Financial stability

Introduction

The *2012/13 Business Plan* highlighted that the FSA would continue to focus on forward looking assessments of risks and that early, proactive interventions should reduce the risks to the stability of the system.

This chapter shows how it delivered on the *2012/13 Business Plan* aims, set out as:

- supervisory initiatives, including developing the supervisory approach, stress testing, assessing operational resilience of firms;
- domestic policy initiatives, including guidance on internal audit and the establishment of the FPC; and
- international policy initiatives, including the Capital Requirements Directive (CRD IV) and Solvency II, work on the liquidity regime for banks and systemically important financial institution (SIFIs).

Key metrics

The principal metrics the FSA used to assess its supervisory effectiveness in relation to its financial stability objective and to gauge financial stability include:

Chart 1: Firm feedback on the quality of FSA supervisory risk assessments

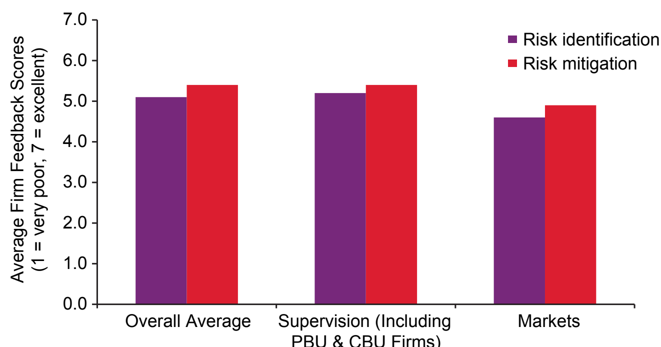
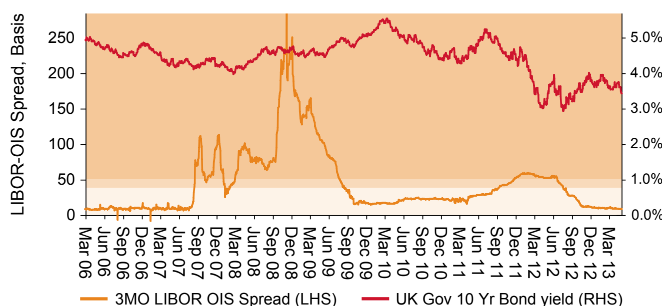


Chart 2: Cost of credit

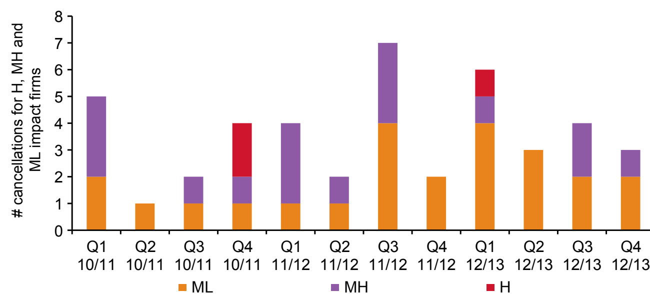


Source: Bloomberg

The (3month) Libor-OIS spread is a measure of perceived counterparty risk in short-term inter-bank funding markets. It can be used as a gauge of banks' reluctance to lend; higher levels indicate less willingness to lend. The spread has been on a downward trend since the beginning of 2012 which suggests lenders are willing to lend.

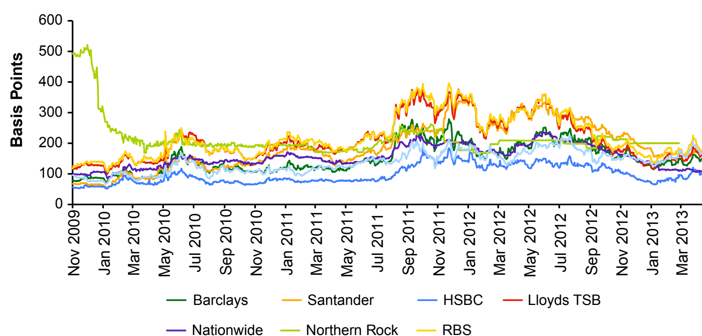
The 10-year gilt yield represents the cost of long-term funding for the UK Government. Weak growth and a prolonged period of low interest rates, the UK's status as a safe-haven country (despite recent downgrades by rating agencies), and the impact of QE, have all led to increased demand for gilts whose yields remained at historic lows in 2012/13. Low gilt yields increase pension fund liabilities and lead to lower annuities for pensioners.

Chart 3: Number of cancellations by firm/sector



The total number of cancellations for all Authorised and EEA-Authorised firms for the period 2012/13 (Q2 2012 to Q1 2013), including where there was no impact score, was 1,779 firms. Within these figures, the data for firms with a high (H), medium high (MH) and medium low (ML) IRM (Interim Risk Manager) impact score is shown in the chart above. This was an 8% decrease in the number of cancellations in the previous year (1,931). There has been a decrease in the numbers over the last few years; the number of cancellations in 2010/11 was 2,080; in 2009/10 2573 firms cancelled and in 2008/9 2,792 firms cancelled.

Chart 4: Major UK banks – CDS Spreads – five year Senior Debt



Source: Bloomberg

Banks' CDS spreads are an indication of market perceptions of credit risk. Spreads have mainly been on a steady decline since peaking around Q3 2011, reflecting banks' efforts to improve their capital positions and greater confidence in the stability of the financial system. However while CDS spreads have narrowed more recently, they spiked at the end of March following statements by the FPC that major UK banks and building societies will need to raise a total of £25billion in extra capital by the end of 2013.

Supervision

Developing a prudential supervisory approach

Banks

In Banking Supervision tools were improved to help supervisors make sound judgements about risk prioritisation and actions that should be taken by firms. This focused on deepening the assessment of banks' business models and their resilience under a range of conditions, as well as assessing their risk management, controls and governance structures.

For banks and building societies for which the FSA was the home regulator, the supervisory strategy focused on building on experience to deepen and enhance understanding and assessments of:

- business model sustainability;
- capital and liquidity stress-testing; and
- governance and risk management effectiveness.

The FSA worked with firms to strengthen their management of capital and liquidity and readiness for implementing the new international capital and liquidity standards.

Work also continued on recovery and resolution plans for banks and building societies, including through supervisory colleges and crisis management groups.

For banks where the FSA was a host, rather than home supervisor, the strategy targeted improving understanding of the risks inherent in firms' business models which in turn helped to focus the analysis of recovery and resolution plans. This informed the FSA's engagement with the relevant overseas home regulators through supervisory colleges and crisis management groups. The FSA also undertook a number of actions to limit the impact on the UK financial system where firms' UK operations have been endangered by risks to the viability of the overseas group. This included working with the BoE's Special Resolution Unit to undertake contingency planning for a number of firms where the FSA considered the risk of failing to have been particularly high.

Co-op – Verde

The UK Government's support of the Lloyds Banking Group (LBG) in 2009 was subject to the European Commission State Aid clearance, which committed LBG to sell or divest part of its retail banking business (known as Verde). LBG identified Lloyds TSB Scotland plc., a regulated entity, for the purpose of creating and divesting Verde.

The FSA assessed and monitored the risks to successful execution of the Verde project, including its IT readiness and system build, and its readiness to divest the business either through sale or an IPO. The FSA had first set out its requirements that the Co-operative Banking Group (Co-op Bank) would have to meet to gain approval of its bid for Verde in 2011. Co-op Bank then became the preferred bidder on 14 December 2011, but the requirements remained in place. During the year, the FSA focused accordingly on Co-op Bank's capacity to take on the Verde business. This included assessment and monitoring of Co-op Bank's readiness to incorporate Verde, including its risk management, controls and governance, and capital and liquidity requirements.

The Co-op Bank's bid for Verde did not progress to the stage where the FSA needed to give approval. The FSA was in regular dialogue with the Treasury on these matters.

Insurers

As with banks, tools continued to be strengthened during the year, ensuring that prudential supervisors made appropriate judgements in prioritising risk and actions that firms need to take.

In Insurance Supervision, the roll out of the more intensive approach to supervision of the major insurance groups and Business Model Analysis (BMA) for other firms was mostly completed. This work enhanced the capability of supervisors to assess the risks to sustainability of firms' business models and financial positions, drawing on business as well as regulatory data.

Solvency II continued to be an important component of the FSA's supervisory work during the year, including assessing the progress firms have made towards implementing the standards anticipated in the new Directive. Further details on the FSA's work on Solvency II can be found on pages 30-32.

In 2012, further work was carried out on developing the supervisory approach, leading up to the publication of the *PRA Approach to Insurance Supervision* document in October 2012. The Insurance Division also designed working level guidelines to ensure this approach can be properly implemented and is sufficiently resourced. This included determining the level and type of supervision that different firms will receive based on their assessed impact category. One important priority in preparing for the new regulatory structure was to consider how to clearly divide responsibilities between the PRA and FCA over the supervision of with-profits. This has now been agreed and codified into the MoU between the two new authorities.

Firms that are neither deposit takers nor insurers

The FSA also continued to develop its wider prudential supervisory approach to firms beyond banks and insurers based on the principle that firms should be allowed to fail. Supervisory focus for these future FCA-regulated firms would therefore fall on minimising the impact of the firm's failure on consumers and market participants by ensuring that customers' assets and money were protected and that the firm could be run down without adversely affecting consumers or markets.

The wider prudential approach to these firms continued to ensure that their minimum prudential requirements were met. For the more prudentially significant firms, these prudential requirements remained based on a supervisory review of the capital and liquidity risks posed to that firm, whereas for the less prudentially significant firms they remained based on the minimum requirements specified in the FSA Handbook.

This wider prudential approach to firms that are neither deposit takers nor insurers will continue now the FCA is responsible for their prudential supervision, however proactive prudential supervision will be limited to a relatively small number of 'prudentially significant' firms.

Whether a firm was deemed to be 'prudentially significant' was determined through an assessment of the impact that the disorderly failure of that firm could cause in terms of market disruption and consumer impact. The assessment took into account factors reflecting the consequences of failure such as the size and nature of a firm's business, its importance to the market, and its holding of client money/assets.

Using Business Model Analysis (BMA)

BMA became a key part of the judgement-based supervisory approach.

Banks

The FSA made substantial progress on integrating BMA into the overall supervisory approach, tailoring the scope of work to reflect the impact and circumstances of the broad range of firms that the FSA supervised.

For the highest impact firms where the FSA was the home supervisor, there was a rolling programme of conducting detailed BMA at business unit and group level to assist with assessing the main threats to viability and sustainability, as well as prioritising the overall supervisory work programme.

For the highest impact firms where the FSA was a host supervisor, a similar approach was piloted but a number of changes were made to reflect:

- the interconnection between the UK operations of a firm and those of the overseas parent;
- the limited ability to undertake a detailed assessment of a group that is headquartered outside the UK; and
- the reliance on overseas regulators to provide information on the overall stability of such groups.

There was also joint work with some overseas regulators to assess the business model risks inherent in a number of firms where the UK presence represents a significant proportion of the group's operations. This helped to focus discussions in regulatory colleges and led to detailed follow-up work by the FSA and the home regulator, including recovery and resolution planning.

With regard to non-systemic UK banks and building societies a proportionate level of BMA was undertaken, using analysis to identify the key issues in each firm, make judgements on viability and influence the development of supervisory strategies. For a large number of lower impact firms where the FSA was the host supervisor, an approach to assess business models by reference to peer groups of broadly similar firms was rolled out.

Insurers

BMA was extended to all insurance firms. This was accompanied by detailed guidance and a central team to support supervisors for the more complex cases. Given the wide variety of firms supervised in the insurance sector, an analytical approach proportionate to the complexity of the insurer's business model and potential impact of its activities on regulatory objectives was adopted. The approach emphasises the assessment of the design and execution of a business model, as well as the mechanism for generating profit, cash and acceptable returns to capital.

Firms were subject to BMA as part of their overall programme of supervisory work and each assessment delivered a judgement on a firm's viability and sustainability. Where the risks identified from a BMA assessment were of sufficient priority, they were addressed through the supervisory strategy for the firm.

Stress-testing in banking

Analytics capabilities were substantially improved to help inform supervisory judgements. Some of the core credit stress-testing methodologies were re-engineered and enhanced to gain a more robust and forward-looking insight into the most material vulnerabilities in credit portfolios. The Analytics & Risk Technology (ART) platform was also completed. This enables concurrent stress tests across firms and scenarios for certain credit portfolios and speeds up the process of testing firm-wide capital adequacy under stress.

Using ART

The Firm Data Submission Framework for supervisory stress test data was underway with seven major UK banks in 2012/13. The FSA worked individually with each of these firms to establish a mapping between their internal data definitions and that of the FSA's, to understand data provenance and flows and tailor the sourcing of data accordingly, and to agree internal reconciliations before submission. The outcome of this will be quarterly submissions for all of these firms under the new regulatory regime. The PRA will then run analytics on these quarterly submissions to inform forward-looking supervisory judgement empirically.

Several pilots were performed successfully using the ART platform to stress test different banks' credit portfolios, in parallel with the existing stress-testing process. These highlighted substantial improvements in efficiency. Following these tests the ART platform went live, and the first set of concurrent multi-firm, multi-scenario stress tests for certain credit portfolios took place in Q1 2013.

Stress-testing in insurers

In December 2012, the FSA launched an updated, standardised stress-testing exercise covering large life insurance firms and groups, based on insurers' 2012 year-end financial positions. This exercise covered the ability of large life insurance firms to meet their regulatory capital requirements following ten market stress scenarios of progressive severity. The FSA also asked firms to assess the impact of stress events on their liquidity and cash flow.

Results are expected in summer 2013 and will provide valuable information on the financial resilience of larger life insurers. The FSA also worked with the BoE to benefit from their expertise in this area.

Resolution and recovery plans (RRPs)

As part of its firm-specific prudential oversight, the FSA focused on ensuring that banks have effective RRPs. The FSA developed its RRP approach and reviewed the RRP plans of both small and medium banking institutions as well as the larger global banking institutions to reduce the impact of any potential firm failure. The FSA reviewed and challenged the effectiveness of the plans in place, to build more robust and actionable RRPs.

Operational resilience and the Market Wide Exercise

The FSA conducted intensive reviews of resilience arrangements at major financial organisations and findings were discussed with them, to improve the understanding of their ability and that of the sector as a whole to withstand a major operational disruption. Observations of general interest were shared with the sector throughout.

An important aspect of follow up to the Market Wide Exercise was to ensure that the sector was prepared for disruption during the Olympic Games. This included improving alternate working plans and communications, widening understanding of payments systems and participation in an industry-wide stress test in May 2012.

Work continued to improve the understanding of the potential impact of large scale cyber-attacks; in particular, discussions with the sector were held regarding a follow-up cyber-exercise later in 2013 to validate improvements to response structure and process. The technology and cyber-resilience practices of 30 major financial institutions were compared to provide participants with peer comparison. Firms received summary reports in February and March 2013. This and the other work streams assisted the FSA's contribution to the Finance Sector Resilience Plan.

Directors of failed banks

The FSA Board Report into the failure of Royal Bank of Scotland (RBS) raised a number of questions about how executives and boards of banks should be incentivised to place greater weight on avoiding downside risks. The FSA worked closely with the Treasury in exploring a number of options in this area. This led to the Treasury's consultation paper in July 2012 on '*Sanctions for the directors of failed banks*'.[1] This discussed the introduction of criminal sanctions for serious misconduct in the management of a bank, and proposed introducing legislation of a 'rebuttable presumption' that a director of a failed bank is not suitable to hold another position as a senior executive.

Domestic policy initiatives

Financial Policy Committee (FPC)

The FPC, which gained its statutory footing on 1 April 2013, is an independent committee of the BoE and an important part of the regulatory reform in the UK. During 2012/13 the interim FPC continued its work to identify, monitor and publicise risks to the stability of the financial system and advised action to reduce and mitigate these risks. The FSA briefed the Committee regularly on supervisory issues. The FSA also supported its preparatory work in advance of the creation of the permanent FPC, including developing the macroprudential toolkit and publishing a draft policy statement, in January 2013, on how the FPC will use these tools.

The FSA responded to a number of recommendations made by the FPC on banks' disclosure, balance sheet resilience, liquidity buffers and capital position. The BoE's Financial Stability Report is published every six months and describes the progress made against these recommendations.

Liquidity regime

The FSA made it clear to firms that their liquid asset buffer can be drawn down in the event of liquidity stress and that they will be given reasonable time to rebuild their buffers subsequently. The FSA also adapted the micro-prudential regime to recognise the additional insurance provided by the BoE through its Extended Collateral Term Repo facility and the Discount Window Facility (DWF). The FSA announced that for those banks engaged in the DWF, it would permit part of the pre-positioned collateral to be included in the banks' liquidity asset buffer. Consistent with these announcements, the FSA also consulted on the removal of the automatic transition path in the Simplified ILAS regime buffer requirement for certain less complex banks and building societies.

The FSA also engaged internationally on the issue of liquidity. Further details of international work can be found on page 29-30.

Capital regime

In September 2012, the FSA clarified changes to its capital regime intended to support lending to the real economy. This makes allowances for the increase in Pillar 1 capital requirements as a result of new lending to European households and non-financial companies by reducing Pillar 2 capital planning buffer requirements. The precise amount of this offset is determined in discussions with banks on their capital adequacy and forward-looking capital plans.

1 http://www.hm-treasury.gov.uk/d/consult_sanctions_directors_banks.pdf

Internal audit

In the *2012/13 Business Plan* the FSA stated that it wished to promote more effective internal audit functions, which FSA supervisors could rely on as part of robust corporate governance at major firms.

It concluded that developing a Code of Practice was best undertaken in conjunction with the appropriate professional body, and in March 2012 the FSA approached the Chartered Institute of Internal Auditors, UK (the CIIA) to explore whether they would be interested in developing such a code. The CIIA established the Institute of Internal Auditors Committee for Effective Internal Audit in Financial Services (Committee) in September 2012 to oversee the development of the Code. The FSA were observers on the Committee and in February 2013 welcomed the publication of its consultation paper. It is expected that the final Code will published mid-2013. To raise awareness of the FSA's interest in this subject, it also engaged directly with the heads of internal audit functions and chairs of audit committees of major UK banks and insurance firms.

International policy initiatives

Banks

CRD IV

The FSA continued its close engagement with the formulation of EU legislation on the prudential regulation of credit institutions and investment firms, known as CRD IV. This legislation is intended to implement Basel III in the EU and to provide for a single rulebook for European prudential regulation. The FSA supported UK negotiating parties through technical advice and analysis of the proposals, with the aim of ensuring the final legislative framework provides a sound and proportionate basis for supervising banks, building societies and investment firms. The ability to tackle systemic risks, ensuring thorough implementation of Basel III, and providing for a judgement-based approach to supervision were among the FSA's key priorities.

The FSA also continued to prepare for implementation on the basis of the best information available, and encouraged firms to do the same, while recognising that the delay to the European timetable meant that implementation would be later than the planned 1 January 2013. The content of CRD IV was finally agreed at European level in March 2013. It is expected that it will take effect from 1 January 2014. The preparation undertaken will nevertheless ensure that there is capacity to move as quickly as possible to implement the necessary supervisory systems and changes and to be able to consult on all rule changes before the final legislation enters into force. Transitional periods and phasing in of various parts of the new requirements will run through to 1 January 2019.

Liquidity

In addition to its domestic work on liquidity, the FSA actively engaged in international work-streams to develop and introduce internationally agreed liquidity standards.

The FSA participated in international efforts at both the Basel Committee on Banking Supervision (BCBS) and at the EU level to establish a common liquidity regime. In the BCBS, the discussions concluded with the Governors and Heads of Supervision agreeing in January 2013 the Liquidity Coverage Ratio (LCR) and liquidity risk monitoring tools standards. The FSA also began work on the transition to the new regime.

At EU level, the FSA contributed to the discussions on liquidity in the CRD IV legislative package on liquidity reporting and on enabling the implementation of the LCR in the EU. Specifically the FSA fully engaged in the European Banking Authority's (EBA) working groups on a number of different initiatives including assessing the impact of the LCR, designing the reporting templates, and developing the binding technical standards. The FSA also continued to facilitate the bi-annual rounds of BCBS and EBA's data monitoring exercise as well as the EBA's voluntary LCR monitoring exercise, which involved collecting and analysing data from participating firms.

SIFIs

During the past year the FSA engaged closely with the relevant international work-streams being led by the Financial Stability Board (FSB), BCBS, International Association of Insurance Supervisors (IAIS) and International Organisation of Securities Commissions (IOSCO) directed at identifying systemic firms and developing internationally agreed policy measures for such firms.

In November 2012, the FSB, drawing on the BCBS methodology, published a list of 28 institutions judged to be global systemically-important banks (G-SIBs). This list included four UK firms: HSBC, Barclays, RBS and Standard Chartered. Firms designated G-SIBs will be required to hold (phased in from 2016) additional capital in the form of an equity surcharge. The UK is also a host jurisdiction to other G-SIBs and potentially a number of other firms of systemic significance.

Shadow banking

A key lesson from the crisis is that bank-like risks (credit extension associated with leverage and maturity mismatches) can be replicated by capital markets and other non-bank entities. The FSA attached importance to the international work to agree a common framework for monitoring and developing policy responses to such shadow banking activity, recognising that much non-bank credit intermediation does play a positive role.

Internationally, the FSA's Chairman, Adair Turner, led a major FSB project in this area, which published a number of important recommendations in November 2012. Given the capacity of shadow banking activity to evolve in the light of changing incentives (including those created by increasing bank capital standards), monitoring work and international collaboration will be an on-going activity requiring continued vigilance under the new regulatory framework.

Insurers

Solvency II

Due to the uncertainty surrounding the implementation date of Solvency II the FSA announced a revised planning horizon of 31 December 2015. The FSA also set out its intention to allow firms to use their Solvency II work to meet, as far as possible, the current requirements under the Individual Capital Adequacy Standards (ICAS). The extended planning horizon, led the FSA to begin re-planning ICAS reviews including for many firms in the internal model approval process (IMAP). In developing this approach, referred to as ICAS+, the FSA benefited from industry technical input via expert groups that convened in late 2012 and set out in further detail in January 2013.

On-going policy negotiations

During the year the FSA's engagement with the Treasury, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) continued. This has included negotiations on the Omnibus II Directive, along with Level 2 and Level 3 of the Solvency II Directive.

Discussions between the European Commission, European Parliament and European Council ('trialogues') began in the second half of 2012 on the Omnibus II and Level 1 negotiations to agree three substantive areas of policy, including the long-term guarantees package. Agreement was not reached at trialogue and EIOPA was asked to undertake an assessment of the long-term guarantees package, which began in January 2013. The FSA invited UK firms to participate in the exercise.

The Level 2 drafting continued and the FSA maintained its representation on the relevant EIOPA committees and sub-committees that advise the Commission. The FSA advised the Treasury on prudential issues to ensure they have sight of risks in the Level 1 and draft Level 2 text. It also provided input to the EIOPA committees and working groups in the drafting of the Level 3 guidelines.

Engagement with industry

Throughout 2012/13, representatives for the FSA spoke at industry events, on a range of topics, to give both internal model firms and standard formula firms information to prepare them for implementation. The FSA's engagement included setting out its thinking on how it will monitor the on-going appropriateness of internal models after approval using 'early warning indicators', as well as holding a number of industry briefings.

Consultation on Solvency II

The FSA consulted on Solvency II rules in Consultation Papers CP 11/22, CP11/23 and CP12/13 based on Level 1 text. It issued a Feedback Statement FS12/2 in response to CP11/23, which included changes to Permitted Links rules. The FSA planned to issue a Policy Statement on Solvency II in January 2013, on both CP11/22 and CP 12/13, together with the final rules of the conduct elements of CP 11/23, to meet a June 2013 transposition date. Delays in the European process to finalise the Omnibus II Directive led to the decision to delay publication.

Plans for implementation

Where policy is stable the FSA completed the relevant design and build of the processes required for the implementation of Solvency II. As the Directive articles summarising the internal model process have been deemed stable and require a significant amount of activity from firms and the regulator ahead of Solvency II implementation, this work was the focus of both the FSA and the insurance industry during this period.

In March 2013 EIOPA launched a public consultation on guidelines to prepare for Solvency II. These were intended to support both national supervisors and firms in their preparation for the Solvency II requirements at implementation.

Reporting requirements

The FSA's engagement with EIOPA, at a working group level, continued throughout the year and it was represented at a number of the decision making and reporting committees. In July 2012, the FSA published a statement to confirm that, for quantitative reporting under CRD IV and Solvency II, it (or future bodies) intended to collect quantitative regulatory data using the Extensible Business Reporting Language (XBRL) standards and formats.

With the creation of the PRA, further consideration is being given as to what national specific reporting requirements are required.

Solvency II training

The FSA continued to train its staff on the Solvency II Directive and on-going policy developments, including the ICAS+ approach, to ensure they were equipped with the specific knowledge and skills to complete their Solvency II work.

Solvency II – IMAP

From April 2012 the FSA received submissions from internal model firms that were in its pre-application process, to achieve the implementation date of 1 January 2014. The FSA gave individual firm feedback through the course of 2012 and it also shared its high-level findings from IMAP review and assessment work on the Solvency II pages of the FSA website to inform and support other firms ahead of their own submissions.