a range of possible scenarios. In addition to the risks around our central case, we also consider some alternative scenarios that provide a contrast to the central case and identify risks to which firms need to be resilient. These alternative scenarios are not forecasts and we do not comment on the probability of their occurrence.

In the first two of these possible scenarios the business risks are to some extent mutually offsetting, with stronger growth but rising interest rates in the first scenario and weaker growth but continuing very low interest rates in the second. In the third scenario, the risks are more concentrated on the downside.

1. Strong economic recovery and disinflationary pressures abate quickly

External and domestic demand grow robustly, leading to a rapid recovery in output. Fiscal consolidation is helped by growing tax receipts, which reduce the public deficit. Asset prices (including house prices) continue to rise, and contribute to a delay in household debt reduction. Disinflationary pressures abate quickly, and the Bank of England begins to withdraw monetary stimulus and return interest rates to more normal levels.

Implications for households and non-financial corporates:
Income growth benefits most households and unemployment peaks at a lower level than following previous recessions. But rising interest rates and mortgage payments put pressure on highly leveraged households, and lead to arrears. For most non-financial corporates, this scenario is broadly favourable.

Implications for firms:
In the short run, an increase in asset prices threatens to create new asset bubbles. Firms will need strong risk management to avoid being vulnerable to subsequent asset price volatility and possible sharp shifts in yield curves as short-term interest rates rise. Credit losses on exposures to highly leveraged households and companies crystallise as interest rates increase. But credit losses do not spread more widely through the household sector and firm exposures differ greatly, depending on the composition of their retail loan book. Pressure on bank and building societies interest margins abates with the unwinding of currently low interest rates.

2. Faltering global economic recovery triggers slower UK economic growth

Global recovery is weak as countries with persistent current account surpluses fail to support a rebalancing of global demand. The rebound of asset prices in 2009 does not continue in 2010. With neither fiscal stimulus nor strong external demand, the UK economy either grows very slowly or returns to recession. Disinflationary pressures grow and the Bank of England keeps interest rates at very low levels.

Implications for households and non-financial corporates:
Unemployment continues to rise, leading to increasing arrears and defaults. But for those remaining in employment low mortgage payments cushion the impact of the weak economy on disposable income, allowing them to reduce their debts. Corporate sector defaults increase and collateral values fall.

Implications for firms:
Credit losses rise. Insurance companies and asset managers suffer as asset prices decline. Low short-term interest rates continue to squeeze banks' and building societies' interest margins. But low debt-servicing costs limit the impact of economic weakness, to some extent, and allow adjustment over a longer period.

3. Weak UK economic growth does not keep up with the recovery in the global economy

The global economy recovers and disinflationary pressures subside, but UK domestic demand remains weak and the UK economy recovers very slowly. Sterling depreciates, but UK exports fail to keep pace with increasing world trade. The Bank of England raises interest rates in response to inflationary pressures from overseas. Banks pass higher funding costs onto UK borrowers.

Implications for households and non-financial corporates:
Unemployment and mortgage payments rise at the same time and arrears increase across a wider range of borrowers. Corporate sector defaults increase, particularly in over-leveraged sectors such as commercial property, which are face pressure from higher debt-servicing costs.

Implications for firms:
Higher interest rates and a weak recovery crystallise losses on household and corporate loans. Losses are magnified by falling asset prices and profitability is further squeezed by higher funding costs.

Financial stability and prudential risks and issues

The financial crisis has highlighted the importance of effectively managing prudential and financial stability risks for all stakeholders in the financial system. The aggregate impact of Government support measures introduced since the beginning of the crisis has stabilised the banking sector. However, as firms prepare for the removal of explicit support, the pressures on capital, liquidity and long-term funding remain significant. Building Societies face capital generation and funding constraints as pressure on profitability and competition for retail funding remains high. Profitability in the life insurance sector also remains constrained as market trends affect insurers' future capital and strategic plans. New regulatory frameworks to strengthen firms' capital and liquidity management under stressed conditions are being developed to increase the likelihood of institutional survival under stressed conditions. Deficiencies in some firms' risk management, including shortcomings in systems and controls, and governance and culture, have been exacerbated by the financial crisis as firms' senior management has been stretched to deal with immediate prudential issues.

Capital, liquidity and margin challenges in banks and building societies

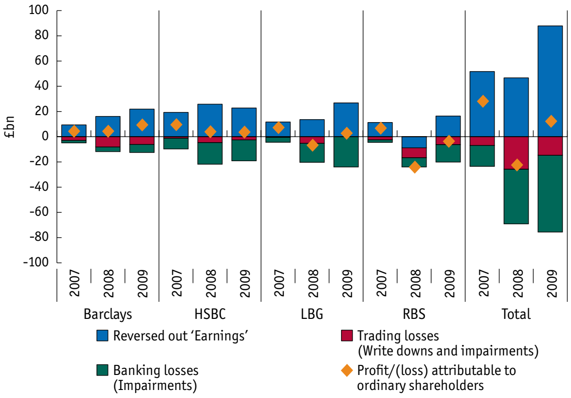
Transition to a new capital regime and withdrawal of exceptional liquidity support create challenges.

The financial crisis resulted from a combination of asset losses, extreme uncertainty about the eventual scale of those losses, and the collapse in funding liquidity. In response, the authorities took unprecedented measures to recapitalise the banking sector and provide large-scale liquidity support. In addition, monetary policy was dramatically loosened to offset demand deflation, with the Base Rate cut to a historically low 0.5% and quantitative easing executed. Looking forward, a new regulatory regime for both capital and liquidity is being designed, which will ensure a more stable banking system in the future. The transition to this new regime, combined with the withdrawal of exceptional liquidity support will, however, create major challenges which will need to be addressed:

- Capital adequacy, stress tests and the transition to a new capital regime;
- Funding challenges as exceptional support is withdrawn and new liquidity requirements introduced; and
- Margin challenges created by low interest rates, especially for building societies.

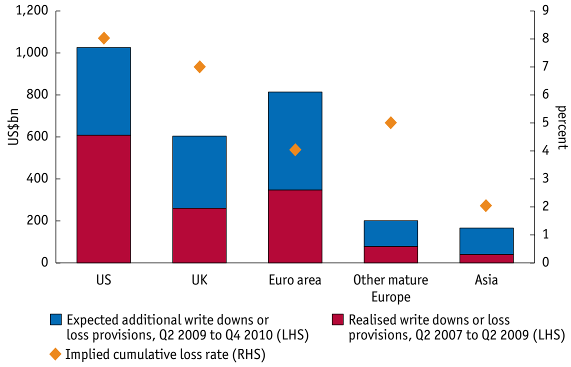
We consider each of these in turn.

Chart B1: Losses of 'Big 4' UK banks during the crisis



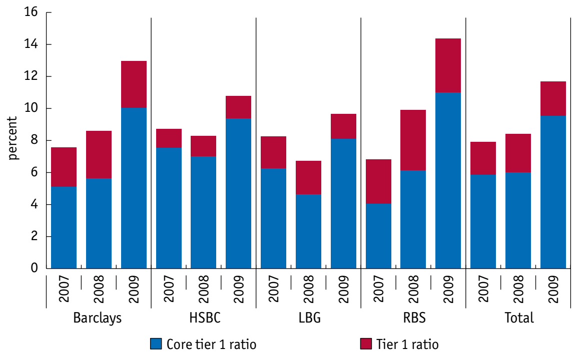
Source: Public data, FSA estimates
Note: Reversed out 'Earnings' is a notional balancing item. LBG is pro-forma Lloyds + HBOS for 2007/08, combined business for 2009 impairments and statutory for 2009 profit. RBS is pro-forma/proportional throughout.

Chart B2: Realised and expected write downs or loss provisions for banks by region



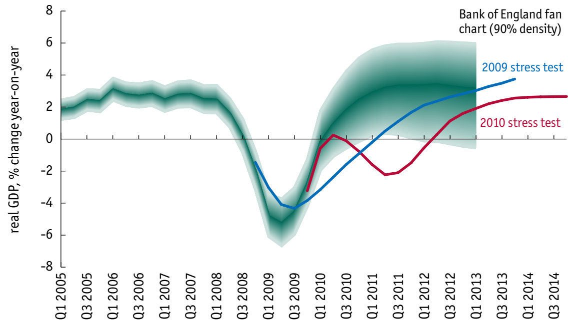
Source: IMF staff estimates
Note: Other mature Europe includes Denmark, Iceland, Norway, Sweden and Switzerland. Asia includes Australia, Hong Kong SAR, Japan, New Zealand and Singapore.

Chart B3: Capital ratio evolution of 'Big 4' UK banks



Source: Public data, FSA estimates
Note: LBG is pro-forma Lloyds + HBOS for 2007/08, statutory for 2009. RBS is pro-forma/proportional throughout.

Chart B4: Real economic variables vs. stress test



Source: Bank of England, ONS, FSA
Note: For an explanation of the fan, see the Bank of England Inflation Report, February 2010, page 6, Chart 1.

Capital adequacy in banks and building societies

The banking system suffered significant losses...

Many banks and building societies suffered significant losses during the crisis, with a combination of write-downs in trading securities and large provisions on banking books. Total trading and credit losses between 2007 and 2009 were £168 billion for the four largest UK banks, absorbing most of their earnings before write downs and provisions and therefore limiting internal capital generation (see *Chart B1*).

...and unprecedented recapitalisation has been required.

Realised losses in international banks (excluding the UK) to June 2009 have been estimated by the IMF at US $1.1 trillion (see *Chart B2*). These losses and severe uncertainty about their eventual size, overall and by specific bank, produced a crisis of confidence and liquidity in autumn 2008. Recapitalisation on an unprecedented scale has been required to restore confidence in the banking system. In the UK, this has involved capital injections of £134 billion (£68 billion private and £66 billion public).

To effectively assess the solvency of banks, especially during periods of stress, a new capital regime was introduced in 2008. As a result, banks need to hold at any time sufficient core tier 1 capital to enable them to absorb potential losses arising in a severe stress test and still have a core tier 1 ratio of at least 4% of risk-weighted assets (*Box B1* sets out the details of the interim capital regime and how it compares with the regime in place before the crisis). The economic scenario used for the stress test is deliberately designed to be more severe than consensus expectations of future economic developments.

This interim regime has already resulted in an increase in actual capital ratios (*Chart B3*).

Capital planning requirements emphasise the quality and quantity of capital.

Regulators, commentators and banks alike have focused on the quality of capital as well as the quantity. In particular, attention has been focused on the level of core tier 1 capital held by banks and how that level would evolve under stressed conditions.[1] Existing non-core tier 1 instruments have generally failed to absorb losses on a going-concern basis.[2] As a consequence, the FSA's interim capital regime now emphasises the quality of capital, as well as its amount, through specifying minimum levels of core tier 1 under stressed conditions.

Looking forward, the capital planning of banks and building societies will need to reflect: the losses which have emerged over the last year and may re-emerge; appropriate stress tests in light of latest economic developments; and the future international capital regime which will emerge during 2010.

Box B1: Interim capital regime 2008

The financial crisis demonstrated the importance of relevant and robust stress testing and forward-looking capital planning by firms. In 2008 the FSA set out new capital ratios in an interim capital regime as part of its enhanced supervisory framework. This framework included a minimum core tier 1 ratio of 4% of risk-weighted assets in stressed economic conditions to complement our existing approach of assessing Individual Capital Guidance (ICG) in a stress, and the setting of capital planning buffers.

Table B1: Interim capital regime

		FSA Handbook[a]	Interim UK Regime[b]
Normal economic conditions	Core tier 1 capital	2%[c]	n/a
	Total tier 1 capital	4%[c]	8%
	Total capital resources	Higher of 8% and Individual Capital Guidance (ICG)[d]	
Stressed economic conditions	Core tier 1 capital	n/a	4%
	Total tier 1 capital	n/a	6-7%
	Total capital resources	Higher of 8% and Individual Capital Guidance (ICG)[e]	

a) As defined in the FSA Handbook (GENPRU and BIPRU), and based on CRD and Basel 2 requirements.

b) FSA Statements of 14 November 2008 and 19 January 2009, and press release of 28 May 2009 on the interim regime.

c) These ratios are derived from the gearing rules associated with the total capital level of 8%.

d) Individual Capital Guidance incorporates the Pillar 2 assessment and includes, as a minimum, the 8% Pillar 1 requirement, plus appropriate Capital Planning Buffers (that are available for drawdown in the course of stressed economic conditions), and is subject to continual monitoring and revision by supervisors as required.

e) Capital Planning Buffers may have been drawn down under these conditions (for clarification see PS09/20: Stress and Scenario Testing – Feedback on CP08/24 and final rules).

Evolution of losses relative to 2009 stress tests

GDP fell further than in our stress test.

The supervisory stress test which the FSA set out at the beginning of 2009, and against which it required banks to hold adequate capital, modelled a deeper and more prolonged recession than those the UK experienced in the early 1980s and early 1990s. The scenario used for this stress test, envisaged a peak-to-trough fall in GDP of 6.9%, a rise in unemployment to a peak of 12.5%, a peak-to-trough fall in residential property prices of 50%, and in commercial property prices of 60%.

The fall in GDP which actually occurred in 2009 was slightly more than under the 2009 stress test during that year of the scenario (see *Chart B4*). However, unemployment and residential property prices have

1 Core tier 1 capital is defined as common equity and retained earnings net of certain filters and deductions. See FSA letter to the British Bankers Association of 1 May 2009 on the definition of core tier 1.

2 *A regulatory response to the global banking crisis*, FSA Discussion Paper 09/2, March 2009.

performed more favourably to date.[3] This evolution of macroeconomic parameters relative to the stress test has been reflected in the evolution of actual estimated losses relative to those modelled in the stress test.

Loss evolution in household mortgages and unsecured credit

But residential loan losses were lower than stressed…

Losses on residential mortgage loans in 2009 were less severe than stressed for under the 2009 stress scenario. Firms' actual impairment in the first half of 2009 was on average only about 25% of the stress test estimates. There are fundamental economic drivers of this more favourable outcome, as explained below, but arrears management practices may also have played some role.

…due to lower property price falls and unemployment.

With unemployment having risen less than envisaged in the stress test and with low interest rates significantly reducing the mortgage payments of many households, fewer mortgagees than anticipated have gone into arrears on mortgage payments. Moreover, since residential property prices have fallen by less than stressed for in the stress test, the incentive to default (as a result of negative equity) has been reduced, and where defaults have occurred, the realised loss has been less than implied under the stress.

The scale of the divergence from stress may, however, have been further increased by firm forbearance strategies, with firms using a variety of techniques to assist consumers in financial difficulties, resulting in a level of arrears that is lower than might otherwise be the case.[4] In many cases these forbearance strategies are mutually beneficial to consumer and lender, enabling consumers to retain their homes and avoiding losses through forced sales. However, the consequence may be that arrears figures may cease to be a consistent measure of long-term underlying losses (see *Chart B6*). In addition, it should be noted that a low interest rate environment means that it can take longer for some categories of non-paying consumers to be counted as formally in arrears. The threshold for reporting mortgages in arrears is when 1.5% of the total loan is in default. This means, for example, that a borrower paying 6% interest on an interest-only mortgage will meet this reporting threshold after missing three payments. Whereas a borrower paying only 3% on an interest-only mortgage will take twice as long to reach 1.5% in arrears. Thus the lower-interest rate environment means that it takes longer for loans to be classified as in arrears, which may have contributed to arrears levelling off.[5]

It is therefore essential that firms monitor carefully their residential mortgage arrears, distinguishing underlying factors from the impact of forbearance strategies and definitional effects.

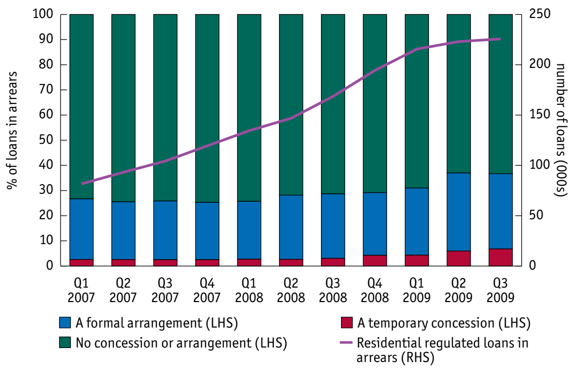
Unsecured losses, which are typically higher but less volatile than secured losses, were closer to the stress test estimates. The low interest rate environment has given some consumers more disposable income due to lower mortgage repayments, but unsecured credit losses will continue to grow if unemployment or interest rates rise. Lenders should therefore pay close attention to identifying and managing the more vulnerable segments of their portfolios.

3 It is important to understand that the fact that the variables performed more favourably than in the stress test in no way invalidates the stress test assumptions. Indeed, precisely because the stress test is intended to test resilience to extreme circumstances, in most years the actual result should be expected to be more favourable than implied by the stress test.

4 Forbearance strategies are designed to provide support to consumers during periods of financial stress. They can include: temporary changes to product terms, such as transferring to interest-only mortgages; arrangements to reduce monthly payments; payment holidays; or transfers to products with a more favourable interest rate.

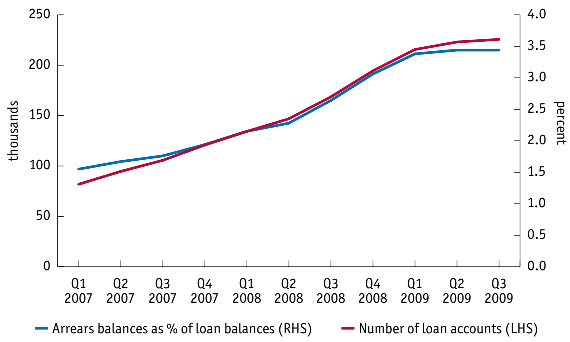
5 The FSA's reporting threshold, arrears equating to 1.5% of the balance outstanding, was chosen to equate to three months in arrears in a normal interest rate environment.

Chart B5: Residential regulated loans in arrears and forbearance



Source: FSA MLAR

Chart B6: Regulated residential loans in arrears (loans >1.5% in arrears)



Source: FSA MLAR
Note: This data excludes unregulated loans (such as, buy-to-let and second charge).

Loss evolution in commercial real estate

Commercial property prices have fallen significantly...

As discussed in *Section A*, commercial real estate has dominated the increase in lending to corporates over the last decade. Since the onset of the financial crisis, commercial property prices have fallen significantly (a fall of 44% from their peak to mid-2009), vacancy rates have increased and there has been a sharp decline in commercial real estate rentals. These factors resulted in a significant deterioration in the quality of commercial real estate lenders' portfolios over the course of 2009. By the middle of 2009, the number of covenant breaches had increased to 8.6% of the value of total loans, up from 6.5% at the end of 2008. And the number of loans in default increased from 2.6% of total value of loans at the end of 2008 to 7% by the middle of 2009.[6]

The 44% fall in commercial property prices is less than the 60% peak-to-trough fall modelled in the 2009 stress scenario. The deterioration in lenders, commercial real estate portfolios have in turn been slightly less severe but much closer to the stress test than in the case of residential real estate.

...and some banks have not undertaken appropriate revaluations.

In commercial real estate, however, even more than in residential property lending, declared provisions depend crucially on firms' management approach to troubled borrowers. In a significant number of cases lenders are waiving breaches of LTV covenants, with debt service covenants increasingly being waived or adjusted. Lenders are sometimes also prepared to extend maturities where cash flow is sufficient to cover interest. While in many cases these practices may be the best means available to maximise returns, where for example such actions are a prelude to a restructuring process or where cash flow has genuinely been subject to a temporary interruption, they could mean that losses are currently being under provided, and that future crystallisation of losses could impair bank balance sheets.

So far, as *Section A* highlighted, lending to real estate companies has continued, as companies have drawn on existing lines. But the sector faces a major re-financing challenge looking forward (*Section A see Chart A22*) and lenders may not be willing to extend existing loans in the face of significant continuing losses. Forced and rapid deleveraging in the sector remains a significant potential risk.

Loss evolution in trading assets

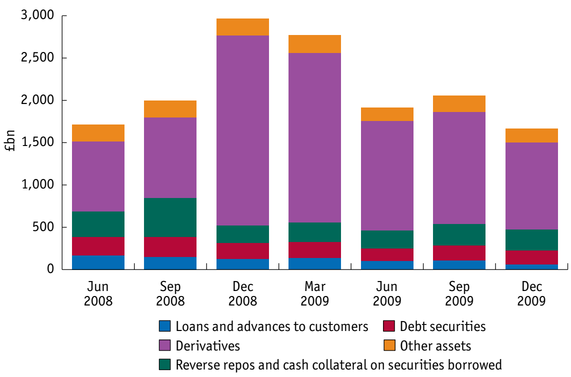
The value of marketable securities held tended to outperform the stress test values.

Losses arising from falls in the value of marketable securities held on bank balance sheets, and from derivatives on these assets, made a major contribution to balance sheet impairment in 2007 and 2008 (and caused firms to reduce the size of their trading books (see *Chart B7*)). The FSA stress test regime requires firms to consider stress tests of the future value of such assets. In particular, this regime requires firms to stress test their trading books against adverse macroeconomic scenarios, and against other market scenarios that would generate losses for their particular books.

During 2009, the value of marketable securities held (including some of the more complex securitised structures, sometimes labelled 'toxic assets') tended to outperform the values used in our stress test, as confidence in financial markets recovered and credit spreads decreased (see *Chart B8*).

6 *Commercial Property Lending Report*, De Montfort University, 2008 year-end.

Chart B7: Major UK banks' trading books evolution

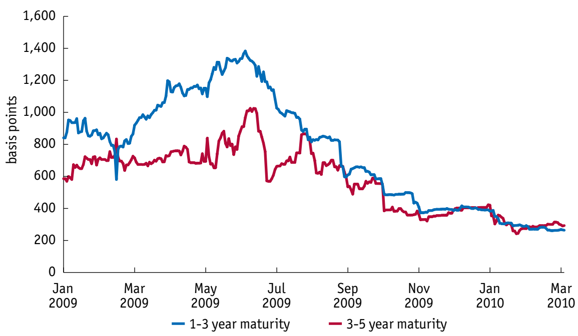


Source: FSA supervisory data and calculations

Chart B8: ITRAXX Eur Crossover S8

Source: Markit Group Ltd.

Chart B9: UK RMBS - LIBOR spread



Source: Markit Group Ltd.
Note: AAA-rated.

Capital requirements will need to reflect the uncertainty of trading book asset values.

Trading book asset values remain, however, inherently uncertain: this fact will be reflected in increasing future capital requirements, and needs to be allowed for in stress tests. Moreover, some marketable securities are held, not in trading books, but in banking books, and are valued on an incurred loss rather than fair value mark-to-market basis. Banking book values therefore remain susceptible to trends in the real economy that increase the likelihood of default. In the past year, ratings on many complex securities have continued to decline, even when market values have recovered from the very low levels of late 2008, as evidenced by upgrade-downgrade ratios from the rating agencies.

The future evolution of risks may be misinterpreted due to accounting mismatches.

Accounting mismatches created by the different treatment of trading books and banking books create the danger that the future evolution of risks will not be clearly understood and communicated. Prior to the crisis, many banks and investment banks executed negative basis trades, holding asset-backed securities (ABS) and buying CDS protection against them. Both parts of the trade were initially held in the trading book. Subsequently, some banks have – under permitted accounting treatment – transferred the ABS to the banking book, while leaving the CDS in the trading book. Under this treatment, any future deterioration in the economy, with a resulting widening of credit spreads, will deliver an immediate profit in trading books, with ABS values unchanged in the banking books, until actual default leads to impairment of assets.

Future stress tests to assess capital adequacy

Stress testing is an important tool in assessing capital adequacy.

We have now embedded our new approach to stress testing into our normal supervisory process. This includes supplementing firms' own stress testing with supervisory stress testing of major firms. This involves regularly updating the stress test scenarios.[7] In 2009, the macroeconomic scenario used as an input for this supervisory stress testing took the economic position of the beginning of 2009 as its starting point, and projected forward for five years (until the end of 2013). Given the changes in economic performance

7 We described our approach to supervisory recommended scenarios in *Stress and Scenario Testing*, FSA Policy Statement PS09/20, December 2009.

and prospects since early 2009, it is now appropriate to define a new scenario for 2010 to 2014. We will continue to keep the appropriateness of the macroeconomic scenario under review.

This new scenario takes the developments of 2009 as given and applies a severe but plausible stress to the macroeconomic environment that prevails at the start of 2010. During 2009, as shown earlier on *Chart B4*, GDP contracted slightly faster than in our 2009 stress scenario and is now at a level approaching what the 2009 stress modelled. A severe but plausible scenario should therefore consider the potential for further deterioration; but any future contraction in output is unlikely (even in a severe stress) to be as large as in 2009, given the lower starting point of the economy relative to productive potential.

Our revised stress test includes a further decline in GDP.

Balancing these considerations, our new macroeconomic stress scenario models a further decline in GDP of 2.3% from the end of 2009 to the end of 2011, with gradual recovery thereafter. Alongside this fall in GDP, the scenario includes a rise in unemployment to a peak of 13.3% in 2012, and allows for a 'double-dip' in property prices, with house prices falling by 23% from current levels and commercial property by more than 34%. The overall peak-to-trough fall in house prices in the new stress (at 36%) is therefore considerably less than modelled in the 2009 scenario; the overall peak-to-trough fall in commercial property prices remains at about 60%. The reduction in the total housing market stress is in line with how house prices have behaved over the last year (that is, considerably milder than under the old scenario), but still represents a severe stress.

Table B2: Comparing the 2009 and 2010 stress test parameters

	2009 scenario	2010 scenario
Period covered by scenario	2009-2013	2010-2014
GDP fall (peak-to-trough, %)	-6.9	-8.1
House prices, nominal (peak-to-trough, %)	-50	-36
Commercial property prices, nominal (peak-to-trough, %)	-60	-60
Unemployment rate (peak, %)	12.5	13.3

Note: Peaks – GDP peaked in Q1 2008; house prices peaked in Q3 2007; commercial property prices peaked in Q2 2007. Indices – The 2009 scenario used the DCLG house price index; the 2010 scenario uses the Halifax house price index. These peak-to-trough stresses cannot therefore be precisely compared.

Given the UK banks' overseas exposures, our scenario also includes stressed projections for the US and other economies, which similarly experience further declines in GDP and property prices from current levels.

The scenario articulated here represents our view of a severe but plausible macroeconomic stress. We expect banks, building societies, investment firms and insurers – including those outside the scope of our supervisory stress testing exercises – to pay regard to this scenario as representative of the minimum forward-looking adverse conditions in which they should assess their ability to meet minimum specified capital levels; for banks, this would relate to specified capital levels such as the 4% stressed minimum core tier 1 ratio as articulated in *Box B1*. In order to assess the impact of adverse external events, firms should therefore use our stress scenario to 'anchor' the severity of their own scenario for capital planning stress testing (depending on their particular exposures, firms may choose to produce alternative but similarly severe scenarios that address other macroeconomic and financial risk drivers).

A new global capital regime

The BCBS review of the international bank capital regime is ongoing.

The FSA's interim capital regime will remain in place until a new global regime is agreed. In response to the crisis, the Basel Committee on Banking Supervision (BCBS) is engaged in a fundamental review of all aspects of the international bank capital regime, with a timetable to create a comprehensive reform package by the end of 2010.

Some reforms have already been agreed and are being reflected in the EU legal framework via amendments to the Capital Requirements Directive.[8] These measures include significant increases in some categories of trading book capital requirements, tightening of hybrid capital eligibility to improve the quality of capital, retention requirements on originators of securitised structures and, restrictions on firms' interbank and intra group lending exposures, among others. These immediate measures have addressed some obvious deficiencies in the existing regime.

Reforms will address issues such as level and quality of capital, leverage ratios and trading capital requirements.

The total package now under development also includes:

- Reforms to the overall required level and quality of capital, against a background of international agreement in principle to increase the minimum requirements for high quality going concern capital above pre-crisis levels;
- Measures aimed at strengthening counterparty credit risk capital requirements;
- The introduction of a leverage ratio to supplement the risk-based capital requirement;
- Measures to ensure that capital buffers are built up in good economic times, which can be drawn upon in periods of stress; and
- A fundamental review of trading capital requirements which may result in further increases in capital requirements against some categories of trading book activity.

The challenge of systematically important banks will also be addressed.

In addition, the BCBS and the Financial Stability Board (FSB) are working to design appropriate responses to the challenge of large systemically important banks. Policy options under consideration include requirements for higher capital ratios in large systemically important banks or higher quality of capital (such as, a greater proportion of capital which needs to take the form of common equity or contingent equity instruments).

The BCBS is currently consulting on key design features of some of these reforms.[9] However, actual quantitative requirements will reflect the findings of the Quantitative Impact Study (QIS) being conducted by BCBS in the first half of 2010. In addition the Macroeconomic Assessment being conducted by a joint FSB/BIS/BCBS working group will assess the cumulative impact of the changes to capital and liquidity requirements now under discussion, and the macroeconomic implications of alternative transition paths to the new regime.

The new regime, once in place, will create a sounder global banking system, less susceptible to solvency and liquidity crises and less likely to be a source of macroeconomic volatility. But in the light of the still gradual and uncertain path of recovery described in *Section A*, and the need to ensure that lending volumes are compatible with a gradual, rather than sudden deleveraging process, the transition to the new regime will need to be managed gradually over several years.

Firms need to be aware that the direction of change will be towards significantly higher capital requirements than existed pre-crisis, overall and particularly in relation to trading activities. They should therefore be aiming to build up capital strength via, for instance, appropriate approaches to dividend and remuneration policies.

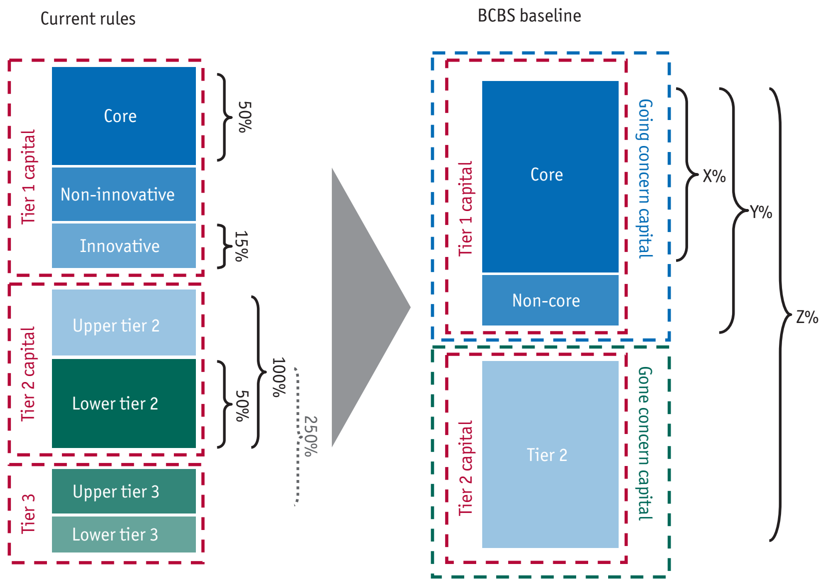
8 In December 2009 the FSA published a consultation paper (CP09/29) discussing implementation of changes to the CRD included in CRD2 and CRD3 packages.
9 The European Commission is also consulting on further changes to the CRD in its CRD4 package, to reflect the BCBS material in EU regulation.

Box B2: BCBS proposals for amendment of the definition of capital

Under current rules, limits and minima on different forms of capital are set relative to total tier 1 capital after deductions: (i) core tier 1 capital must be at least 50% of this total; (ii) innovative tier 1 capital cannot exceed 15%; (iii) total tier 2 capital cannot exceed 100%; (iv) lower tier 2 capital cannot exceed 50%. In addition, for the purposes of meeting market and concentration risk requirements, the amount of excess tier 2 plus upper tier 3 capital that may be used cannot exceed 250% of the tier 1 capital (after deductions) that has not previously been used to meet credit, operational, counterparty and base requirements.

The BCBS proposal simplifies the capital structure by removing tier 3 capital and clarifying the criteria for eligibility in the remaining categories. Separate explicit minima would be established for the common equity component of tier 1, total tier 1, and total capital. These would be set relative to risk-weighted assets, in contrast to the current rules where the limits are based on tier 1 capital the bank has issued. The new minimum requirements will be calibrated in the coming months using, among other inputs, the results of the QIS exercise.

Figure B1: Current capital regime and BCBS baseline



The proposals also include changes to deductions from capital – both where they are deducted from (core tier 1) and new deductions (such as deferred tax assets). The BCBS proposed new criteria to strengthen the quality of non-core tier 1 as well as setting out criteria for tier 2. There will also be some further work on contingent capital, convertible capital instruments and instruments with write-down features in terms of what role they should play in a regulatory capital framework, both in the context of entry criteria and how they can be used to provide part of a capital buffer over the minimum requirement.

Key messages

- Banks and building societies are better capitalised against the risks they run, both in terms of quantity and quality of capital. They need to maintain this cushion, even under the possibility that the recovery will falter.
- Comprehensive stress testing frameworks for evaluating capital adequacy, both those internal to the firm and those used by supervisors, coupled with policy reforms informed by the outputs of those frameworks, are important instruments to ensure risks are evaluated and managed effectively.
- By continuing to improve the quality of assets through new, higher quality lending, firms can improve their capital ratios.
- Economic conditions and firm actions to manage defaults may mean that firms are underestimating the number of borrowers in financial difficulty.
- Firms need to remain aware of the impact of interest rate changes on their chosen arrears measurement and ensure internal reporting continues to reflect the quality of the underlying portfolio.
- Firms need to ensure that the true level of impairments, including forbearance cases, are reported to senior management to provide a clear view of distress in the mortgage book.

Liquidity and funding in the banking and building society sector

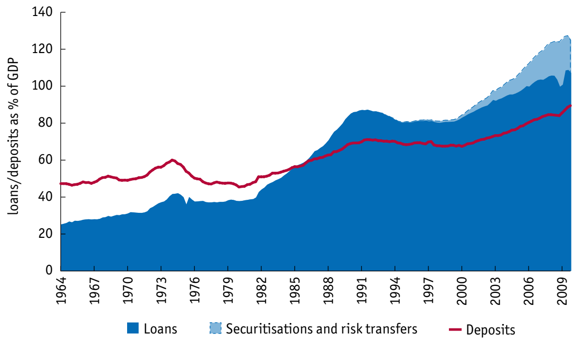
In the years running up to the crisis, the UK banking system (both building societies and banks) became increasingly dependent on potentially risky sources of funding and on funding from abroad. In the crisis, some of these sources of finance rapidly dried up, and the authorities had to underpin the system with HM Treasury funding guarantees and exceptional Bank of England liquidity support. To ensure a less risky system for the future, the FSA is introducing a new liquidity regime. However, the transition to this new regime, combined with the withdrawal of exceptional public funding and liquidity support, will create major challenges. Firms need to develop robust future funding strategies, and the FSA will determine the transition path to the new liquidity regime in the light of a feasible pace of adjustment.

Emergence of a major funding gap and vulnerabilities

A customer funding gap emerged in the late 1980s…

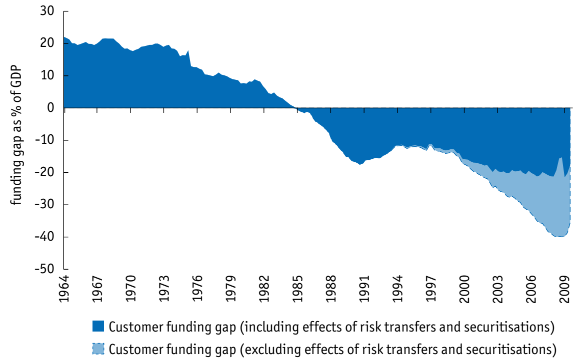
Up to the mid 1980s, bank deposits from UK corporates and households exceeded lending to those sectors, creating a 'customer funding surplus' for UK banks and building societies. By the late 1980s, however, a large customer funding gap had appeared, and this continued to grow steadily in the decade before the crisis, reaching 20% of GDP in 2007 (*Charts B10 and B11*).

Chart B10: Household and corporate lending and deposits



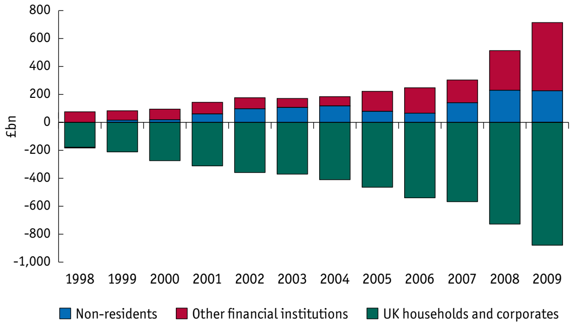
Source: Bank of England (BankStats) M4 data, ONS, FSA calculations

Chart B11: Customer funding gap (deposits minus loans)



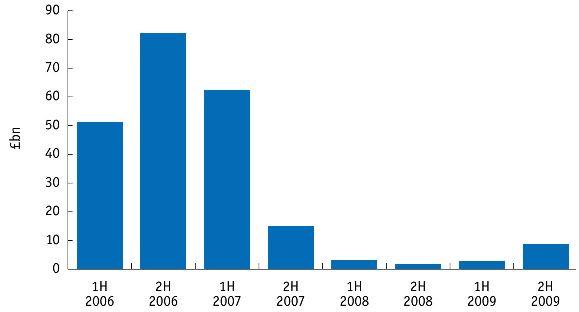
Source: Bank of England (BankStats) M4 data, ONS, FSA calculations

Chart B12: UK banking sector net balance sheet counterparts (liabilities minus assets)



Source: Bank of England (BankStats), ONS, FSA calculations
Note: Liabilities and assets of UK resident banks with different sectors are netted to give a sectoral 'funding gap/surplus'. 2009 data is correct up to September 2009. This representation of the banking sector balance sheet omits the impact of 'Capital & Other Internal Funds' and all other items for which a sectoral counterpart cannot be determined.

Chart B13: UK-owned bank issuance of ABS, MBS and covered bonds



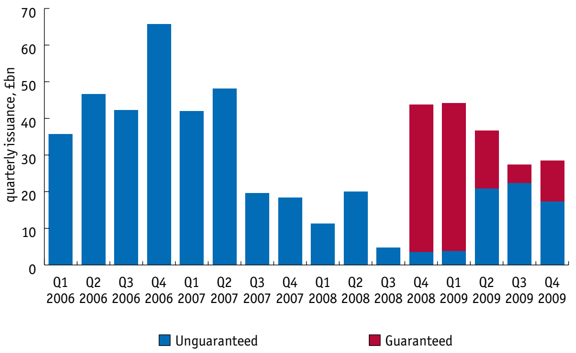
Source: Dealogic, Bank of England, FSA calculations
Note: Issuance data converted at Bank of England average quarterly spot rates for sterling equivalent. Excludes debt issuance classified as retained by Dealogic.

...with securitised lending increasingly being used to fund the gap from the late 1990s.

In addition, however, from the late 1990s onwards an increasingly significant proportion of lending (in particular household mortgages) took a securitised form, with the banks and building societies packaging loans into securities (primarily RMBS) which could then be distributed to non-bank investors. Lending in this form reached a sixth of all lending and nearly 20% of GDP by 2007. As long as the distribution was to non-bank investors, this lending did not require funding on bank balance sheets. However, it created a funding vulnerability if at any time the willingness of investors to purchase these credit securities were to dry up. In addition, the retention of some of these securities on balance sheets or their purchase by other banks, rather than by non-bank investors, meant that at the level of the banking system, there was an increased funding requirement not apparent from standard comparisons of loans and deposits. In some sense, therefore, the customer funding gap of the UK banking system can be considered as including the securitisation wedge shown on *Charts B10 and B11*.

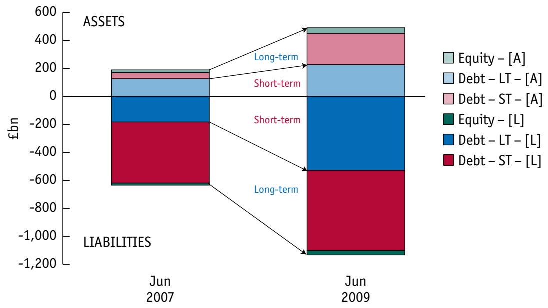
A significant part of this funding gap was covered by financing flows from abroad and other domestic financial institutions (see *Chart B12*). These flows included, for instance, purchases of RMBS by bank-sponsored overseas SIVs and conduits and by US money market mutual funds. They also included foreign purchases of bank medium-term debt securities, and short-term interbank placements from foreign banks. The continuation of these flows was therefore vulnerable to any loss of confidence in the UK banks.

Chart B14: Public issuance of debt securities by UK-owned banks



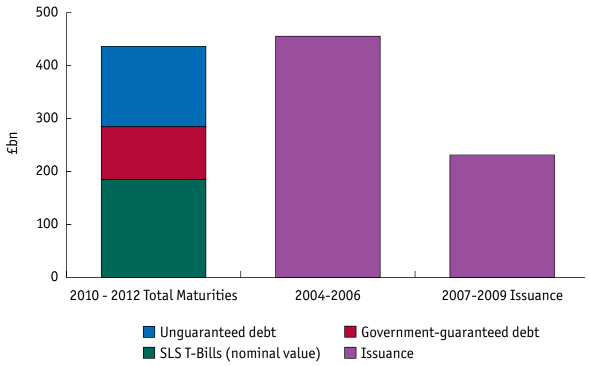
Source: Dealogic, Bank of England, FSA calculations
Note: Issuance data converted at Bank of England average quarterly spot rate. Excludes debt classified as 'retained' by Dealogic.

Chart B15: Selected UK public sector financial assets and liabilities



Source: Bank of England (BankStats), ONS, FSA calculations
Note: Excludes 'Currency' and 'Foreign Exchange'. The gilts held by the Bank of England as a consequence of quantitative easing do not appear in the above due to the balance sheet consolidation. Treasury bills issued under SLS are shown as short-term liabilities and the equivalent SLS collateral is shown as a long-term asset, based on amounts published by the Bank of England.

Chart B16: Debt maturities of UK-owned banks



Source: Dealogic, Bank of England, FSA calculations
Note: Dealogic data converted at quarterly average USD/GBP spot exchange rate (Bank of England). Maturity profile does not include debt classified as 'retained' by Dealogic (which would include SLS pledged collateral). Therefore, any retained debt that is not SLS-collateral is omitted from the above. Issuance data does not include debt classified as 'government-guaranteed' or 'retained'.

The increasing extent of maturity transformation also increased vulnerabilities.

Vulnerability was also created by the increased extent of maturity transformation being performed both by the banks themselves and by the non-bank or 'shadow' bank purchases of securities (see *Chart B13*). An increased proportion of bank liabilities were not 'sticky' customer deposits, the average maturity of bank debt securities declined and, crucially, institutional investors such as SIVs, conduits and mutual funds, were themselves running very large maturity transformation risks, with assets of far longer contractual maturity than their liabilities, relying on market liquidity (the ability to sell rapidly) to ensure their ability to meet liabilities as they fell due.

Crystallisation of risks and policy response

Several key funding sources declined in the financial crisis…

In the financial crisis, several major sources of finance which had previously funded lending by UK banks and building societies declined. Distribution of securitisations off balance sheet fell from £130 billion in 2006 to £5 billion in 2008 (see *Chart B13*) as investing institutions became unwilling to take on either credit or maturity transformation risk. Unguaranteed issuance of debt securities by UK banks decreased from £190 billion in 2006 to £40 billion in 2008 (see *Chart B14*), and the willingness of banks to lend to each other in interbank markets (particularly across borders) seized up in autumn 2008. As a result, several UK banks faced a funding crisis.

...and large-scale liquidity support was required.

In response, the rescue measures of autumn 2008 included not only the capital support discussed earlier, but also funding and liquidity support. HM Treasury's Credit Guarantee Scheme (CGS) guaranteed the issue of bank medium- and long-term debt. And the Bank of England Special Liquidity Scheme (SLS) enabled banks to borrow Treasury bills from the Bank against the collateral of securities (predominantly UK RMBS). *Chart B14* shows the dominance of CGS guaranteed in the debt issuance of UK banks in late 2008 and the first half of 2009. In addition, since 2008 the majority of securitised lending by UK banks has been held on balance sheet and then primarily used as collateral for SLS liquidity support or used to obtain liquidity from overseas central banks, rather than distributed to end investors. Together the CGS and SLS provide over £300 billion of funding and liquidity support which equates to over 10% of the liabilities of the top six UK banks.

Through these support measures, the public authorities have played a key role in ensuring the continued funding of the banking system. In addition, these measures have had the effect of switching some maturity transformation from the financial to the official sector. Quantitative easing has added to this switch, since it has the net effect of the Bank of England holding long-term gilt assets, via the Bank of England Asset Purchase Facility Fund (APFF), and commercial banks have increased short-term reserve balances held at the Bank of England. Overall the consolidated short-term liabilities of the UK government and Bank have increased significantly (see *Chart B15*).

These emergency interventions addressed the short-term crisis. To prevent a repetition, the FSA has designed and, at the international level, the BCBS, is designing new liquidity standards which will increase the resilience of individual firms and of the system as a whole. These measures include better individual firm measurement and management of liquidity risks; larger buffers of clearly liquid assets; and structural measures to reduce the overall extent of maturity transformation to safer levels, extending the tenor of liabilities relative to the tenor of assets (see *Box B3*).

Challenges in transition to a more sustainable system

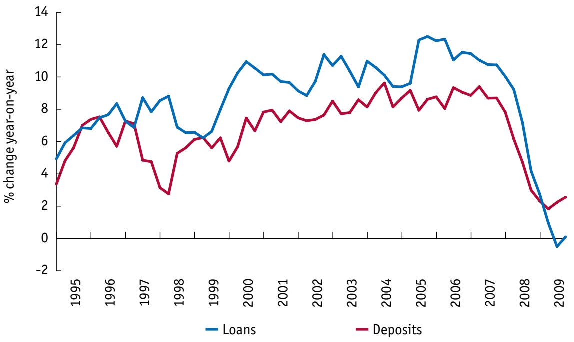
The new liquidity policies described in *Box B3* will create a safer banking system for the future. But the transition to this system will require challenging adjustments in funding approaches. And these challenges are accentuated by the need for the authorities to withdraw emergency support measures, in order to achieve a return to a sustainable market-based system.

More sustainable funding sources are required to replace the emergency sources.

The SLS is scheduled to expire in 2012; by then banks will have to have repaid £185 billion of Treasury bills lent under the scheme to the Bank of England in exchange for the securities held as collateral under the SLS. The CGS-guaranteed debt, along with maturing non-guaranteed debt issues, will need to be refinanced (see *Chart B16*). Banks and building societies therefore face major challenges in developing alternative sustainable sources of funding needed to close to some degree the 'customer funding gap' which opened up in the years before the crisis.

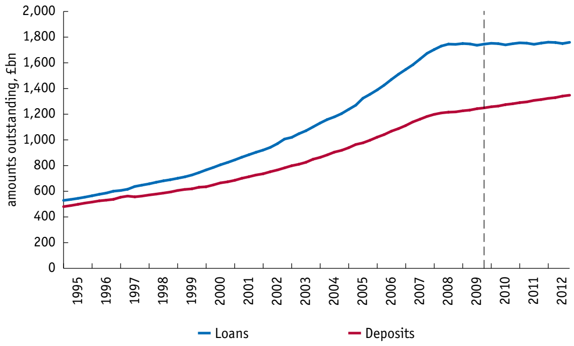
One way partially to close this gap will be through increased customer deposits. As *Section A* described, the household savings rate has increased significantly from its very low pre-crisis levels, and some of this new saving will take the form of increased bank deposits. As *Chart B17* shows, the growth rate of household and corporate sector deposits together, while significantly reduced from recent years, now exceeds the growth of loans for the first time since the mid 1990s. Various factors will determine the future path of retail and commercial deposits, including not only the household and corporate sector savings rates, but also how household savings are allocated between paying down debt and accumulating financial assets, and the allocation within new assets between retail bank deposits, National Savings products, and non-bank assets such as equities and pension contributions. One reasonable scenario, however, suggests that if the stock of lending stayed flat in nominal terms and deposits continued to grow at the same annual rate as in Q4 2009 (2.6% per annum), the gap between deposits and loans would fall from just under £500 billion today to just under £400 billion by the end of 2012 (see *Chart B18*).

Chart B17: Growth in lending and deposits of UK households and corporates



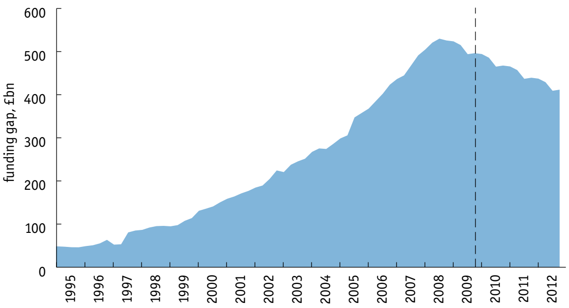
Source: Bank of England (BankStats) M4 data, FSA calculations
Note: Lending data is M4 excluding the effects of loan transfers and securitisations.

Chart B18: Outstanding lending and deposits of UK households and corporates



Source: Bank of England (BankStats) M4 data, FSA calculations
Note: Lending data is M4 excluding the effects of loan transfers and securitisations.

Chart B19: UK household and corporate funding gap



Source: Bank of England (BankStats) M4 data, FSA calculations
Note: Lending data is M4 excluding the effects of loan transfers and securitisations.

However, it is clear that neither the total customer funding gap between deposits and loans, nor the full extent of SLS support, is likely to be offset by increased deposit growth alone. Closing the entire customer funding gap by the end of 2012, for instance, would require a growth rate of 12% per annum in household deposits which would imply a savings rate far in excess of conceivable levels.

It is therefore essential that firms develop plans for other sources of more sustainable and longer-term finance, for instance through issuing significant quantities of medium- and long-term debt. New debt issuance (unguaranteed and unretained) between 2010 and 2012 would need to be at a similar level to that achieved in the period between 2004 and 2006 in order to replace the £440 billion of maturing debt issues plus SLS liquidity support which come due between now and end 2012 (see *Chart B16*). If public issue securitisation can be restarted, this could contribute to closing the gap. Securitisation issues of almost £10 billion were successfully launched in Q3 and Q4 2009 (see *Chart B13*), but significant further growth will be needed if such issues are to make more than a marginal contribution to the restoration of a balanced and sustainable funding profile.

It is therefore vital that firms develop funding strategies which respond to the phase out of SLS and CGS support. The FSA will be reviewing these plans in detail with firms. The FSA and international authorities will meanwhile design the transition paths to new liquidity requirements which take account of the need to maintain lending volumes in the face of the withdrawal of official support, while making progress towards a sounder future system.

Box B3: Liquidity policy

The new liquidity policy, published in 2009 and outlined in BIPRU 12 is based on the following four pillars:

- **Improvements to liquidity risk management:** Our new policy incorporates internationally proposed principles from the BCBS. In January 2010, we sent a 'Dear CEO' letter to firms asking them to certify compliance, the first time the FSA has asked for self-certification in this fashion in relation to liquidity. We will undertake further thematic work later in the year.

- **Increased resilience to liquidity stresses:** The new regime requires firms to survive a severe name-specific as well as a market-wide stress for three months. Firms must hold liquidity resources to cover outflows under these scenarios. Liquidity resources are limited to central bank reserves and highly rated government bonds denominated in major currencies.

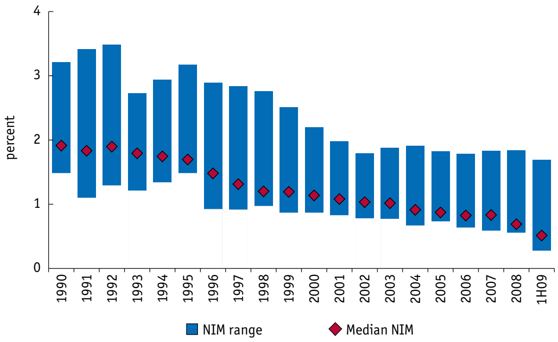
- **Reporting requirements:** The new policy requires significantly enhanced reporting to allow us to form firm-specific and sector-wide views of liquidity risk. Major firms are already providing us with this information and we are making a significant investment in our own systems to use this data.

- **International cooperation:** As part of the new liquidity regime we have developed a framework for enhanced international cooperation between regulators of cross-border banking groups to help mitigate supervisory issues that arose in the crisis from foreign firms operating in the UK.

On 17 December 2009 the BCBS published its paper titled 'International framework for liquidity risk measurement, standards and monitoring' for consultation. The paper proposes to set common minimum international standards for mitigating liquidity risk by using the following two ratios: i) a **liquidity coverage ratio** (LCR) would require banks to hold a sufficient amount of high quality liquid assets to survive a severe stress for a period of 30 days. Outflows can only be met by generating liquidity from high quality government bonds and central bank deposits; and ii) a **net stable funding ratio** (NSFR) that measures stable funding relative to the liquidity of the assets funded, and the potential draw on off-balance sheet commitments over a one-year period. The FSA does have concerns that the NSFR makes unsupported ex-ante assumptions about the future liquidity of assets, and contains unwelcome macro-prudential incentives by assuming a large-scale and simultaneous liquidation by firms of securities and encouraging firms to change their lending to the form of marketable securities rather than non-marketable retail and corporate lending, which may impact lending to the 'real economy'.

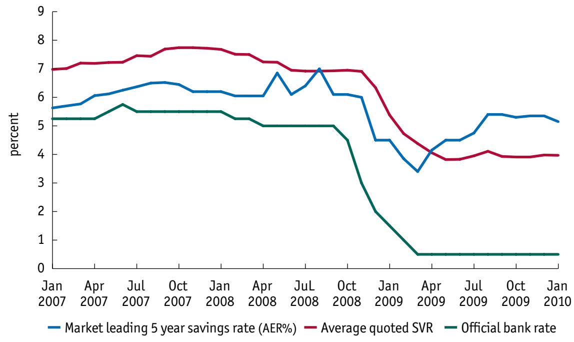
As we announced in publication of our policy, we will not seek to tighten quantitative standards before economic recovery is assured. The transition path to meeting our new standards will ensure sufficient flexibility for us to align the UK regime with the EU/international regime as ultimately agreed. In the meantime, we will continue to work with those banks that are likely to be impacted the most by new liquidity requirements to understand what steps they are taking to mitigate liquidity risk and what additional impacts, if any, will result from progressively tightening our regime. The BCBS QIS will also cover liquidity proposals. This will inform further international work in finalising standards.

Chart B20: Building societies Net Interest Margin (NIM) evolution



Source: Bankscope, FSA calculations
Note: Based on historical data for 20 largest building societies by assets as at December 2008. 1H2009 and 1990-1993 data employs smaller sample size due to limited data availability.

Chart B21: Crossover of mortgage rates and deposit rates



Source: Bank of England, MoneyFacts
Note: Deposit rates available for minimum £1,000 investment.

Key messages

- Maturing debt and withdrawal of public support will leave a funding gap which could be closed by a number of channels: by gradual deleveraging, increasing retail deposits or increasing wholesale funding domestically or abroad.
- Firms will need, over time, to increase resilience to future liquidity stresses by building up a buffer of high quality liquid assets, essentially government bonds and central bank reserves, which they can liquidate to meet outflows that may occur in a stress.

Margin compression challenges: particularly in building societies

Section A noted the impact of the very low interest rate environment on the mortgage market, with many households benefiting from a boost to disposable income after mortgage payments and mortgage arrears much lower than in previous recessions. Very low interest rates, however, are creating major challenges for some building societies, particularly when combined with problems deriving from unsuccessful and risky diversification.

The building society sector has faced a gradual decline of net interest margins over the last twenty years (*Chart B20*). Originally this was a positive business model choice, to pay a mutual 'dividend' in the product price as a response to the demutualisations of the late 1990s. Subsequently margins were squeezed by cross-subsidies and by wholesale funded lenders which under-priced risk in the near prime market, with knock-on effects in the prime market.

Building societies face margin and profitability pressures...

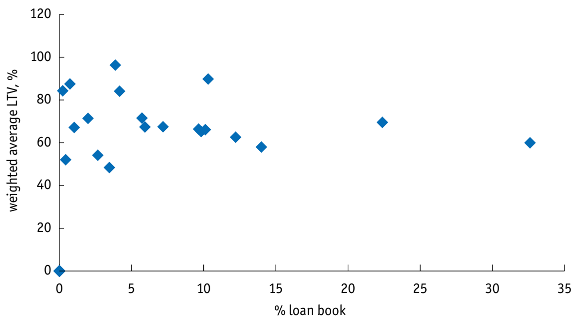
In the years running up to the crisis, some building societies responded to margin and profitability pressures by diversifying away from their traditional focus on prime residential mortgages, and into higher margin but riskier lending, in particular commercial property, subprime and non-income verified residential mortgages and some types of buy-to-let lending. The wide variety of portfolio choices (illustrated in *Chart B22*) has resulted in a wide variety of loan loss experiences, with significant loan losses in commercial property and some buy-to-let portfolios, but much lower losses in prime residential lending. The biggest problems have arisen in building societies which combined significant participation in several high risk categories. In almost every one of these cases the building societies lacked the appropriate risk management resources and systems to identify and manage the risks that they were taking on.

...which have been compounded by low interest rates.

The recent low interest rate environment has further increased pressure on the building society sector by reducing the level of earnings on free reserves and by narrowing, or even reversing, the margin between wholesale rates and retail funding rates. While base rates have fallen to 0.5%, there was no scope for similar reductions in savings rates because of the so-called 'zero bound' and the actual deposit rates required to attract marginal funds have been considerably higher, sometimes in excess of lending rates (*Chart B21*).

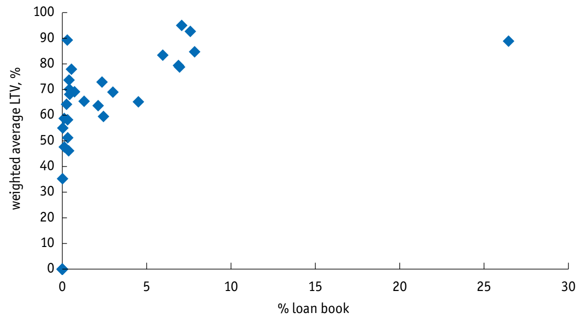
Chart B22: Building societies' portfolio choices

Chart B22a: Building societies' fast track/self-certification portfolios



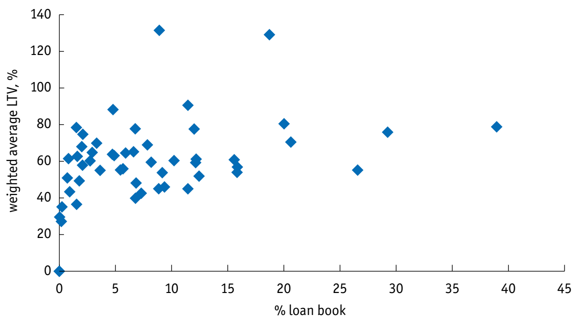
Source: FSA supervisory data and calculations
Note: Data requested from societies as a one-off 'snap-shot' as at end June 2009.

Chart B22b: Building societies' sub-prime lending portfolios



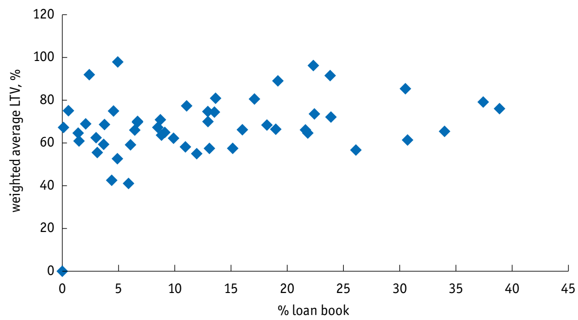
Source: FSA supervisory data and calculations
Note: Data requested from societies as a one-off 'snap-shot' as at end June 2009.

Chart B22c: Building societies' commercial lending portfolios



Source: FSA supervisory data and calculations
Note: Data requested from societies as a one-off 'snap-shot' as at end June 2009.

Chart B22d: Building societies' buy-to-let portfolios



Source: FSA supervisory data and calculations
Note: Data requested from societies as a one-off 'snap-shot' as at end June 2009.

The challenge of the very low interest rate environment has been compounded for those building societies that have a significant proportion of their mortgages priced as base rate trackers with low or no floors. They will continue to suffer very low margins unless or until the mortgages revert to SVR or another higher margin rate. A number of societies also have capped their SVRs at a narrow spread over Bank Rate, with little or no contractual ability to reset them; if base rates remain low, these societies will continue to experience margin pressure even after fixed or tracker rates revert to SVR. Finally, many societies have been affected by low earnings on fixed rate lending that has been swapped to LIBOR – the reduction in wholesale funding has increased basis risk associated with these loans and locked in low margins until the end of the fixed rate period. For all societies with significant interest income linked to base or LIBOR rates, the second alternative scenario presented in *Section A* (a very slow recovery but with continued low base rates) is the most problematic.

Additional profit pressures for the sector have also arisen from continued high FSCS levies following the bank failures of the third quarter of 2008.

The current challenges may even become more severe over the next few years as the withdrawal of exceptional funding and liquidity support from deposit takers drives further strong competition for retail deposits. These challenges are to a degree faced by retail banks as well as building societies, but are potentially more acute for building societies because they are required by the 1986 Building Societies Act to raise at least 50% of their funds from retail sources. While building societies continue to source wholesale, the amount of that funding has reduced, in particular for smaller societies and those larger societies which have not been able to maintain strong credit ratings. Constraints on the ability to grow balance sheets via either retail or wholesale funding make it difficult for building societies to expand new lending activity to take advantage of the higher margins now available for new lending.

Despite these pressures, most building societies made a profit in 2008 and are expected to do so again in 2009. Many societies are currently adopting a 'hibernation' approach, constraining costs and curtailing lending whilst they sit out the market downturn. This approach, together with their low profitability, means that societies' balance sheets will either shrink slightly or grow very slowly for some time to come. Their mutual status and lack of shareholder pressure can however allow societies to take a longer-term view than would be possible for listed companies. Most societies have sufficient existing capital to sustain a period of very low profit, or even low level losses caused by inverted margins, provided that mortgage arrears are contained within levels experienced in previous recessions.

Offsetting this advantage of mutual status, however, building societies cannot issue ordinary shares and therefore have restricted ability to raise new capital – retained earnings have historically been the only source of core tier 1 capital. Total capital has been supplemented by Permanent Interest Bearing Shares (PIBS) and by subordinated debt (lower tier 2 capital).

The financial crisis has, however, revealed the vital importance of high quality capital which is loss absorbing on a going-concern basis. PIBS do not have the required loss absorbing qualities to count as core tier 1 capital and proposed changes to the Capital Requirements Directive from the end of 2010 will require new PIBS issues to have enhanced loss absorbency features even to continue to count as non-core tier 1. Whilst the innovations during 2009 of Profit Participating Deferred Shares (PPDS) as a new core tier 1 instrument, and of contingent convertibles, have made it possible for societies to improve the quality of existing capital and strengthened the resilience of the sector in the face of current challenges, the marketability of building society core capital and contingent capital instruments.

Key messages

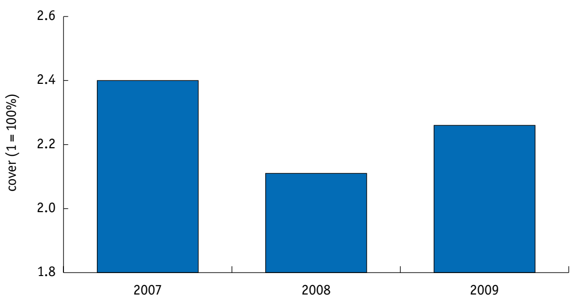
- Low net margins and a difficult macroeconomic environment will continue to challenge the profitability of the building societies sector in the immediate future.
- Competition for retail funding is likely to remain high, and may intensify further.
- Funding and capital constraints will result in reduced capacity to lend, so society balance sheets are likely to shrink or grow only slowly.

Prudential risks and issues in the insurance sector

Profitability in the life insurance sector also remains constrained.

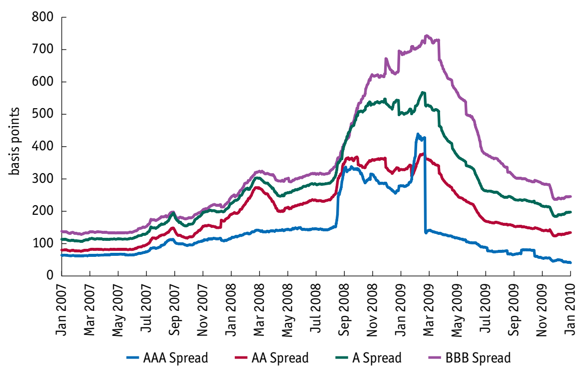
Insurers continue to face prudential challenges caused by the macroeconomic and regulatory environment. Over the last year, life insurers in particular have been affected by market turbulence and the downturn in the UK economy. However, solvency levels for many, but not all, life insurers are now more comfortably above minimum requirements as equity markets and property prices have recovered and credit spreads have narrowed. *Chart B23* illustrates the movement in the average level of Pillar 1 cover for a selection of life insurance firms between year ends 2007 and 2009. Although prudential issues for general insurers have not been as severe, other risks have emerged for them, for instance rising claims costs leading to reserve adequacy pressures. The market and economic environment, together with regulatory developments, will make it challenging for many insurers to return to the level of profitability experienced before the financial crisis, unless they make significant changes. It is important for insurers to consider carefully whether their future capital and strategic plans and their risk management activities take account of the issues discussed below.

Chart B23: Pillar 1 cover – sample of life insurers



Source: 2007 and 2008 FSA returns, 2009 firms' own estimates

Chart B24: Sterling corporate bond spreads



Source: Markit Group Ltd.

Prudential issues caused by the macroeconomic environment continue to challenge all types of insurers. *Table B3* below highlights how different types of insurance firm may be vulnerable to changes in different economic risk factors.

Table B3: Vulnerabilities of insurance firms

Risk factor	Which types of firm are most vulnerable?
Corporate bond spread widening/default/downgrade	Annuity firms and firms with defined benefit pension schemes
Equity price volatility	With-profits life insurers
Equity price falls	With-profits and unit linked life insurers
Interest rate falls	General insurers and some life insurers
Interest rate rises	Some with-profits life insurers
General inflation increases	General insurers
Exchange rate fluctuation	General insurers
Low or negative economic growth	All insurers

Credit risk in annuity books

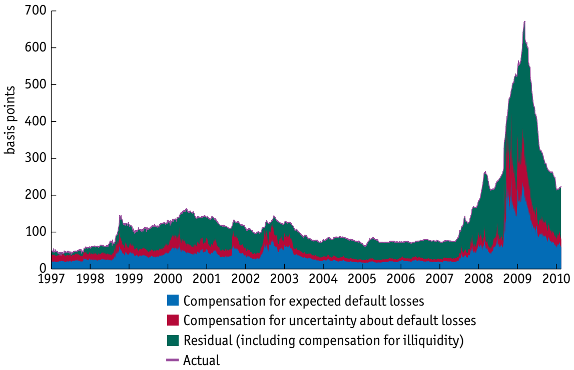
Widening corporate bond spreads affected annuity firm liabilities.

Market turbulence in late 2008 to early 2009 led to a significant widening in corporate bond credit spreads (see *Chart B24*) which affected the value of annuity firms' liabilities. There are a number of components wrapped up in corporate bond spreads to compensate bond holders for different risks (see *Chart B25*), but no universally agreed basis for decomposition. Determining how much benefit to take for illiquidity is a particular issue for annuity providers because annuity liabilities are backed predominantly by corporate bonds and our rules allow firms to take account of this illiquidity premium in valuing annuity liabilities. If a greater proportion of the spread were attributable to default risk, then this would increase base liabilities and capital requirements for annuity providers, potentially by a significant margin. Some insurers have taken more benefit for the illiquidity premium in calculating their liabilities than we consider prudent and we have taken steps to address this.

Market conditions have eased but there is a risk of renewed credit spread widening.

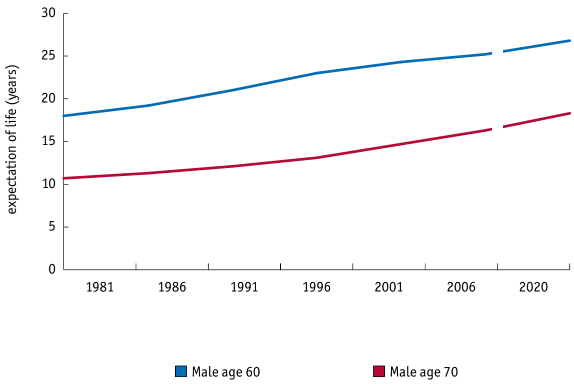
Credit spreads started to narrow from mid-2009. We expect firms' senior management to challenge their valuation assumptions as market conditions evolve. Their judgements should be informed by ongoing stress testing, and firms should remain alert to the possibility of further market shocks and widening credit spreads.

Chart B25: Decomposition of sterling investment-grade corporate bond spreads [a]



Source: Bloomberg, Merrill Lynch, Thomson Datastream, Bank calculations.
Note: [a] Webber, L and Churm, R (2007), 'Decomposing corporate bond spreads', *Bank of England Quarterly Bulletin*, Vol. 47, No. 4 pages 533-41. Option-adjusted spreads over government bond yields.

Chart B26: Movements in male expectation of remaining life over time



Source: ONS

Longevity

Over the last 20 to 30 years (see *Chart B26*) life expectancy has continued to improve for the population as a whole. These improvements have occurred at an unprecedented and increasing rate. It is particularly important that annuity writers and their reinsurers keep pace with these changes, research longer-term population trends, and continue to analyse their own mortality data. Firms are expected to use a variety of modelling approaches to determine appropriate pricing and reserving assumptions for mortality improvements. We have seen most firms strengthen their longevity assumptions quite significantly over the past few years but in some firms these assumptions may need to be strengthened further.

Claims inflation risk to general insurers

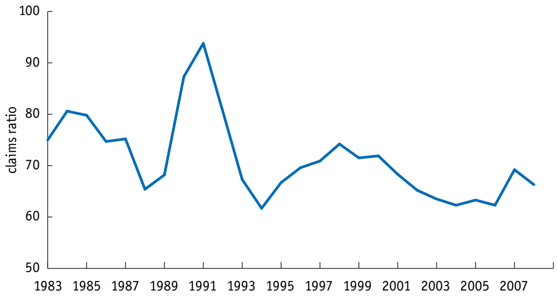
Claims inflation remains a risk to general insurers…

In the general insurance market, a number of economic, sector-specific and consumer behaviour factors may begin to trigger higher claims inflation, with changes in the number, size and type of claims across several classes of business. A higher incidence of claims fraud, which is already becoming apparent, is one cause of the upwards pressures on claims costs. It is not possible to isolate the drivers of claims ratios as, in addition to claims inflation, ratios could also be affected by changes in premiums and the number of claims. However, *Chart B27* does illustrate that claims inflation has risen sharply during previous recessionary periods, as was experienced in the early 1990s. This can materially distort insurers' claims cost trends and should be taken into account in reserving.

…however staff may not fully appreciate the risks.

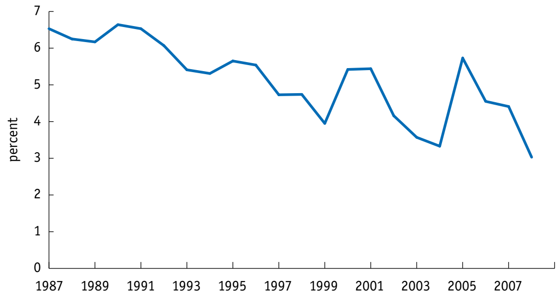
Excluding major catastrophe events, such as Hurricane Katrina and the 9/11 terror attacks, the underlying claims trends for the sector over the past decade have been broadly benign. There is a risk that insurance claims and underwriting staff may not have worked in an unstable claims trend environment and therefore may not fully appreciate the implications of claims inflation. The early warning signs may not be noticed or may be ignored until it is too late. Monitoring systems need to be put in place and firms should also consider this issue as part of their risk and capital management processes.

Chart B27: Claims ratio for annual business (UK motor and non-motor)



Source: ABI statistics

Chart B28: UK general insurance worldwide investment returns as a percentage of invested assets



Source: ABI statistics

Reserving and underwriting adequacy in general insurers

Tighter margins increase the importance of underwriting for profit.

In addition to the inflation risk discussed above, reserving adequacy has re-emerged as an issue for general insurers. Firms have been progressively releasing surplus reserves from earlier underwriting years. The levels of recent releases are unsustainable, and some firms risk compounding the problem by pricing new business inadequately to remain competitive. Lower investment returns and limited scope to release prior-year reserves mean that general insurers need to maintain profitable underwriting as they cannot rely on investment income (see *Chart B28*) or margins in reserves to subsidise underwriting losses. These pressures may prompt firms to tighten claims management processes. However firms should balance operational efficiency with the need to treat their customers fairly.

The financial crisis may have fundamentally altered the characteristics of some risks underwritten within both personal and commercial lines classes – the latter, for instance, reflecting potentially significant changes to the structure and operational management of industry and commerce across the wider economy. So firms also need to ensure that their reserving, underwriting, and pricing of insurance risks, as well as their internal modelling, take proper account of these potentially significant changes.

Solvency II

Solvency II will radically alter the capital adequacy regime for the European insurance industry, and potentially change the amount of capital some firms are required to hold. It aims to establish an enhanced, more risk sensitive set of EU-wide capital requirements, require robust risk management standards, and provide a consistent measurement of assets and liabilities. All firms in scope will need to review their operations and, given the far reaching nature of the directive, we anticipate that most firms will need to make substantial changes. There is a risk that if firms do not engage early enough or apply sufficient resources, they will not be ready by 31 October 2012 when they are expected to be operating in line with the Directive.[10]

Firms should be well advanced in planning Solvency II implementation.

Although there are material technical issues that are not yet finalised, firms should not be waiting for these to be resolved. There are bigger risks associated with inadequate engagement than with managing through the uncertainty. If firms do not familiarise themselves, and keep themselves updated with developments in the processes and content of Solvency II, their implementation plans may become out of date. Firms wishing to use full or partial internal models in their calculations of their Solvency Capital Requirements will need to ensure that they are engaged with the FSA's pre-application process ahead of their application for internal model approval.

The Individual Capital Adequacy Standards (ICAS) regime in the UK provides a good starting point for firms to make the transition to Solvency II but the new directive goes much further. The requirements for delivering and demonstrating the standards of risk management and governance will be challenging, and especially so for groups that operate in multiple countries. Solvency II will require greater disclosure and transparency, together with additional and more frequent reporting.

10 Solvency II will apply to all firms in both the life and general insurance markets where the firm's annual gross written premium income exceeds €5 million and the firm's total of technical provisions exceeds €25 million.

Key messages

- Planning and preparations should be well advanced for the Solvency II regime. It is important that firms are vigilant in keeping up to date with developments and published material on Solvency II.
- It is unlikely that the trading environment will quickly, if ever, allow firms to return to the levels of income and profitability experienced prior to the crisis, unless they make significant changes and this may present new risks.
- The long-term structural changes to the wider economy arising from the financial crisis may fundamentally alter the characteristics of some risks insured by the industry. It is essential for firms to understand this, so that they establish appropriate reserving, pricing and underwriting strategies.
- A recession can trigger significant increases in the number, type and size of claims made. This can materially distort trends in insurers' claim costs and should be taken into account in reserving. Monitoring systems need to be put in place and firms should also consider this issue as part of their risk and capital management processes.

Risk management practices in financial firms

Deficiencies in some firms' risk management have been exacerbated by the financial crisis.

The financial crisis highlighted deficiencies in some firms' risk management, including: a weak risk culture, evidenced by an over-dominant sales culture; shortcomings in governance frameworks which in some cases did not clearly articulate risk appetite or result in effective risk control; and general shortcomings in systems and controls. The issues highlighted here can affect firms, consumers and market confidence through a number of channels, including less effective decision making, inadequate management of risks and operational failings. In some cases these issues have been exacerbated by the financial and economic crisis as firms' attention has been focused on prudential issues and senior management has been stretched.

In the course of our supervisory work we have become aware of significant gaps in data quality at firms. This covers credit as well as other risk classes. We have found non-reconciled differences in credit portfolios within firms depending on which system is being considered and this can arise due to items not translating properly from one system to another, missing fields or incorrect mapping. In exceptional cases, significant portions of a portfolio are not visible, leading to questions over the reliability of capital calculations performed with such inputs. The issue is heightened in merger situations as different data models may hold different data formats, requiring extra vigilance. The FSA has strengthened its data analysis capability to provide more systematic examination of the quality of firms' data underpinning the use of any advanced Basel model.

Risk management weaknesses have also been seen in lending, arrears and provisioning policies, as discussed earlier. As the structure of the financial sector changes through mergers and takeovers, as well as demergers, specific issues around integration risk are also growing. These issues, along with risks around firms' valuation processes and controls, and the management of client money and assets, are discussed below.

Key messages

- It is the role primarily of the Board and senior executives to set the tone within their organisations and to foster a permanent attitude that is based on sound risk management practices and a strong ethical culture. Shareholders, Board members, senior management, employees, advisers and auditors, need to review the extent to which changes in risk management need to take place within their firm.
- Any changes in risk culture need to be permanent and support a cultural shift in attitudes to risk taking and risk management.

Weak valuation processes create the risk of profit and loss errors.

Valuations

Weaknesses in valuation processes and controls continue to give rise to a heightened risk of material mis-statement of profit and loss, through errors or exploitation of control deficiencies. While we note that some firms are in the process of enhancing controls, we continue to identify weaknesses in oversight of trading valuations by front office operations and control functions, including: lack of internal consistency; lack of cross-functional coordination; poor quality of product control systems; and lack of profit and loss attribution. The effectiveness of challenges to front office operations from control functions is also a concern, as is the formalisation, documentation and control over valuations and valuation methodologies.

Non compliance with valuation principles remains high…

Many firms have still not formally considered their compliance with our prudent valuation principles. Many have failed to implement effective frameworks to identify products and positions where fair value and prudent value may diverge, or propose regulatory capital adjustments relating to those products and positions. More widely, the discipline of assessing, communicating to senior management, and controlling the quantum of valuation uncertainty, requires significant improvement across the financial sector.

…affecting market confidence and effective prudential risk management.

The dispersion between the valuations of similar instruments held at fair value has decreased from the levels observed during the last three years, but in many instances dispersion has not reverted to pre-crisis levels. This has the potential to adversely affect market confidence, and since financial accounts form the basis for regulatory capital calculations, this could reduce the effectiveness of prudential risk management. Dispersion in valuations of derivatives is magnified by differences in the application of valuation adjustments, such as bid-offer and credit valuation adjustments. These differences are made possible due to the lack of specific guidance contained within accounting standards in this area. This is exacerbated by weak disclosures by banks on some aspects of fair value and valuation adjustments, making it more difficult for users to understand how valuations are derived, and to assess their impact on a firms' financial position.

Key messages

- Poor oversight of trading and valuations can lead to material mis-statement of profit and loss and be detrimental to market confidence and prudential risk management within firms.
- The assessment of compliance with regulatory prudent valuation principles and the measurement and reporting of valuation uncertainty should be an area of focus for firms.
- Weak disclosures around fair value can make it difficult for users to understand how valuations are derived and affect their assessment of a firm's financial position. Firms need to ensure they provide sufficient disclosures on the more subjective aspects of fair value.

Oversight of client money and assets

Failure to ensure adequate systems and controls over client assets can lead to investor loss.

Inadequate systems and controls can lead to client money and assets not being properly protected and segregated while a firm is a going concern. In the event that a firm fails, the client asset regime is designed to ensure that client money and assets are protected from the general creditors of the firm to the greatest possible extent. Failure to manage client money and assets appropriately can lead to client loss if clients are unable to reclaim assets that have become stolen or co-mingled with firms' assets. Such failings can lead to consumer detriment and market instability as client money and assets become trapped, or eventually lost, while insolvency practitioners determine entitlements.

A period of market expansion, followed by the financial crisis, has increased the risks related to client money and assets. Widespread failings in this area could undermine market confidence, as UK financial firms hold billions of pounds of client money and trillions of pounds in client asset value. Our work has identified a number of firms from across the financial services industry failing to comply with FSA's Client Assets Sourcebook (CASS). Many of these problems related to the proper segregation of client money and assets. Our work has indicated that such failings could be widespread across the industry. In light of these findings, we will continue to focus on compliance with the client money and assets rules.

This risk is heighted during consolidation.

Consolidation in the financial sector gives rise to potential risks over client money and assets. Operational errors on client accounts are more likely to occur during transitional periods; for example, when a firm is integrating legacy systems, or dealing with increased transactions resulting from the acquisition of new business.

The need to ensure that client money and assets are adequately diversified is crucial. Clients can be exposed to concentration risk where they have not sufficiently diversified, and have money or other assets held with just one financial group.

Key messages

- The protection of client money and assets is necessary to ensure consumer and market confidence in UK financial services. Clients must be confident that they will receive their money and assets swiftly in the event of firm insolvency.
- It is vital that firms which hold or control client money and assets are diligent in ensuring they meet all the requirements in this regard and maintain adequate systems and controls.
- Regulatory action has been taken against firms that have not complied with our requirements and we will continue to take action where client money and assets are not sufficiently protected.

Consolidation and integration risk

The financial crisis has necessitated more rapid execution of consolidation and integration in the financial sector than seen prior to the crisis. In the banking and building society sector, for example, only one of the five major banks and one of five largest building societies have not been affected by this development. In some cases this consolidation and integration has led to financial pressures and insufficient focus on longer-term infrastructure, thereby placing stress on accounting and risk functions, which in turn could contribute to operational losses and strategic challenges in the future. Insufficient due diligence can also present a challenge to the strategic merits of the consolidation/integration, and this can lead to uncertainty in the strategy and the business plan of the new organisation.

Consolidation and integration can also have a significant impact on firms' infrastructure, and the merging of legacy data models can lead to difficulties, for example where fields have different names despite sharing similar information. These challenges could heighten the weaknesses exposed in some firms' data quality and management, discussed earlier.

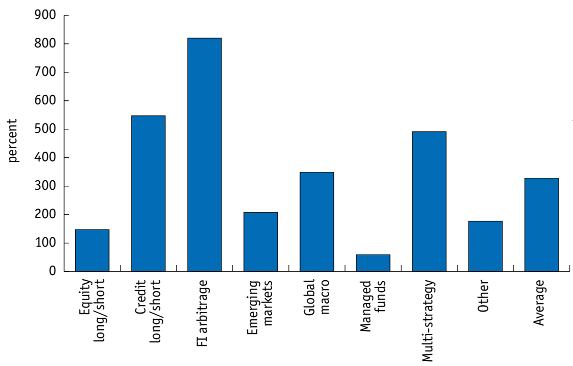
In some instances in the investment banking sector, high financial pressures have led to maximising short-term business gains at the expense of core infrastructure investments, such as regulatory reporting or accounting consolidation. In these cases, most of the resources allocated to the integration are to the benefit of front-end and business-facing systems, while the consolidation of post-trade controls (risk consolidations, financial and regulatory reporting) receive insufficient management attention and are either left in pre-integration states or benefit from poor testing and migration standards.

Many restructurings in the wholesale sector involve systemically interconnected organisations and in many cases these organisations have fragmented and sometimes sub-standard legacy infrastructures. Such restructurings cannot be considered in isolation and may impact the wider financial sector: in some highly concentrated markets, in particular, the inability of a major player to perform its pricing and risk management role or to fulfil its settlement obligations can have a notable impact on this market's functioning and confidence.

Key messages

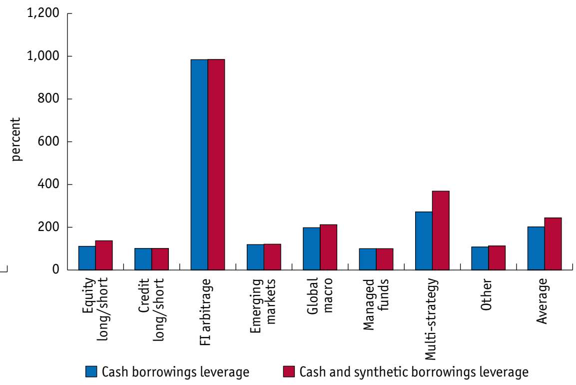
- The crisis has highlighted the vulnerability of firms' post-trade control infrastructures. These vulnerabilities are stressed even further within firms going through integration or restructuring efforts and can translate into operational losses, exposure to internal fraud and have an impact on some markets' functioning.
- Firms should remain focused on the importance of preserving and reinforcing core control infrastructures 'front-to-back' and 'risk-to-accounting' while in merger or de-merger mode. The consolidation of enterprise-wide risk and accounting systems in particular should not be neglected or conducted with lower standards.

Chart B29: Footprint as a multiple of net equity



Source: FSA Hedge Fund Survey, October 2009

Chart B30: Borrowings as a multiple of net equity



Source: FSA Hedge Fund Survey, October 2009

Box B4: Assessing possible sources of systemic risk arising from hedge funds

Although hedge funds were not a cause of the financial crisis, they could pose a source of systemic risk to the financial system. We therefore need to ensure that as part of our overall regulatory approach we assess the risks that hedge funds could pose. In addition to our six-monthly survey of *Hedge Fund as Counterparty Survey (HFACS)*, which surveys some of the largest FSA-authorised banks with exposures to hedge funds, we have recently commenced a *Hedge Fund Survey (HFS)*, which asks the largest FSA-authorised investment managers about hedge fund assets they manage.[9]

An important aim of the HFS is to understand the use of leverage by hedge funds. The concept of 'leverage' is difficult to define in a consistent way across hedge funds, but one important measure we examine is a hedge fund's total gross 'footprint' across asset classes compared with the equity they have raised from investors.[10] This gives us a view of the scale of a fund's presence. *Chart B29* suggests this footprint is, on average, 328% of net equity and the results demonstrate that with spread-based strategies there is a greater ratio of gross footprint to net equity than for fundamental strategies.[11] Gross footprint can include exposure gained to the underlying asset classes with borrowed money and derivatives.[12] *Chart B30* shows that average cash borrowing for surveyed hedge funds was 202% of net equity, rising to 244% when synthetic borrowing was included.[13]

The surveys also allow us to examine the credit counterparty risks existing between banks and hedge funds. HFACS data suggests the maximum potential credit exposure that any one surveyed bank had to any one hedge fund was less than US$500 million and that the largest hedge fund in terms of aggregate credit exposure accounted for just over US$1 billion of credit exposure across a number of banks.[14] While these are large numbers, they are manageable in the context of the overall credit risks and capital requirements of the surveyed banks.

While our analysis revealed no clear evidence to suggest that as at the end of October 2009, from the banks and hedge fund managers surveyed, any individual fund poses a significant systemic risk to the financial system at this time, this position could change and future surveys will be an important tool in identifying emerging risks.

9 The October 2009 HFS covered FSA-authorised managers, 'touching' over $300 billion of hedge fund assets. This includes FSA-authorised firms that might be acting as sub-advisor for larger US hedge fund managers. We surveyed 50 firms in October 2009, but may increase the number of participants in future surveys though we are mindful of maintaining a proportionate approach to assessing systemic risk.

10 'Footprint' is defined here as the long and short positions held in equities, corporate bonds, convertible bonds, sovereign bonds, loans, CDS and structured credit (for securities, this means whether they are held physically, synthetically or via derivatives – in which case delta adjusted notional value of options and total notional value of futures). It does not include FX, commodity or interest rate derivatives.

11 A larger footprint does not necessarily equate to a larger risk, as this metric takes no account of netting long and short positions or the volatility of the assets that make up the footprint.

12 Channels through which hedge funds can borrow money include collateralised borrowing under prime brokerage agreements, sale and repurchase (repo) agreements, or synthetically using instruments like swaps and CFDs.

13 As per market convention this is measured as: (cash borrowed + net equity)/net equity.

14 'Potential Exposure' is defined as potential exposure which is equal to an unsecured exposure plus a risk-based element (typically VaR-based) standardised to a 99% confidence interval and 10-day holding period.

Market risks and issues

The crisis has revealed the importance of risks in over-the-counter (OTC) derivative markets which had built up gradually over many years, and to which regulators and market participants now need to respond with major changes, for instance through the greater use of central counterparty clearing systems. There have also been responses to particular potential problems revealed by the crisis, such as in the area of short selling. Some of the most important market related risks to which firms and the FSA need to respond do not, however, arise directly from present macroeconomic conditions or market trends. The structure of equity markets has evolved in a way unrelated to either the financial crisis or to recent economic developments, and where increased competition and fragmentation poses significant challenges. The potential for market abuse remains an ever-present issue to which the FSA continues to respond with robust surveillance and enforcement.

Global financial markets have shown strong recovery from the lows reached at the beginning of 2009, with central bank intervention helping to stabilise the volatility experienced in 2008. However, economic and financial market conditions remain challenging and continue to have a significant impact on market participants. Whilst some areas of business saw an increase in activity, such as the corporate bond market and secondary issuance in equity markets, a large portion of activity related to participants restructuring their balance sheets. Signs of increasing confidence began to emerge towards the end of the year, and although a degree of risk appetite has returned to the markets, conditions remain fragile.

Changes to over-the-counter (OTC) markets

Counterparty credit risk and position transparency for OTC derivative markets

Counterparty and transparency risks remain.

The financial crisis has highlighted significant deficiencies specific to the OTC derivative markets, most notably shortcomings in the management of counterparty credit risk and the absence of sufficient position transparency to regulators.

An acute sensitivity to counterparty risk, particularly at the height of the crisis, had severe implications for financial markets and led to a retraction in liquidity as participants became reluctant to trade with each other. This, in turn, was exacerbated by the significant web of interconnections between counterparties, and led to further negative consequences as participants could not properly access financial markets.

In response, the FSA, alongside other international regulatory bodies, has prioritised greater use of central counterparty (CCP) clearing for OTC derivative markets. A CCP can bring consistent and robust risk management practices, as well as acting as a circuit breaker to the default of a member. In addition, greater use of CCP clearing can aid market liquidity and efficiency, be a motivating force behind contract standardisation, and reduce systemic risk.

Clearing facilities continue to develop.

Clearing arrangements were already in place for interest rate derivatives, and began to be introduced for credit derivatives in 2009. Regulators, including the FSA, continue to work with industry to set ambitious targets for the increased use and expansion of such facilities for an internationally defined set of products which are eligible for clearing.

Enhancing risk management for non-cleared products is a priority...

In addition, given that a substantial range of products will not be suitable for clearing, it is important that firms implement robust bilateral counterparty risk management arrangements and related prudential requirements. The FSA is leading international work to strengthen bilateral arrangements on a global basis. Firms should ensure they stay abreast of developments in international best practice.

We have seen an increase in requests for the inclusion of termination events in derivative contracts which allow for a client to terminate the trade if a credit rating agency downgrades the dealer below a certain trigger level. Firms should consider developments in this area and the implications for their own stress testing and risk management.

...and momentum needs to be maintained.

Actions already taken by the industry to establish both clearing and trade repositories are important steps, but these developments have only partially addressed the risks concerned. With regards to clearing, the residual risk will be resolved by expanding the range of products offered by clearing houses, and expanding direct and indirect access to such facilities. With regards to trade repositories, the industry needs to work with regulators to ensure these develop in a timely manner to meet regulators' requirements. Failure to maintain momentum on the existing work streams or to develop this work further will result in OTC derivative markets continuing to pose a systemic risk.

Emerging legislation will help address key risks.

New OTC derivatives legislation being drafted in the US and Europe will advance efforts to address the key risks. The FSA is focused on ensuring the appropriateness, proportionality and consistency of these developing frameworks. Firms should stay abreast of developments in legislative and regulatory requirements and assess the impact on their own operations.

Key messages

- Counterparty risk management and post-trade operational risk remain key issues for firms. To address these, major market participants should continue to strive to meet existing post-trade targets agreed with regulators and to engage with regulators to define, resource and implement, in a timely manner, further steps to meet the regulatory objectives of effective market operation and appropriate risk management.
- For the non-cleared portion of the OTC derivative market, firms should ensure their counterparty risk management is robust and that it incorporates developments in international best practice. This should include consideration of externalities, such as potential volatility following a sector downgrade if rating termination triggers are incorporated into contracts on a market-wide basis.
- Firms should ensure that their approach remains robust and provides for effective risk mitigation, including externalities, according to their own risk management principles. Firms should not seek to promulgate a 'race to the bottom' of regulatory standards.

Post-trade transparency in OTC markets

OTC markets are currently opaque…

Many OTC markets are dominated by dealer participants (that is, large banks) and, as a result, non-dealer market participants could be unfairly disadvantaged because of inadequate access to information on OTC-traded prices and asset volumes. A lack of post-trade transparency can negatively impact the price formation process, as participants may not be able to make informed decisions regarding the perceived market price of an asset. This increasingly is being raised as an issue by firms investing in corporate bond markets.

…but work is underway to address this.

A lack of post-trade transparency can also obstruct the accurate valuation of positions, particularly in times of market stress. We are actively working in both the European and international arena to bring about improved post-trade transparency for OTC markets – including derivatives and corporate bonds – both in terms of access and the granularity of information available.

An ill-calibrated transparency regime might have unintended consequences.

An ill-calibrated transparency regime could reduce market liquidity. Therefore it is essential that any post-trade transparency regime should be tailored to account for the individual characteristics of the market in question including factors such as market liquidity, the degree of transparency already available and existing infrastructure. Without consideration of these factors, timings and reporting thresholds could be overly onerous, leading to a situation where market participants are reluctant to trade and may ultimately withdraw liquidity from the market.

Developing models for clearing and settlement

Greater use of clearing exposes clearing houses to more concentrated risks…

Whilst the greater use of clearing services described above can bring considerable benefits, it also has the potential to introduce new, more concentrated risks. The expansion of clearing to cover previously uncleared asset classes, along with an increase in the size and variety of clearing houses' membership, may expose clearing houses to increased counterparty, operational and legal risks, which they may be unable to manage effectively. Furthermore, pressures from commercial or regulatory stakeholders to develop new clearing services may distract clearing houses from their focus on ensuring the operation of robust risk management, operational and compliance processes, and may also adversely affect their operational and prudential resilience. Such risks augment competitive pressures on clearing houses to reduce their fees and increase their commercial attractiveness, and may serve to weaken their risk management and operational standards.

…and increases their systemic importance.

The increased use of clearing services raises the systemic importance of participating clearing houses. The growing range of products and volumes cleared, due to the greater proportion of business processed through CCPs, will increase the level of counterparty risk concentrated in each clearing house. This raises the market impact should a clearing house fail. The failure of a clearing house would impact clearing firms whose default fund contributions may be at risk and who will be exposed to uncertainty about the status of positions, previously cleared by the failed clearing house. It would also impact markets in general, as the failure of a clearing house may prevent the transaction of additional business. However, whilst noting this risk, the benefits from greater use of CCP services to market participants and the market itself will generally outweigh the costs and risks entailed.

The greater emphasis placed on the development and use of clearing services has prompted regulators and other authorities to review the regulatory and legislative environment in which clearing houses operate, such as the review of the CPSS-IOSCO Recommendations for Central Counterparties, which set out international standards for the risk management of central counterparties.[1] Such reviews risk introducing different standards for clearing houses from those which are currently in force. The FSA is working with the other UK authorities, as well as European and global regulators and legislators, to ensure that any future standards are both robust and proportionate. This will be essential in promoting system-wide market confidence and avoiding differing regulatory regimes for different locations, which could create opportunities for regulatory arbitrage.

1 The Committee on Payment and Settlement Systems (CPSS) serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems, as well as in cross-border and multicurrency settlement schemes.

Key messages

- Clearing houses should continue to operate with a prudent and appropriate risk appetite, and ensure effective mitigation of the counterparty, operational and other risks arising from any new product they propose to clear.
- It is essential that clearing houses continue to operate with strong risk management, operational and legal standards across all their services.
- Clearing members and other users of clearing services should conduct sufficient due diligence into each clearing house that they propose to use. Only once they are satisfied that their risk exposure to each clearing house matches their risk appetite or capacity, should they use such services.

Changing structure of equity markets

The implementation of the Markets in Financial Instruments Directive (MiFID) in 2007 has significantly changed the equity secondary markets landscape across Europe. Established regulated markets have seen their positions challenged, particularly from new multilateral trading facility (MTF) trading venues. New technology and trading patterns are also changing the structure of the market.

Impact of MiFID on equity markets

The growth in the number of MTFs, alongside greater freedom for investment firms to internalise trades, has increased competition in the provision of trading services and has led to a wider choice of trading venues. In 2009, MTFs accounted for around 20% of total trading in FTSE 100 shares, and approximately 25% of order-book trading. In order to remain competitive, established trading venues have had to reduce direct execution costs. Whilst competition in trading services is welcome, potential risks from the fragmentation of equity trading and data have resulted and need to be appropriately mitigated.

For trading platform operators, competition is making the commercial environment more challenging. That challenge may intensify if market volume growth slows for a sustained period. This could place strain on the capital position of Market Infrastructure Providers, especially loss-making new entrants. If they fail to carve out a sufficient proportion of market share this could potentially lead to some consolidation in the sector. Pressures on the profitability of trading platforms could also work through to post-trade service providers, where increasing competition has started to drive down clearing fees. This could increase the risk of reduced quality and standard of the services offered by those entities.

Post-trade transparency data

Some problems exist in relation to the consolidation of transparency information, despite the trade transparency provisions introduced in MiFID.

There have been calls for regulatory intervention to address concerns over the quality of OTC post-trade information.

Post-trade transparency information is used by firms for price discovery, to analyse transaction costs and ensure best execution obligations are fulfilled. Information published through different sources needs to be reliable and collated in a way that allows for comparison between the prices prevailing on different trading venues. With the implementation of MiFID there was an expectation that commercial providers would offer ways of accessing consolidated data. Although a number of such initiatives have been implemented, they are not of a standard that fully satisfies market participants. In particular, there are concerns regarding the quality of information related to OTC transactions executed by investment firms. In order to address some of these concerns, our June 2009 Market Watch 32 publication provided information to help investment firms trading OTC to apply the post-trade transparency requirements. Although market participants have some concerns in relation to pre-trade transparency information, there is agreement that regulators should focus primarily on addressing issues related to the consolidation of post-trade transparency information.

We are working with CESR to develop a pan-European approach.

We are working with the Committee of European Securities Regulators (CESR) to assess the impact of MiFID and to develop a harmonised approach across Europe to address concerns relating to the consolidation of post-trade transparency information. More effective consolidation would be an important mitigant to some of the market monitoring risks arising from greater fragmentation.

Key messages

- Market Infrastructure Providers' revenue streams could face downward pressure in the face of competition and challenging market conditions. Market Infrastructure Providers should ensure that such concerns do not detract from maintaining fair and orderly markets, in particular by devoting adequate resource and prioritisation to market surveillance.
- In order to address some of the concerns relating to the quality of post-trade transparency information, we encourage investment firms trading OTC to consider the information published in Market Watch 32 (June 2009) when applying the post-trade transparency requirements.

Competition between trading venues

There has been a proliferation of trading venues, which operate under different regulatory umbrellas...

Greater competition between different types of trading venue has raised a number of issues around the consistent regulatory treatment of venues that may be offering similar functional services. Although there are some minor differences in MiFID wording between regimes, the FSA aims to supervise Regulated Markets and MTFs to the same standards, taking into account relative market importance.

There has been considerable recent commentary around dark pools. In MiFID, dark pools are simply trading systems that allow buying and selling interests to interact without pre-trade transparency. Such non-transparent pools can be operated by Regulated Markets and MTFs, or by investment firms. The precise regulatory requirements differ between these venues; in particular, Regulated Markets and MTFs can offer non-transparent trading facilities only if they satisfy the conditions of specific waivers from transparency under MiFID.

...use differing models...

The various trading venue models attract different users and types of order flow, as well as offering different clearing and settlement regimes, ranging from use of a central counterparty to direct bilateral settlement. Users should ensure they understand the variety of models on offer and their differing characteristics.

...and pose challenges to market monitoring.

Fragmented trading also creates issues around market monitoring. For example, many non-transparent venues reference prices from the primary markets, namely the incumbent exchanges. There is the possibility that users may attempt to distort the primary market reference price in order to complete an execution in another venue at a profit. Users and operators of all trading venues, together with regulators, need robust processes, including the use of Suspicious Transaction Reports (STRs), to be able to monitor such activity.

Key messages

- Firms and their clients need to understand the differences and the range of risks that different trading venue models may pose.
- Firms are reminded that if they are suspicious of transactions then there is an obligation to assess and submit a Suspicious Transaction Report to the FSA.

High frequency trading (HFT)

HFT is a significant market development...

IT enhancements by both platforms and participants have led to an increase in the number of firms pursuing HFT strategies. HFT is a type of trading strategy which uses computers and algorithms to pursue trading strategies that generate huge volumes of relatively small trades executed at very high speeds. Order life is generally measured in seconds or sub-seconds and positions may be opened and closed in equally short times. While highly active during the course of the trading day, high frequency traders do not usually carry positions overnight. Within the last decade HFT has grown from negligible amounts to an estimated 60-70% of equity trading volume in the US, and to 30-50% within the EU. This suggests that there may be potential for further growth in HFT trading in Europe, particularly if there are further reductions in the costs of trading, which is critical for HFT firms.

...which may bring benefits to the equity markets.

The benefits which HFT strategies may bring to the market include additional liquidity and, according to anecdotal reports, a reduction in spreads. It is argued that in the US this reduction in spreads has been passed through to the retail investor giving enhanced price execution quality. It may be too early to see this impact in Europe. However, any benefit of reduced spreads may have been diminished by the reduction that has occurred in the average size of trades, leading to a need for more trades to complete larger orders.

The withdrawal of HFTs could impact the functioning of the market.

Unlike traditional market makers, there are no requirements for firms operating HFT strategies to provide liquidity to the market on a continuous basis. Given that firms using HFT strategies may account for 30-50%, or higher, of equity trading volume, their sudden withdrawal from the market could reduce liquidity, potentially widening spreads and increasing price volatility. However, the experience of volatile markets during the recent crisis suggests this was not the case.

There is concern about whether HFT provides an unfair advantage.

There is debate in market centres around the world about whether HFT firms may have an unfair advantage over other market participants as a consequence of their capabilities in receiving and processing data at faster speeds. They often achieve this through co-location arrangements where they pay to place their computers in the same space as the trading platform's matching engine, thus reducing access time. Discussions of the fairness of these arrangements need to consider the perceived benefits of this type of trading strategy.

Increased use of HFT strategies increases the necessity for robust risk management.

The increase in volumes traded using HFT strategies means that firms using these strategies and those who provide them with access to the marketplace, will need to ensure they have robust risk management controls in place to adequately oversee such trading strategies, and that these controls keep pace with rapid technological advances. Trading platforms need to ensure that they have systems to handle and monitor the orders generated by HFT strategies.

The FSA is reviewing the impact of HFT participants on the market and will also feed into CESR work on this topic.

Market abuse

The financial markets remain vulnerable to market abuse.

Market abuse is an ongoing issue in financial markets, carrying implications for wider market confidence if investors and market participants do not have trust in the cleanliness of markets. Developments, such as the increased fragmentation of equity markets, mean that effective market surveillance is becoming more challenging.

Financial market conditions in 2008 and 2009 increased the risk that abusive short-selling trading strategies could be used to undermine confidence in the UK markets. Short-selling activity in 2008 highlighted that companies can be particularly susceptible to short-selling when they are undertaking vulnerable activities, for example when looking to raise funds through rights issues. In June 2008 disclosure requirements were introduced for significant short positions in such stocks. Since September 2008, holders of significant short positions in the stocks of UK financial sector companies have been required to make public disclosures of these positions. Initially a temporary regime, this was extended indefinitely in June 2009 pending decisions on a comprehensive permanent short selling disclosure regime at the European level. The measures dealing with short selling have to date been made under the FSA's market abuse powers. However, the Financial Services Bill, currently going through Parliament, will give the FSA wider free-standing powers to make rules concerning short selling, including the ability to introduce temporary emergency bans on financial stability grounds.

There is too much information leakage relating to public takeover deals.

Leaks of inside information continue to damage market confidence. In particular we continue to see information leaks during public takeovers due to poor systems and controls around such information or deliberate improper disclosure by individuals. We continue to take action against firms and individuals for offences in this area. We have observed a number of apparent strategic leaks in the market. Strategic leaks are the improper disclosure of information which is damaging for market cleanliness especially when used to further bids, speed up a current bidder or to assist a defence strategy. Whilst media liaison may be an important element of corporate communications, systems and controls around the contact between issuers, their advisers and the media need enhancing. If firms do not have robust, well communicated policies for handling the media, individuals may be more inclined to deliberately or inadvertently disclose inside information. Additionally, UK listed companies must comply with the relevant provisions of the Listing Regime. The FSA, acting in its capacity as the UK Listing Authority, polices this regime.

Box C1: Criminal insider dealing prosecutions concluded in 2009

As part of the FSA's strategy to achieve a credible deterrence to market abuse, tough action, including criminal prosecutions, is being taken against individuals that have been involved in market abuse. Individuals risk receiving custodial sentences for market abuse. Convictions were obtained by the FSA in two criminal insider dealing cases in 2009. Each case covered dealings ahead of public takeovers and both trials resulted in convictions of all defendants with custodial sentences being handed down.

Case Study 1: Information leaks

In March 2009, Mr McQuoid was found guilty of taking advantage of the trust placed in him as Legal Counsel by passing inside information about an impending takeover of his company to Mr Melbourne. The latter was found guilty of trading on the information to make a profit of almost £49,000.

Case Study 2: Information leaks

In December 2009, Matthew Uberoi was found guilty of passing inside information, gained through his role in a corporate broking firm to Neel Uberoi, who was in turn found guilty of trading on the information making profits of £110,000.

It is important that firms identify and report suspicious transactions.

Market abuse is difficult for the regulator to detect in isolation. Errors in firms' transaction reporting or a failure by firms to correctly identify and submit Suspicious Transaction Reports (STRs) can have a major impact on the ability of the FSA to effectively monitor and take action against market abuse. Firms should therefore review their controls, ensure that their reporting is robust, and make sure that staff understand both the factors that might indicate suspicious behaviour and how to act on suspected abuse. This process applies to all relevant products, not only to equity markets.

Box C2: Enforcement action regarding suspicious transaction reporting

Case Study 3: Suspicious trading reporting

In September 2009, the FSA fined Mark Lockwood a financial penalty of £20,000 for failing to act on a suspicious client order that allowed his firm to be used to facilitate insider dealing.

Case Study 4: Systems and controls

In September 2009, FSA found inadequate systems and controls at Barclays which led to major failings in its transaction reporting and the firm was fined £2.45 million.

Key messages

- It is important that firms have strong anti-market abuse systems and controls to identify, mitigate and report potential cases of market abuse, particularly in relation to public takeovers and suspicious transactions.
- Media policies need to be robust.
- Firms should maintain an awareness of the potential for abusive short selling to undermine confidence in the UK markets and ensure their trading strategies pay due regard to this.
- Firms should ensure they are able to demonstrate the completeness and accuracy of transaction reports.
- Firms need to have robust risk management controls over high frequency trading.

New product development

As investor confidence returns, so does appetite for innovative products, and investors may be tempted to return to excessive risk-taking practices.

As investor confidence begins to return, issuers and investors may begin to explore how innovative products can, among other things, facilitate capital raising, hedge or transfer pre-crisis inventory, and provide a yield pick-up for investors in a low interest rate environment.

Innovation can sometimes play a useful role. However, novel untested products can leave those that invest, and those that design them and facilitate investment, vulnerable if the risks involved are not fully understood or disclosed. Additional risks are posed if the disclosure is not of sufficient quality; or if investors fail to perform sufficient due diligence, or do not have the capacity to measure, monitor, manage and report the risk. Such risks are amplified where products, and their associated payoffs, are of a highly complex nature and include a high degree of leverage. Following amendments to the CRD from 1 January 2011, investors will be required to perform enhanced due diligence on securitisation exposures prior to investing.

The FSA is involved in a number of international fora where various aspects of the prudential framework are under consideration. This includes ensuring that the prudential framework can deal with new, innovative and potentially complex products as they enter the market.

As markets normalise, both originators and investors may face incentives to revisit riskier and potentially inappropriate products and practices that contributed to excessive risk-taking before the financial crisis. Vulnerability to liquidity and price volatility – which are risks commonly embedded in leveraged products – can become systemic risks if large exposures are built up in systemically significant firms. This risk is exacerbated if the investor population is small, which is frequently the case for new product types. We expect investors to have, implement and dynamically update policies to manage such exposures in order to minimise this systemic risk. In future, the FSA will consider taking action should we feel that the risks presented to our statutory objectives are not being managed appropriately.

Key messages

- Poor disclosure can result in investors assuming unknown risks. Firms originating innovative products should assess the quality of their product disclosure and ensure it is of sufficient quality and detail for the investor to make an informed decision.
- Investors in new products should ensure that they are able to assess, monitor and manage the risks assumed.
- Issuers of innovative products should maintain robust underwriting standards even if transferring the risk.
- All firms should carefully and dynamically manage their large exposures and be aware that authorities will pay particular attention to those with systemic impact.

Impact of EU credit rating agency regulation

EU regulation on credit rating agencies is now in effect.

The EU regulation on credit rating agencies (CRAs) entered into force on 7 December 2009. Under the articles of the Regulation, existing EU CRAs will have to apply for registration between 7 June and 7 September 2010. HM Treasury is proposing that the FSA will be appointed the UK's competent authority responsible for registering and supervising CRAs.

The regulatory use of ratings relating to many EU Directives (including the Capital Requirements Directive (CRD) will be restricted to registered CRAs or CRAs in the process of registering from 7 December 2010.

Impact on authorised firms

The regulation is likely to have a material impact on the users of ratings…

The regulation grants supervisory authorities the power to restrict a registered CRA's ability to issue ratings or to prevent the use of these ratings for regulatory use within the EU. The regulation also distinguishes between ratings elaborated within the EU and in other jurisdictions. The likely end result is that some ratings produced by External Credit Assessment Institutions will no longer be allowed to be used for calculating capital requirements under the CRD.

…so firms will need to assess whether the CRA ratings can be used for regulatory purposes…

Firms should assess their use of ratings for calculating capital requirements and evaluate the potential impact of the regulation, particularly the treatment of non-EU ratings so that they are in a position to respond to the changes that will come into effect from 7 December 2010. It is possible that of the non-EU ratings produced by large global CRAs and currently used for regulatory purposes, a proportion will not be able to be used in this way in future. When considering these issues firms will also need to take into account the guidance due to be published by CESR later this year. Where firms use their own internal models for determining their capital requirements, they will need to assess whether the regulation impacts on any use of external assessments within their models.

…and should continue to monitor this.

The structure of the regulation means that firms will need to continually monitor whether the ratings that they are using for meeting regulatory requirements can still be used for these purposes. This may alter due to either regulatory action or the impact of the non-EU rating regime. The European Commission will publish a list of registered CRAs within 30 days of the decision to approve the registration. The FSA will maintain a public list of CRAs that they have registered, which will be updated at the time the decision is made – we expect other EU authorities to do the same.

Key messages

- The EU CRA regulation will have an impact on the regulatory use of ratings from 7 December 2010. It is likely that some ratings that can currently be used for regulatory purposes will no longer be acceptable for this use after this date.
- Firms that use ratings will need to assess the regulation and prepare for the impact it may have on their business and on their ability to meet regulatory requirements.
- Firms will need to monitor the impact of the regulation, and of future regulatory policy development at both the EU and global level, on their own processes including the availability of ratings for regulatory use on an ongoing basis.

Retail conduct risks and issues

Underlying market failures, coupled with firms' incentives and consumers' behavioural characteristics can lead to the emergence of conduct risks. These risks can arise throughout the product life cycle, from product design, to marketing, to post-sales handling. The economic cycle and market context will influence where conduct risks arise, how significant they are, and when consumer detriment crystallises. We currently face a number of crystallised conduct risks, including the mistreatment of consumers in arrears and PPI mis-selling. Furthermore, the current challenges that financial firms face, stressed economic and market conditions, and regulatory reform could lead to the emergence of new conduct risks.

Market failure drivers of conduct risk

Market failures create the conditions for conduct risk.

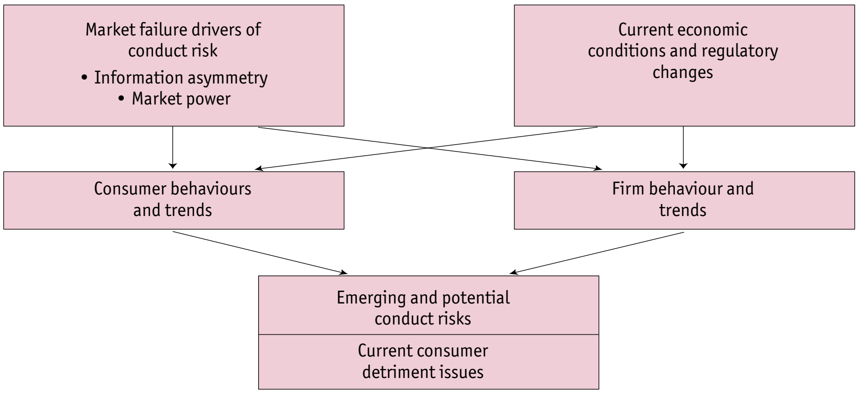
There are underlying market failures in retail financial services which can give rise to conduct risks and can lead to consumer detriment. These market failures are not dependent on the prevailing economic conditions.

A key market failure is asymmetry of information between firms and consumers. In retail financial services this asymmetry is particularly acute because of: the complexity of products and services; the fact that in many markets consumers make few purchases, so there is little learning from experience; and the length of time that can elapse before the characteristics of the product are fully evident.

The asymmetry is further exacerbated by consumers' limited financial capability.[1] This can make it hard for some consumers to process the information that is available and make informed decisions. Firms can further increase this advantage by complexity in product design and proliferation of product offerings. These factors can increase consumers' reliance on firms to help them navigate retail financial services.

1 Refer to the *Financial Capability Baseline Survey*, Financial Services Authority, 2006.

Figure D1: A high-level overview of the approach to analysing conduct risks



This reliance, in turn, can increase the opportunity for firms to take advantage of the information gap in ways that are detrimental to consumers.[2]

An additional factor is that consumers display systematic behavioural biases which can lead them to make financial decisions that are not in their best interests.[3] Again, firms are often aware of these biases and can take advantage of them.

Firms have a strong incentive to exploit this information asymmetry to maximise profits. This incentive can be increased: when it may be only much later that consumers realise they have been disadvantaged; where firms perceive that other firms will benefit from exploiting the asymmetry if they do not; and where firms do not feel that their own reputation will be damaged by their behaviour. In such circumstances a structural misalignment of firm and consumer incentives may occur. One example is the provider-determined commission structures in retail investment markets which we are addressing through the Retail Distribution Review (RDR).

Another key market failure is market power. This arises where firms can set prices above the competitive market price. It can lead to consumers purchasing more expensive or poorer quality products. Market power can occur when one or more firms have significant market share, or at the point of sale when firms effectively capture consumers and so can, for example, promote secondary products that might not be good value.

Crystallisation of conduct risk is driven by several factors.

Underlying market failures, coupled with firms' incentives and consumers' behavioural characteristics, can lead to the emergence of conduct risks. The economic cycle and market context will influence where conduct risks arise, how significant they are, and when consumer detriment crystallises. We therefore consider the interaction between these factors to identify areas of risk (see *Figure D1*).

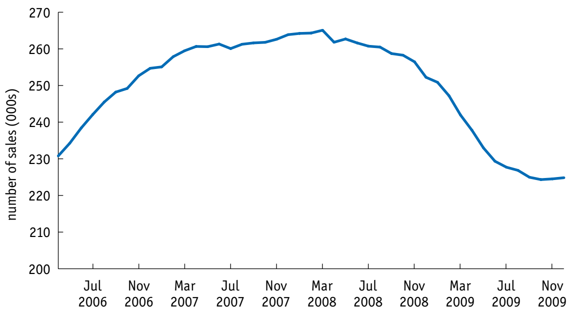
Consumer behaviours and trends

Consumers respond differently to changes in their environment, which makes it difficult to analyse the trends in the consumer sector as a whole. The impact that the economic and financial environment has on consumers will vary according to their financial capability, financial wealth and position in the life cycle.

2 We also believe that markets will work more effectively if consumers are more involved, capable and empowered. While we do not regulate consumers, we believe that we can work with firms, industry bodies and other stakeholders to encourage and enable consumers to consider their own interests more effectively in their decision making. The FSA and other stakeholders support a significant programme of work to improve financial capability.

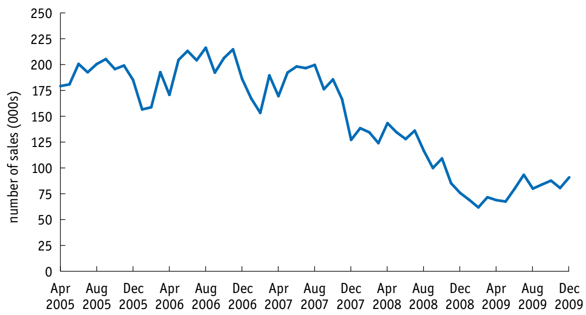
3 *Consumer Responsibility*, FSA Discussion Paper 08/5, December 2008, contains a fuller description of the behavioural biases exhibited by consumers and how these are relevant to financial decision making. See also, *Financial Capability: A Behavioural Economics Perspective*, Financial Services Authority, July 2008.

Chart D1: 12 month rolling average of retail investment product sales



Source: FSA Retail Investments PSD

Chart D2: Total mortgage sales over all interest rate types



Source: FSA Mortgages PSD

Consumers entered the recession heavily indebted…

As discussed in *Section A*, consumers entered the recession with high levels of secured and unsecured debt, leaving them vulnerable to property price, income and interest rate shocks. Overall levels of debt remain high and these vulnerabilities still exist. Where debt repayment has occurred, this has been focused on the more expensive unsecured debt. Even though debt levels have not fallen, consumption has fallen below its pre-crisis level and the savings ratio has seen a significant increase. In addition to influencing debt levels, property price, income and interest rate shocks are also important in changing consumer attitudes and behaviours.

…and faced falling asset prices and reduced income…

Property, equity and asset prices more broadly fell during the financial crisis and, although they have since stabilised, have reduced consumers' overall financial wealth. Unemployment and underemployment have risen and this has had an income effect. Falling asset prices and rising unemployment have had broader consequences than the impact on consumers directly affected by them, especially in terms of confidence in their financial circumstances. These factors have influenced risk appetite and the demand for retail financial products.

…leading to changes in risk appetite…

Different consumer segments are likely to react to these factors in different ways. Among many consumers there appears to be a considerably reduced appetite for investment risk. Indeed, many financial advisers have noted that clients have started to take a more defensive approach to investments.[4] Such consumers may be vulnerable to detriment if firms have incentives to sell products that are not in line with their lower risk appetite. Such consumers may be sold products that appear to offer capital guarantees or guaranteed returns, without fully understanding the capital protection available or the cost and likely impact on investment return.

There is also likely to be another segment of consumers who, having seen the value of their investments fall, will seek future returns in line with pre-crisis expectations. They may therefore be tempted to purchase products (and firms may seek to sell them) with the potential for greater return, but which are not suited to their individual circumstances, or which are higher-risk than they appreciate or desire. If the consumer does not understand the risk characteristics they may make unsuitable investment choices.

…and reduced demand for some products.

Demand for certain products has fallen significantly. Sales of retail investment products and mortgages have fallen from their pre-crisis levels (see *Charts D1 and D2*), although declining supply has also been a factor in mortgages sales.[5] Consumers also appear to be reducing some forms of insurance cover. A survey by ABI Research in June 2009 suggested that 22% of those surveyed had stopped taking out home contents insurance and 17% had stopped taking out building insurance.[6] Falling sales will increase pressure on the profitability of some firms (both product providers and financial intermediaries) and could increase incentives to raise revenue elsewhere, potentially through means that may be unfair to some consumers.

4 *Eye on intermediaries – Savings and Investments, Finance Intelligence,* MINTEL Oxygen, November 2009.

5 It is worth noting that the FSA Products Sales Data (PSD) does not currently include data on transactions made through fund supermarkets and nominee accounts (such as those used in platforms), and therefore these sales are not included in our analysis. For further information on the PSD data refer to *Retail Investments Product Sales Data (PSD) Trend Report*, FSA, August 2009, and *Mortgages Product Sales Data (PSD) Trend Report,* FSA, August 2009.

6 *Uncovered and exposed in the recession – one in four people cancel their home insurance*, ABI News Release, Ref: 69/09, 9 June 2009.

There are particular difficulties for consumers close to retirement.

Some consumers have been affected by a combination of these factors, particularly those close to retirement. As a result, some may face lower retirement incomes than they would have expected a few years ago. Annuity rates have continued to fall due to low nominal interest rates and rising longevity. The average male annuity rate was down by 10.5% in the year to October 2009, whilst female annuity rates were down by 10.9% over the same period.[7] Falling asset prices may have reduced the value of pension pots. Furthermore, those consumers intending to use the equity in their home to help fund retirement, either through mortgage equity withdrawal or downsizing, may find that there is less equity available than they were expecting.

Those consumers close to retirement could potentially be vulnerable to mis-sales through churning of accumulated assets in the run-up to retirement; they have assets from which distributors can generate income through churning of single premium investments, which offer an immediate return to the distributor. They are also vulnerable to mis-sales of decumulation products, such as drawdown, which may generate higher income for distributors than sales of annuities, and mis-sales of asset classes which are higher risk than the consumer's agreed risk appetite (decumulation is discussed in more detail later in this section). The shift from defined benefit pension schemes to defined contributions (where the investment and longevity risks reside with the individual) will further increase demand for decumulation products and thus the potential scale and impact of any mis-selling problems that do arise.

Firm behaviours and trends

Many firms involved in financial services have been affected by increased pressure on profitability and business model sustainability. These pressures are driven by a range of factors and we consider the key issues and trends for various types of firm.[8]

The economic environment has increased pressures on some financial services firms.

Retail banking and building societies

Retail banking conduct risks reflect both long-established features of retail banking business models and new pressures arising from the economic environment.

Current accounts in the UK are typically provided on a 'free if in credit' basis, with no transaction or account maintenance charges for consumers who maintain an in-credit position or who stay within authorised overdraft limits. Many consumers receive a core product which makes a loss, or very low return for the firm. Consequently, firms have sought to profit either by cross-selling higher-margin products (such as personal loans and related protection products) or by charging for specific product features (such as charges on unauthorised overdrafts). This combination of a loss-making core product and higher-margin cross-sold products creates incentives to push inappropriate sales. This should be offset through a strong focus on appropriate marketing, selling processes and product suitability.

Some features of the macroeconomic and financial stability environment described in *Sections A* and *B* have intensified these underlying conduct risks. Very low nominal interest rates have depressed core current account profitability, and the cross-over of deposit and lending rates (see *Chart B21*) has led to variations in the profitability of different product lines and consumer groups. Firms may be tempted to respond to this falling profitability in ways which could create consumer detriment.

7 *Pension annuity rates hit an all time low*, Investment, Life and Pensions Moneyfacts, November 2009. The figures are average rates for adults aged 65 years purchasing a level without guarantee annuity based on a £10,000 purchase price.

8 The Sector Digests published alongside this Financial Risk Outlook contain further information on key trends affecting firms in the insurance, banking, asset management and retail intermediaries sectors.

Box D1: Charges on unauthorised overdrafts

Charges on unauthorised overdrafts have featured prominently in the media. The Office of Fair Trading (OFT) is responsible for licensing most businesses that offer credit or lend money to consumers (including overdrafts), and has regulatory powers in these areas. While the FSA does not regulate this area, we took an interest in the issue given our responsibility for the rules that govern how firms handle complaints, and because of the potential impact on the banking sector. Although the Supreme Court ruled that the OFT could not fully assess charges on unauthorised overdrafts for fairness under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs), some firms have changed their product offerings in this area. The OFT continues to have concerns about this aspect of the personal current account market and is discussing with the industry, consumer bodies and other relevant stakeholders ways to address these concerns.

General insurance

General insurance firms are facing increased profitability pressures. One reason for this, as discussed earlier, is that some consumers are reducing expenditure on what they perceive to be non-essential insurance products. These profit pressures are exacerbated by current low investment yields. In addition, firms may be subject to increased claims levels, both legitimate and fraudulent, as discussed in *Section B*.

Life insurance

In 2008/09, life insurers' capital levels came under pressure as asset values fell and liability values rose (the latter reflecting lower interest rates and higher costs of embedded guarantees). New business profitability continues on a downward trend, reflecting lower volumes as well as tighter margins. Within the life insurance sector, with-profits and annuity providers have been most affected by the deterioration in economic conditions. Profitability pressures can create incentives for firms to increase sales of higher-margin products that may not necessarily be suitable for all consumers, or to extract additional margin from existing business in potentially unfair ways.

Intermediaries

Falling sales of retail investment products and mortgages have placed pressure on the profitability levels and revenue streams of some intermediaries. Mortgage intermediaries have been particularly affected and over three quarters have noted that current economic conditions are having a negative impact on their cash flow. Over 60% also report that they are experiencing a negative impact on the level of capital reserves they hold.[9] Some intermediaries could have increased incentives either to leave the industry or to try raising revenue by increasing sales of other products. The movement of intermediaries into product areas where they have little or no experience could potentially give rise to conduct risks.

Emerging and potential conduct risks

The consumer and firm behaviours and trends described above, in combination with the underlying market failures, can create conditions for conduct risks to arise. We now consider emerging and potential conduct risks, grouped under five areas: retail banking business models; investment and decumulation; platforms; insurance; and regulatory changes.

Retail banking business models

Banks are responding to the various pressures they face in a number of ways: disposing of non-core operations; rebuilding lending margins to price more appropriately for the associated risk; reducing reliance on net-interest income through increased diversification into products and services that generate fee income; and employing greater customer segmentation with a focus on higher-value consumer relationships. Each of these actions will impact consumers and could result in increased conduct risk. Specific examples where we see the potential for actions of firms to lead to consumer detriment include:

9 *Mortgage Intermediary Census: 'Barometer' Quarterly Report*, NMG, Quarter 4 2009.

Product bundling can create risks for consumers.

- Packaged accounts may offer value for money for some consumers, but they may not benefit all; consumers could be better off purchasing products individually or not at all.[10] And some may find that where the add-ons are insurance products, they do not provide the expected level of cover. The potential for consumer detriment, although not likely to impact any individual consumer significantly, could occur across a large population; around 15% of UK adults have some form of packaged account.[11]

- There are incentives for firms to structure loans in such a way that they also attract deposits. This may be through increased marketing of offset mortgages, preferential rates for borrowers holding or opening deposit accounts, or linking deposit accounts to the loan providing access to higher loan-to-value products. These products could offer good value for some consumers as they are not necessarily higher risk. However, there is a possibility that some consumers may not fully understand the terms and conditions of these products.

Increased reliance on bancassurance could lead to inappropriate sales.

- Profitability pressures in retail banking may have increased incentives for firms to try to increase revenues in areas outside traditional retail banking activity. One example might be an increased reliance on bancassurance business, where the incentive to provide investment products to a greater number of clients could lead to inappropriate investment advice or to sales of products that are inappropriate for the target market.

Key messages for firms

- Firms must not increase margins in ways that result in unfair treatment of consumers. Consumers' needs should be reflected in decisions on future strategy, product variation or design, targets for cross-selling, and the sales process. Packaged accounts, for example, may not represent good value for money for all consumers and firms should make clear to consumers that they need not purchase a packaged account.
- There are specific risks around the treatment of consumers who are moved from one firm to another during banking consolidations or banking break-ups. We will look to firms to manage these risks during such transition periods.

Investment and decumulation

Complex products and strategies may not be understood by consumers…

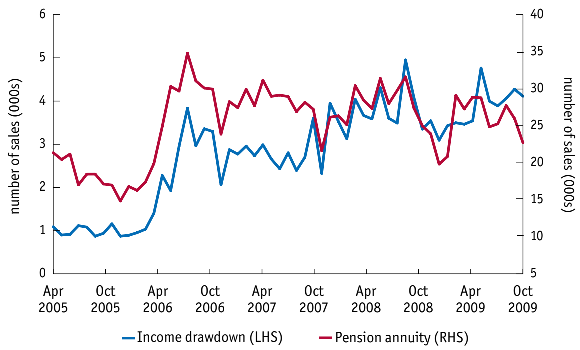
As discussed earlier, there is evidence to suggest that consumers' appetite for investment risk is changing. One manifestation of this has been an increased appetite for capital-protected products. However, certain features, such as the extent of capital protection and the circumstances in which it does or does not operate, could be hard for consumers to understand. There is also the possibility that the cost of the product could outweigh the benefits, and that a consumer could be better served by a different product. This demand for complex capital-protected products creates the risks that providers design poor value products, financial promotions overstate the nature or degree of capital protection, and distributors seek to sell them even when they do not meet consumers' needs (issues regarding the mis-selling of structure products are discussed below). Some consumers could also be attracted to products or investment strategies that are promoted as limiting volatility. Absolute return strategies, previously available only to institutional investors through hedge funds, are increasingly being offered to retail investors, for example through UCITS wrappers.

…and firms have incentives to sell decumulation products which may not be in consumers' best interests.

An increasing number of consumers, especially those moving from defined benefit to defined contribution pension schemes, may demand products which allow decumulation of capital. However, this is an area where consumer financial capability is particularly low.[12] For many, an annuity will be the most appropriate option. However, people approaching retirement may be more susceptible to sales of income drawdown because, as discussed earlier, annuity rates are lower and could generate an income below consumers' expectations. These factors create the conditions for potential mis-selling of products which generate higher fees or commissions than annuities, even when annuities would be more appropriate for

10 A packaged account is a package of products (such as travel insurance and mobile phone insurance) sold with a current account, usually for a flat monthly fee.
11 *Current, Packaged, and Premium Accounts, Finance Intelligence,* MINTEL Oxygen, June 2009.
12 *Financial Services and Later Life: A Scoping Project*, Financial Services Consumer Panel, June 2009.

Chart D3: Income drawdown and pension annuity sales



Source: FSA Retail Investments PSD

consumers. A related risk is that consumers who buy drawdown products do not understand the need for regular review or take the after-sales advice offered to them to help decide when to purchase an annuity. While the market for income drawdown is small, there has been a significant increase in the volume of sales in recent years (see *Chart D3*).

Key messages for firms

- Firms should recognise that consumers' investment needs and attitudes to risk may have changed given the economic climate. Firms need to satisfy themselves that their systems for assessing consumers' attitudes to risk are fit for purpose given these likely changes in risk appetite. Firms should also ensure that their assessment of the appropriate target market for new and existing products is updated.
- Both providers and distributors of products need to provide clear and transparent information to consumers regarding the extent of capital protection, circumstances in which it would not apply and the cost of the product. They should also make it clear what protection the product offers under the Financial Services Compensation Scheme (FSCS).
- Firms providing income drawdown, or advising on it, should bear in mind that this product is unlikely to be appropriate for consumers with pension pots under £100,000.

Key messages for consumers

- Consumers should check that they understand the risks to their investments as well as the potential benefits, particularly if they feel that their desire to take risks with their money has changed.
- Consumers approaching retirement should be aware that if their pension pot is under £100,000, income drawdown is unlikely to be the most appropriate option. Consumers who do purchase income drawdown products need to ensure that their financial position is reviewed regularly.

Platforms[13]

Platforms have been growing rapidly and may not always benefit consumers.

It is estimated that around half of all new investment business is placed through platforms and that they now hold about £110 billion in assets.[14] Growth is expected to continue, particularly as some financial advisers view using a platform as one way of helping them meet their obligations under the Retail Distribution Review (RDR).

13 Platforms are online services used by intermediaries to view and administer investment portfolios. As well as providing facilities for investments to be bought and sold, platforms are often used to aggregate and arrange custody for customers' assets.

14 *Platform Survey*, Money Management, February 2010. The report surveyed 15 platforms.

Platforms are a convenient avenue through which to arrange investments and can bring benefits to the investment industry and consumers. They provide services paid for by consumers directly or by product providers. However, there can be a lack of transparency around charges and services, and platform services may not always be in the consumers' best interests. Some examples of specific risks include:

- Although platforms make it easier for advisers to provide their clients with ongoing investment advice, there is a risk that consumers may incur additional costs without receiving additional benefits. This risk may not be managed effectively if a firm has not changed its oversight arrangements to take account of the new services being provided.

- The ability of advisers to deliver competent ongoing advice could be compromised if they become too dependent on a platform's services, for example, by ignoring investments that are not held on the platform.

- Platforms which do not enable re-registration may make it difficult for consumers to move their assets between platforms. Consumers could face additional costs if they are advised to sell and repurchase an investment in order to move from one platform to another.

- Platform providers are increasingly providing tools that suggest particular funds or products that meet certain investment needs (for example, model portfolios and guided architecture). Advisers and consumers may not understand the basis on which particular funds or products are featured or recommended to them, and this could lead to inappropriate recommendations.

- Smaller fund managers could find it more difficult to distribute their funds through advisers if the majority of intermediary business is conducted through platforms. The large fund supermarkets dominate the platforms market and may demand fees which smaller fund managers cannot afford.

Key messages for firms

- Platforms can bring benefits to industry and consumers, but there are risks that could lead to consumer detriment. Firms must ensure that consumers benefit from being placed on platforms and not place investments on a platform where this is not in a client's best interests.
- Firms should not become overly dependent on a platform's services and should offer consumers suitable products, whether or not they are available on a platform.
- Firms should ensure that products and services suggested by a platform as generically suitable are actually suitable for their individual clients.
- In deciding which platform to use, firms must take into account whether it allows consumers' assets to be transferred to another platform without holdings having to be sold and repurchased.

Insurance

Profitability pressures in the insurance sector mean that insurers could face incentives to find alternative means of raising revenue or cutting costs, which could result in consumer detriment.

In general insurance, price-driven exclusions could create problems post-sale.

- Consumers are often better informed about general insurance compared to other financial products, and many shop around. However, as some consumers tend to focus primarily on price, some insurers may reduce the coverage of policies to maintain competitive prices. As general insurance products are often repeat purchases, consumers do not always adequately check the policy benefits and exclusions. In such cases, consumers could purchase a product that does not provide the cover they reasonably expect and only find this out when making a claim.

- Some general insurance intermediaries doing business through price comparison websites take low or zero commission to maintain competitive prices, and then sell highly profitable insurance add-ons alongside the primary product. Consumers may not be familiar with these add-ons and may not be in a position at the point of purchase to make an informed decision about suitability, benefits and price.

Claims need to be handled fairly.

- General insurance firms facing increased claims levels may have incentives to make their claims handling procedures more stringent. This could lead to an increase in rejected, valid claims or to consumers suffering undue delay in settlement.

Products featuring guarantees can be complex.

- In the life insurance market, current market and economic conditions, (particularly because of low interest rates and high equity market volatility) have increased the cost of providing guarantees, which could absorb a significant proportion of product charges. The introduction of Solvency II, and the changes in solvency capital requirements, may mean that the cost of providing certain guarantees could further increase. However, as discussed earlier, consumers may demand products with guarantee features in the future, and firms may therefore market more of these products. Although the products themselves may be suitable for many consumers, the pricing and terms relating to the guarantees can be complex and opaque. Moreover, the distinction between risks borne by the firm and those that remain with the consumer could be unclear. This complexity and lack of clarity can increase the potential for mis-selling, and create further prudential risks for insurers.

- Issues around the transparency, complexity of operation and potential conflict of interests inherent in the provision of with-profits products can cause conduct risks. Some of the risks arising from these difficulties become particularly acute in recessionary or volatile market conditions. Capital constraints, for example, can lead to firms using with-profit estate capital to support strategic investments that could be detrimental to with-profits policyholders. Firms could also use existing capital to subsidise guarantees on new business at the expense of returns to existing policyholders.

Key messages for firms

- Consumers may focus primarily on price when purchasing certain general insurance products. Firms should ensure that pricing and product terms are transparent and that products are designed to provide appropriate levels of cover for their target market.
- Increased levels of fraudulent claims can lead to firms tightening their claims handling procedures. Firms should ensure that claims handling controls are proportionate and fair to consumers.
- Firms should ensure that the nature of any guarantee is made clear to consumers so they understand what is and what is not guaranteed.
- There are certain issues in the provision of with-profits products that can lead to risks to consumers. With-profits funds need to continue to manage conflicts of interest rigorously, in line with with-profits policyholders' interests.

Key messages for consumers

- Consumers should be aware that some general insurance products may not provide the levels of cover that they expect. Consumers should read the policy terms to make sure the cover offered is right for them.

Regulatory changes

Some firms' responses to regulatory change can increase risk in the period before implementation.

There are a number of changes taking place in the regulatory environment. While these are designed to address market failures, conduct risks could arise in the period leading up to their implementation.

One example is the RDR, due to be implemented at the end of 2012. One of the key objectives of the RDR is to address the conflicts of interest that currently exist in the market for retail investment advice. Under the RDR, provider-determined commission will be banned from the beginning of 2013.[15] In the interim period, this could create an incentive for advisers to focus more on products that attract high levels of provider-determined commission. This may not always be the most appropriate product for consumers.

Pension reforms (to be phased in from October 2012) mean that all employers will have an obligation to provide and contribute to a pension for their employees (dependent on age and earnings), on an automatic

15 *Distribution of Retail Investments: Delivering the RDR*, FSA Consultation Paper 09/18, June 2009.

enrolment basis. Both providers and intermediaries may see a reduction in their share of the pensions market and the demand for pensions advice after these reforms. This expectation of a fall in demand could incentivise some forced pension sales, particularly in the corporate pension market. In the period before 2012, there may be some uncertainty among consumers, which could result in delayed decisions about retirement saving, potentially to their detriment. There is also a possibility that advisers and providers withdraw from certain segments of the market if they think business will lapse in 2012 and this could create continuity risks.

Key messages for firms

- Advisers should ensure that recommendations are in the best interests of clients and are not driven by commission incentives. We are actively looking for evidence of commission bias in the run up to the implementation of the RDR and will take enforcement action where we find inappropriate behaviour.
- Firms should be preparing themselves for the implementation of the RDR at the end of 2012.
- Firms should consider the implications and potential impact of pension reforms on their clients and business models before they are introduced.

Current conduct risks

Many recent conduct issues were not driven by the recession.

Over the last few years, the market failures and consumer and firm behaviours discussed earlier have resulted in the crystallisation of several conduct risks. These risks have manifested themselves at different points in the product life cycle; sometimes in product design and sometimes in sales and marketing. In some cases, the current economic environment has played a role in crystallising or revealing these risks. In others, the drivers of risk are ongoing and largely independent of the economic cycle.

We consider the following five key areas of crystallised conduct risks:

- Lenders' treatment of their existing mortgage consumers and treatment of loans in arrears.
- The sale of structured products, where firms sold higher-margin products to consumers who often did not understand the risks.
- The sale of Payment Protection Insurance (PPI) and Mortgage PPI (MPPI), where consumers purchased products that they did not necessarily need, understand, or were aware they had purchased.
- Poor complaints handling.
- Consumers falling victim to unauthorised share fraud firms.

Treatment of existing mortgage consumers and loans in arrears

Funding pressures and constraints on new lending mean that lenders may seek to move existing mortgage consumers to more profitable products and to 'manage out' higher-risk consumers. While this may improve the prudential position of these firms, it could take place in ways that are unfair to consumers.

Risks have arisen in relation to the treatment of existing mortgage customers.

Examples of conduct issues that have arisen in relation to the treatment of existing mortgage consumers include attempts to withdraw benefits associated with existing mortgage deals and to move mortgage holders onto more expensive, but more profitable, products. As mortgage product availability has reduced and credit standards have tightened, consumers have less flexibility in being able to respond to these changes by switching mortgage providers. Consequently, some consumers may end up with products that are significantly more expensive, or have more restrictive terms, than when they first took out a mortgage.

As discussed in *Section A*, mortgage arrears and repossessions have been rising since 2005. On average, repossession occurs about a year from the point at which the consumer falls into arrears. In 2008, rapidly falling property prices created an incentive for firms to move consumers in arrears towards repossession quickly, so as to minimise losses on forced sales in a falling market. This trend of hasty repossession led to widespread consumer detriment, as households were not provided with the opportunity to discuss the potential option of forbearance with their lender. Nevertheless, since the fourth quarter of 2008, the mortgage pre-action protocol has worked to deter this behaviour.[16]

As arrears and repossessions continue to rise, conduct issues around the handling of mortgage arrears remain a concern. Consumers going into arrears could be treated unfairly if lenders do not pay sufficient regard to individual circumstances. Lenders may decide to repossesses a property without undertaking an evaluation of whether the consumer's current financial difficulties are short-term and whether the consumer is likely to be able to pay in the future. The FSA's Mortgage Market Review is consulting on strengthening arrears handling requirements.[17]

Further risks could arise where the mortgage book has been sold to an unregulated entity (such as private equity firms) and is being managed by a third party. There is a risk that the buyer of the book will seek to maximise income by pro-actively and aggressively managing the arrears.

Key messages for firms

- The economic climate means that there are incentives for firms to mistreat existing mortgage customers. Lenders need to meet commitments to existing consumers, and treat them fairly, despite changes in the economic climate.
- Lenders need to fully explore alternatives to repossession and must ensure an individual consideration of the circumstances of any borrower in payment difficulties. Repossession should only be considered as a last resort.

Key messages for consumers

- Consumers should look carefully at what their existing mortgage deal will offer when the introductory term finishes.
- Consumers should contact their lenders, as soon as they believe they will enter financial difficulty, to discuss alternative arrangements.

Sale of structured products

Mis-selling of structured products was revealed, but not caused by, the financial crisis.

After the collapse of the Lehman Brothers Group in 2008, the FSA identified over 5,000 UK retail investors who had invested a total of £107 million in structured products. The protection of the capital at maturity for these products had been provided solely by firms within the Lehman's Group. The Bank's failure triggered significant losses for these investors. Our subsequent review into the marketing literature provided by some of the plan managers found serious failings. For example, in the descriptions of counterparty risk, the inappropriate use of terms such as 'guaranteed' or 'protected', and the use of language that the target audience was unlikely to understand. We also found significant advice failings, including recommendations that were inconsistent with consumers' attitude to risk, needs and circumstances, and tax requirements.

The market for retail structured products continues to grow, and during 2009 around £13.65 billion was invested in these products.[18] The issues associated with the Lehman-backed structured products could extend to other similar products, and we have highlighted the need for clear and suitable advice in this market.

16 *Pre-Action Protocol for Possession Claims based on Mortgage or Home Purchase Plan Arrears in Respect of Residential Property*, Ministry of Justice, November 2008.
17 *Mortgage Market Review: Arrears and Approved Persons*, FSA Consultation Paper 10/02, January 2010.
18 The source of this data is www.StructuredRetailProducts.com, Arete Consulting.

Key messages for firms

- There have been significant advice failings in the market for structured products. Firms should provide clear and suitable advice in this market that takes into account concentration of counterparty risk, and the particular consumer's needs, tax requirements and attitudes to risk.

Key messages for consumers

- Consumers should be aware that structured products can be higher-risk than they first appear and may not necessarily generate the expected returns. Consumers should endeavour to understand the risks of the product prior to purchase.

Payment Protection Insurance (PPI)

Mis-selling of PPI has been widespread.

PPI mis-selling has been a particularly significant conduct issue in recent years. Conduct issues associated with the sale of PPI include inadequate consumer eligibility checks and inadequate disclosure of key information, such as price. Most policies covering loans were sold on a single premium basis, paid for by adding a second loan for the insurance to the loan amount originally requested. This in turn increased interest payments and inflated the total cost of the loan. Common weaknesses included the failure to assess the appropriateness of the product for the individual; for example, life insurance for consumers with no dependents, and recommendations of cover to those with existing insurance.

PPI was a significant source of profit for many firms. Since 2005, around 12 million individual policy sales generated gross written premiums of £14 billion.[19] The Competition Commission noted that the overall claims ratio for the first half of 2008 was 18.1%.[20] This is low relative to the claims ratios of other general insurance products.

Because PPI was usually sold as a secondary product, many consumers did not focus on the product at all. Many were led to believe that they needed to buy PPI in order to qualify for the loan in the first place, or were simply not told that the product was being added to their loan. Moreover, several firms had inadequate controls over the sales process, which led some consumers to purchase PPI even though they were not eligible to claim.

New products are emerging which have similar characteristics to PPI. These products could be sold in ways which lead to similar consumer detriment to that experienced with PPI.

Key messages for firms

- PPI products were often prone to mis-selling which led to significant consumer detriment. Firms should ensure that products designed with similar characteristics to PPI are sold only to consumers for whom the products are relevant.

Key messages for consumers

- Consumers are particularly susceptible to sales of products that are sold in addition to a primary product and should consider whether they need this secondary product before they purchase it.

19 *The assessment and redress of payment protection insurance complaints*, FSA Consultation Paper 09/23, September 2009.
20 *Competition in the Underwriting Market, Appendix 7.1*, Competition Commission, 2009.

Mortgage Payment Protection Insurance (MPPI)

Many MPPI contracts included unfair variation clauses.

Many MPPI contracts included unfair variation clauses which gave firms discretion to unilaterally alter contract terms. Furthermore, these terms were sometimes inadequately disclosed to the consumer. In 2009, many firms announced their intention to increase premiums or reduce cover based on these terms. For example, the extension of the period before which MPPI would start making payments in the event of unemployment was extended from 30 to 90 days. However, following FSA discussions with the industry in October 2009, firms have agreed to address the issues arising and we continue to monitor the implementation of this agreement.[21]

> **Key messages for firms**
> - Firms must continue to meet their obligations as set out in the agreement in October 2009.

Poor complaints handling

FSA work in a range of areas has identified concerns with firms' complaints handling.

There are concerns around firms' complaints handling procedures.

We are concerned that poor quality complaints handling may be leading to poor outcomes for complainants and ultimately to consumer detriment. Weak management control of complaints handling could lead to poor investigations, weak decision making, inadequate redress payments and delayed resolution. Firms need to ensure that they focus on improving standards of complaints handling and use complaint trends to prevent the rise of systemic issues.

This will remain a key area of FSA focus, particularly as failure to deliver improvements could affect consumer confidence in financial services. New rules requiring firms to publish their own complaints data by August 2010 will increase transparency in this area and should improve complaints handling standards.[22]

> **Key messages for firms**
> - The quality of complaints handling will remain a key area of FSA focus.
> - The FSA has identified concerns around firms' quality of complaints handling and all firms need to ensure that they focus on improving standards in this area.

Unauthorised share fraud firms

A variety of financial scams seek to exploit consumers.

Consumers' willingness to seek high returns is not always accompanied by an understanding of the additional risks involved. This can be exploited by unauthorised firms to the detriment of consumers through a variety of financial scams such as share sale fraud. Unauthorised share fraud firms, commonly known as 'boiler rooms', are not authorised by the FSA and act illegally by selling and promoting the sale of shares in the UK.

Despite reported share fraud activity remaining constant during 2009, evidence suggests that the proportion of people actually losing money to these firms is decreasing. This could be as a result of the recession causing consumers to be more cautious about where and with whom they invest their money. Consequently fraudsters are becoming more creative in their attempts to obtain consumers' money. For example, there has been a significant rise in boiler rooms using the names, details and cloning websites of authorised firms in an attempt to convince people of their legitimacy.

We have increased our focus on unauthorised business and have adopted a strategy to take action which aims to disrupt fraudsters' activity and discourage firms and individuals from dealing with unauthorised firms, both overseas and within the UK. For example, we recently wrote to over 6,500 UK consumers to warn them that their names appeared on a list being used by share fraudsters.

21 *FSA and firms reach agreement on MPPI*, FSA Press Release, 7 October 2009.
22 The FSA collects complaints data from individual firms but due to its lagging nature, complaints data does not provide a good indicator of emerging risk.

Key messages for consumers

- Consumers should be cautious if someone tries to sell them shares in a company unknown to them. These firms may offer a free research report on the company in question, a free gift, or a discount on their dealing charges. Consumers may be left with worthless shares or may have no rights to complain or claim compensation.
- Consumers should be careful about which firms they deal with and they should always check a firm's status on the register before dealing with it.

Our conduct strategy going forward

We want to detect and prevent risks early.

We will continue our focus on ensuring that a firm's culture and retail business strategy reflect a focus on treating customers fairly. We also want to do more to detect and prevent risks before they cause significant consumer detriment. Consequently we are:

- Strengthening our retail market analysis capabilities to identify and analyse earlier the nature and potential sources of consumer detriment. This will allow earlier intervention to protect consumers and maintain market confidence.

- Increasing our focus and analysis on the whole life cycle of products. In particular, we will be paying more attention to firms' product development and design activities. This is in addition to scrutinising product marketing, distribution and post-sales handling. We want to ensure that firms, at each step in the value chain, have the right incentives to provide products that address real consumer needs. We will intervene to change incentives and relationships if they result in poor consumer outcomes.

- Developing a more consistent and intensive supervisory framework for conduct issues, including increased focus on emerging risks, environmental factors and firm-specific business model analysis to better understand firm strategies, profitability drivers and potential conduct implications.

Key messages for firms

- Firms should focus their retail strategies on putting the interests of their clients first. Firms should understand the importance that culture can play in the emergence of conduct risk.
- We will be challenging firms to demonstrate how their culture, retail strategies and controls ensure the fair treatment of consumers.
- Firms should expect increased scrutiny of product design and product governance.

Conclusions and links with the Business Plan

The Financial Risk Outlook sets out the main risks and issues present in our operating environment. Many of these risks and issues will be addressed though our policy reform agenda and enhanced supervision. We will also be carrying out further analysis of many of the risks and issues identified in order to better understand their implications, and in some cases we will undertake specific thematic work streams to assess their impact in greater detail. Our priorities in response to the Financial Risk Outlook are discussed in the Business Plan 2011/12.

Our analysis of the main risks and issues in this Financial Risk Outlook is based on our current assessment of the operating environment for firms, markets and consumers. The operating environment is shaped by economic and financial market conditions, as well as by the political environment, and structural, legal and regulatory changes. Idiosyncratic shocks, such as pandemic flu, extreme weather events and unexpected geo-political events, can also influence the operating environment. Therefore, material changes in any of these areas could alter the balance of risks that we, firms, markets and consumers face.

Macroeconomic background and outlook.

As discussed in *Section A*, our central economic scenario is for gradual economic recovery throughout 2010. However, there remain a range of uncertainties around the possible outcomes for the economy, and the financial sector is vulnerable to shocks. Our use of stress testing continues to play a key role in our assessment of firms' adequacy to withstand the risks that could arise under the alternative scenarios discussed in *Section A*, as well as other scenarios of varying degrees of likelihood and impact. Our financial stability strategy, detailed in the Business Plan, describes our ongoing work to identify and analyse risks, including the impact of fiscal consolidation and global imbalances.

Financial stability and prudential issues and risks.

The financial crisis highlighted the importance of effectively managing prudential and financial stability risks for all stakeholders in the financial system. *Section B* outlines some of the main challenges that firms currently face in this area, including pressures on capital, liquidity and long-term funding and deficiencies in some firms' risk management. We are responding to these risks by delivering more effective intensive supervision, supported by our credible deterrence philosophy. This will require firms to be far more proactive in their assessment of risks.

In conjunction with our new supervisory approach, we are developing new policy frameworks to strengthen firms' prudential positions, including new capital and liquidity regimes and Solvency II. This period of policy implementation will in itself pose challenges to firms and we will be carrying out thematic reviews to assess firms' preparedness for these policy reforms, alongside our intensive supervision. We are also working to achieve globally agreed standards as quickly as possible to achieve consistency and a clearer understanding of the cumulative impact of policy changes.

Market issues and risks. Together with other market risks, such as market fragmentation and the changing structure of the equity market, market abuse continues to be a significant part of our market regulation and anti-market abuse work. In *Section C*, we briefly described some of the cases where we have taken enforcement action against firms and individuals for market abuse. We will continue to undertake enforcement measures, which include the implementation of penalties policy to discourage market abuse and continuing work on prosecuting criminal actions, to deter abusive action.

Retail conduct issues and risks. Underlying market failures, coupled with firms' incentives and consumers' behavioural characteristics can lead to the emergence of conduct risks. We are seeking to address conduct risks that are developing in the mortgage market through a range of thematic projects and the implementation of new policies arising from the Mortgage Market Review. Other policy initiatives, including the RDR, are also being implemented to ensure fair outcomes are delivered to consumers in particular market segments. The implementation of our core conduct programme will ensure that higher-quality, intensive and risk-focused supervision is carried out to identify risks which could cause consumer detriment and that firms are challenged and well governed. In *Section D* we also describe our revised conduct strategy which will enhance our approach to identifying and addressing conduct risks.

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Glossary

ABS – asset-backed security

BCBS – Basel Committee on Banking Supervision

bn – billion

bp – basis point

CCP – central counterparty

CDS – credit default swap

CESR – Committee of European Securities Regulators

CGS – Credit Guarantee Scheme

CML – Council of Mortgage Lenders

CPSS – Committee on Payment and Settlement Systems

CRA – credit rating agency

CRD – Capital Requirement Directive

EU – European Union

FOS – Financial Ombudsman Service

FSB – Financial Stability Board

FSCS – Financial Services Compensation Scheme

GDP – gross domestic product

HFT – high frequency trading

IASB – International Accounting Standards Board

ICAS – Individual Capital Adequacy Standards

ICG – Individual Capital Guidance

Itraxx Crossover Index – an index offering credit default protection against European companies of sub-investment grade

IMF – International Monetary Fund

IOSCO – International Organisation of Securities Commissions

IPD – Investment Property Databank

LCR – liquidity coverage ratio

LIBOR – London interbank offered rate

LTV – loan-to-value

MBS – mortgage-backed security

MiFID – Markets in Financial Instruments Directive

mn – million

MPPI – Mortgage Payment Protection Insurance

MTF – Multilateral Trading Facility

MVR – Market Value Reduction

NIM – Net Interest Margin

NPISH – Non-Profit Institutions Serving Households

NSFR – net stable funding ratio

OFT – Office of Fair Trading

ONS – Office of National Statistics

OTC – over-the-counter

PIBS – Permanent Interest Bearing Shares

PPDS – Profit Participating Deferred Shares

PPI – Payment Protection Insurance

PSD – Product Sales Data

QIS – Quantitative Impact Study

RDR – Retail Distribution Review

RMBS – residential mortgage-backed security

SIV – structured investment vehicle

SLS –Special Liquidity Scheme

SMEs – small and medium-sized enterprises

STR – Suspicious Transaction Report

trn – trillion

UCITS – Undertakings for Collective Investments in Transferable Securities

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