FSA

Internal Audit Division

# The supervision of Northern Rock: a lessons learned review

Report

March 2008

# Contents

Part B describes and assesses the supervision of Northern Rock. Part D addresses the other topics that form part of the Terms of Reference (see Appendix 1) for this review. We recommend actions throughout Part D and these are grouped beneath seven high level recommendations in Appendix 2.

Part C is designed to link Parts B and D. It contains a list of lessons that emerge from the supervision of Northern Rock, which are also separately flagged throughout the Northern Rock chapters. Part C then shows where in the report each lesson is developed and to which recommended action(s) it contributes.



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# A Executive summary

## Background

1. In October 2007, the Chief Executive of the FSA asked Internal Audit to carry out a lessons learned review of the supervision of Northern Rock plc during the period 1 January 2005 to 9 August 2007. The Terms of Reference are in Appendix 1. They were published as part of the submission to the Treasury Select Committee (TSC) of 11 December 2007. A commitment was made to publish the conclusions of this review in March 2008.

2. From early August 2007, conditions in credit markets deteriorated and Northern Rock experienced increasing difficulty in securing wholesale market funding. From 9 August, the FSA took part in daily discussions with the other Tripartite authorities to discuss the latest market conditions. The significance of 9 August, therefore, is that it was the start of what can be termed 'the crisis period'. The scope of this review excludes the crisis period.

3. The extent of the market disruption that occurred in the crisis period – to wholesale funding markets, including securitisation markets – was generally not foreseen by commentators. It was the crystallisation of a low probability, high impact risk. It prompted the need for Northern Rock to seek emergency liquidity assistance from the Bank of England; ultimately, it prompted the run on Northern Rock's retail deposits. The FSA, while recognising that primary responsibility for Northern Rock lay with the firm's senior management, initiated this review: to examine the supervisory approach for Northern Rock; to identify the lessons which the FSA should draw; and to recommend changes that those lessons suggested for its risk assessment and risk mitigation practices in general.

## Approach

4. We have carried out a detailed review of the supervision of Northern Rock for the period in question. This has included researching what information was available on the firm at the time, both within the FSA and externally. We have made a number of findings and assessed their significance to form an overall view of whether the FSA's supervisory strategy for Northern Rock was in line with its risk profile. The conclusion is, therefore, based on the evidence and our judgement of it.

5. In order to assess whether the supervision of Northern Rock was an outlier, we have reviewed, as comparators, the FSA's approach to a sample of five other firms[1], rated in accordance with the FSA's ARROW risk framework as high impact. The sample firms were supervised in different departments, spanning the FSA's Wholesale and Retail Business Units, and provided examples of risk assessment under both ARROW I and revised ARROW II methodologies.

[1] This report uses the terms 'firm' and 'firms' as shorthand, referring sometimes to the relevant legal entity itself and sometimes to the group of which it is part.

6. As part of our review work we interviewed 65 FSA staff and former staff. We also reviewed 129 files (lever arch or equivalent) and a similar number of electronic files.

7. In line with the Terms of Reference, our high level recommendations and recommended actions are designed to apply to the supervision of all high impact firms, although we recognise that many are more generally applicable. Where the proposed scope of an action is more limited, we specify that it is designed for high impact *deposit-takers* and high impact *investment firms*.

8. We set out our conclusions from this review in two parts. The first conclusion is in paragraph 27 and covers whether the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the FSA's supervisory strategy, including the supervisory period and level of resourcing, was in line with the firm's risk profile. The second conclusion relates to our review of the other elements of the Terms of Reference. This is set out in paragraph 43.

**Key points arising from the supervision of Northern Rock**

*Context*

9. In this section we summarise the key aspects of the supervision of Northern Rock which have contributed to our findings and our opinion of whether the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the FSA's supervisory strategy, including the supervisory period and level of resourcing, was in line with the firm's risk profile.

10. In April 2004, the FSA effected a major re-organisation, the principal outcome of which was to create separate Business Units for the supervision of retail and wholesale firms. As part of this re-organisation, responsibility for the supervision of Northern Rock was transferred to Major Retail Groups Division (MRGD). There were subsequent re-organisations within MRGD, in June 2006 and February 2007.

11. From the start of our review period to June 2006, Northern Rock was supervised in a department whose primary responsibility was for insurance groups. Between June 2006 and February 2007, Northern Rock was supervised by a team which had responsibility for one other group – an insurance group. From February 2007 to the end of the review period, it was supervised with deposit-taking peers. As a consequence of these moves, Northern Rock was the responsibility of three heads of department (HoDs) during the period of the review, although the last of these had responsibility for Northern Rock in practice for only three months. There was, however, continuity of manager and lead associate on the team responsible for supervising Northern Rock throughout the review period.

12. Supervision of Northern Rock took place against a background of significant activity, on top of normal pressures, in relation to many of MRGD's firms – including significant one-off events such as takeovers (for example Banco Santander of Abbey), bids (for example by Barclays and RBS for ABN Amro) and demutualisation (Standard Life) as well as enforcement investigations. In addition, the continuing moves to implement

changes to the capital adequacy framework stemming from reform of the Basel accord created a heavy workload.

*Period up to ARROW risk assessment Panel on 20 February 2006*

13. The supervisory approach adopted for Northern Rock flowed from the formal risk assessment, which was endorsed at the ARROW Panel of 20 February 2006.

14. We have reviewed the pack of material that was submitted to the Panel. It complied with the prevailing ARROW I standards[2]. It included an overview of the firm's strategy and business, its principal activities, capital and liquidity positions, and nature of funding, as well as a summary of management and of the control environment. We were unable to assess the content of the analysis alongside what key Northern Rock executives and the external auditors had contributed during the discovery work because, contrary to ARROW I and ARROW II standard practice, formal records of key meetings were not prepared.

15. Under ARROW I there was no requirement on supervisory teams to include any developed financial analysis in the material provided to ARROW Panels, and for the Northern Rock Panel none was provided either for the firm itself or in relation to its peers. That type of analysis might have thrown into relief key aspects of Northern Rock's business model. Comparison would have shown Northern Rock, relative to its peers, as having a high public target for asset growth (15-25% year-on-year) and for profit growth; a low net interest margin; a low cost:income ratio; and relatively high reliance on wholesale funding and securitisation.

*The input of the ARROW Panel*

16. The ARROW Panel agreed the supervisory team's proposal not to issue a Risk Mitigation Programme (RMP). It also recommended lengthening the supervisory period (the period between formal ARROW risk assessments) to 36 months, from the 24 months proposed by the team. 36 months was the upper limit within ARROW I methodology. These decisions were against a backdrop of the FSA's publicly stated objective that 'we should create incentives for firms to do the right thing in return for a regulatory dividend – that is less regulatory intervention'[3] where the FSA judged that their behaviour (including in their regulatory relationship) and the quality of their management, merited it.

17. Following the Panel, the draft ARROW letter to Northern Rock, laying out the FSA's conclusions from the risk assessment, was amended to highlight the issues that would be addressed in its Close and Continuous (C&C) supervision. These included: the viability

[2] ARROW II was gradually rolled out from March 2006, with transition of firms' risk assessments to the new Interim Risk Manager (IRM) system being aligned with supervisors' training in ARROW II. The Northern Rock assessment was transferred in November 2006 to IRM. From then on, IRM became the vehicle for capturing the firm's risk profile.

[3] From 'Better regulation: objective or oxymoron' speech by the FSA's then Chief Executive, at the Securities and Investment Institute Annual Conference, 9 May 2006.

of the firm's strategy in the prevailing market conditions, and the firm's capacity to deliver its strategic objectives whilst ensuring that its credit risk profile remained consistent with its risk appetite; that its access to funding, particularly through securitisation, was maintained; the adequacy of its stress-testing; on-going developments of the firm's risk management framework, particularly with respect to Basel; the operational risks arising from its rapid pace of growth; and the mitigation of the internal and external risks associated with the impending retirement of the Finance Director. We infer that these risks were drawn out as a result of the Panel's input.

18. The Panel's assessment of Northern Rock, in terms of the ARROW risk framework, as 'low-probability' was key to many elements of the subsequent supervision of the firm.

*Period after the ARROW Panel*

19. The decision not to issue an RMP elevated the importance of C&C supervision for Northern Rock. However, the supervisory team set out to us an incomplete understanding of C&C: they did not evidence that they understood that it entailed the regular re-assessment of the firm's business risk profile and control risks as new issues arose.

20. After the ARROW Panel, there was only one 'set' of C&C meetings with the firm in the period under review. These took place on 30 April 2007. We found agendas for five of those meetings, but there was a typed record for only part of one of them, so it was not possible to assess what was discussed.

21. We know that during 2006-07 considerable supervisory effort on Northern Rock was expended on Basel work, including ten visits, but risk indicators arising from that work (for example of management stretch, Northern Rock's reliance on specialists and weaknesses in risk management) do not appear to have been factored into the FSA's on-going supervisory assessment nor strategy for the firm.

22. In addition to the rapid growth of Northern Rock's lending book, a number of other business risks emerged during 2006-07. They did not, either individually or in aggregate, lead the supervisory team to create an RMP, which is a mechanism, shared with the firm, designed to highlight, pursue and track risk issues using a common framework. None of the issues was recorded in Interim Risk Manager (IRM), the FSA's database from which internal management information (MI) is generated and which triggers escalation of concerns, including to the Firms and Markets Committee. No change in the firm's ARROW risk scores was recorded in IRM. And none of the risks identified by the FSA for possible sub-sectoral work was imported into Northern Rock's profile on IRM.

23. These findings, taken together, indicate that the supervisory team did not adequately identify and pursue risks arising in the firm as a whole and in relation to its business model and control framework.

24. Our findings also show a level of engagement and oversight by supervisory line management below the standard we would expect for a high impact firm. This placed undue reliance on the associates.

25. There was also insufficient engagement by the HoDs responsible for Northern Rock. This was due, in part, to a lack of continuity (as noted above, there were three HoDs in the review period, albeit one was responsible, in practice, for only three months). They also had other significant demands on their time during the period, including covering gaps arising due to manager turnover. On average, they met one of their firms every week, although none met Northern Rock in the period reviewed. They were not proactive in ensuring there was a robust process that meant they built up a complete picture of issues, or (in the absence of a requirement) in holding a periodic comprehensive stocktake of each firm in their portfolios.

**Conclusions from the review of the supervision of Northern Rock**

26. From our analysis, we believe that:

- the ARROW Panel would have had a fuller insight into the firm if it had received from the supervisory team, or probed in the meeting for, a more comprehensive analysis of the risks inherent in the business model at the time; but we consider the firm's planned growth should have led to an RMP being agreed;
- it was understandable that the ARROW Panel reached a view that Northern Rock was low-probability risk, based on the material provided to it;
- the Panel process resulted in a number of the key risks – among them the viability of the firm's strategy, including its need to maintain its access to funding, particularly through securitisation – being drawn out for the supervisory team to pursue;
- those risks were not effectively pursued by the supervisory team in line with Northern Rock's increasing business risk profile and control framework;
- the lack of formal risk re-assessment, of recording of issues in IRM and of escalation of the risks which emerged during the supervisory period meant that there was no trigger to re-assess the level of supervisory resource nor to increase FSA management scrutiny;
- the situation was compounded by the level of engagement and oversight by supervisory line management which was lower than expected for a high impact firm; and
- there were neither the challenge mechanisms nor MI at divisional level to trigger a periodic review of the firm.

27. In relation to the requirement on this review set out in paragraph 8 above, we conclude that **we cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firm's risk profile.**

**Other elements of the Terms of Reference**

28. The Terms of Reference also required us to examine a number of main elements in the FSA's approach: its risk framework; its coverage of stress testing, liquidity and firms' governance and management competence; intelligence and information flows within the FSA; and its supervisory resources. The report sets out our findings, conclusions and recommended actions in relation to each. These draw on our work on the sample of high impact firms.

29. We conclude that the ARROW risk framework provides the appropriate underpinning to support effective risk-based supervision. Where we observed framework shortcomings, they were largely in ARROW I. However, we have identified a number of areas in which the framework was not used effectively, or as intended, and – in some cases – was not being used as local senior management thought. So in this area, our recommended actions are largely aimed at securing more effective and rigorous use of the existing framework, and monitoring of that use, rather than creating, say, 'ARROW III'.

30. The FSA's focus on stress testing was developing through the period under review. Considerable emphasis was placed on stress testing as part of the Basel changes, and in particular in the Pillar 2 Internal Capital Adequacy Assessment Process. We recommend more work to challenge firms on the vulnerabilities of their business and strategic plans, in line with the 'Comprehensive Approach' set out in the FSA's 2005 Discussion Paper[4].

31. Our understanding is that, during the review period, the FSA's approach to liquidity reflected a presumption that, in the event of a crisis like that experienced in August 2007, general market liquidity provided by the Bank of England would be increased and, *in extremis*, liquidity would be provided for systemically important institutions. For the retail firms in our sample, the combination of the FSA's liquidity risk identification, including that by the relevant sector teams, and on-going supervision were not sufficiently effective as mitigants for the level of risk. And monitoring of compliance with the qualitative Handbook material introduced in December 2004 was variable within our sample of firms. This was recognised in 2007 with thematic work on liquidity and securitisation which, for Northern Rock, highlighted a number of weaknesses.

32. In relation to supervisors' assessment of firms' governance and management, we found generally good engagement with our sample firms over governance. However, where uncertainties arose about management, they were not always effectively escalated within the FSA or raised with the firm.

33. We recommend actions to address weaknesses in flows of intelligence and information, arising for information available both internally and externally. These weaknesses included inconsistent and at times poor use of publicly available data; inconsistent implementation of the ARROW sub-sector issue mechanism; and absence of arrangements to filter priorities from the FSA's Financial Risk Outlook through to supervisors. Finally, we found no area which considered itself responsible for in-depth peer-firm analysis including the identification of outlying firms. Most of our

[4] DP05/2 'Stress testing' (December 2005).

recommended actions here are to bring about a *structure* to enhance the use of available intelligence and two-way information flow. We recognise, however, that part of the answer is *cultural* and we reflect this in Recommended Action 4.7. We have given particular thought to encouraging a style of supervision which is peer-group focused.

34. Our findings on supervisory resources were mixed, based primarily on those associated with the sample of firms within this review. All those we asked highlighted the complexity of the supervisor's role, given the nature and volume of issues that arise for high impact firms. And many recognised that, partly because of turnover, the FSA is short of expertise in some fundamental areas, notably prudential banking experience and financial data analysis.

35. The FSA has, in recent years, been pursuing a resourcing strategy of 'fewer, better staff'. To that end, divisions with high impact firms have put in place plans to improve quality (for example the introduction of a new manager grade 'E' within the regulatory 'job family') as well as to achieve a consequential reduction in numbers. MRGD's headcount, for example, has reduced by some 20 staff over the past four years, notwithstanding the need to deal with substantial FSA priorities such as Basel and the Treating Customers Fairly initiative, in addition to day to day firm risk assessment and mitigation work.

36. Our concern is that some of the fundamentals of work on assessing risks in firms (notably some of the core elements related to prudential supervision, such as liquidity) have been squeezed out as a result of prioritisation decisions and resourcing capacity issues. As the likelihood of a less benign market environment increased, the need to focus on these elements became all the more critical.

37. We have observed instances where FSA management oversight has been insufficient to identify that some of the key elements of the risk framework were not being used as intended. This oversight should occur at various levels. The supervisory manager should provide the first line of challenge to the team. This was weakened in some of the peer firms as a result of staff turnover.

38. The second line of challenge should come from HoDs. The processes which the HoDs used to check the individual firms in their portfolios relied mainly on 'signals' or alerts being raised by the supervisory manager or the team. If signals did not arise in relation to a particular firm, and we have been told that they did not in Northern Rock's case, there was no effective mechanism to alert HoDs to issues within their firms. Nor were the HoDs proactive in ensuring there was a robust process allowing them a complete picture of issues and in holding a periodic comprehensive stocktake of each firm in their portfolios.

39. A third level of challenge applies at the level of director and above. Here we observed some lack of reliable MI and of formal resource planning to assess and monitor what was happening in practice.

40. More generally, we recommend that more management time should be spent on assessing and engaging with internal supervisory judgements and decisions, as well as on assessing and challenging firms in particular areas. We believe this will be most effective if accompanied by an approach to supervision which has a stronger basis of comparing

firms with their peers, having a fundamental understanding of the business model drivers, and identifying outlying firms or other firms with particular risks and what those risk factors imply.

41. One of the themes emerging from the review has been the apparent ease with which individual members of staff have been able not to comply with established processes (for example recording key meetings, document filing, updating IRM and importing sub-sector issues). Moreover, our rate of progress in carrying out this review was hampered by the poor quality of record-keeping.

**Conclusions from other elements of the Terms of Reference**

42. As specified in the Terms of Reference, we used the sample of peer firms to provide comparison with the supervision of Northern Rock. In so doing we carefully considered the implications and the significance of individual findings. It is clear that some shortcomings have more weight than others. So, for example, we believe the turnover of HoDs was of greater significance than some of the other findings. Some combinations of shortcomings are also more significant than others. Our overall assessment for Northern Rock of whether the prevailing framework for assessing risk was appropriately applied, so that its supervisory strategy was in line with the firm's risk profile, rests not so much on the number of individual findings, but on the effect of the combination of those shortcomings. Particularly significant in our view was the combined effect of: the maximum supervisory period (36 months); the failure to update IRM; the absence of an RMP; the turnover in HoDs and their insufficient engagement with the firm; and the long intervals between Close and Continuous meetings.

43. Some of the findings from the supervision of Northern Rock were mirrored in our review of the sample firms. However, the supervision of Northern Rock revealed the most significant combination of shortcomings. **Our overall conclusion is that the supervision of Northern Rock was at the extreme end of the spectrum of the supervisory practices we observed.**

44. Most of the key shortcomings do not lend themselves to quantitative comparison. However, where meaningful data are available, we have looked at a wider sample of high impact firms over the review period in order to assess whether they support our conclusion that the supervision of Northern Rock was at the extreme end of the spectrum of the supervisory practices we observed. These data are set out in the table below, which was provided to us by the Retail Management Services Unit, and covers the high impact firms in MRGD and in Wholesale Investment Banks Department.

*Northern Rock is in the highlighted box in each population*

**Supervisory Period** - data taken from IRM

| Firms with regulatory periods of: | | |
|---|---|---|
| 18-24 months | 24 | 63% |
| 25-30 | 10 | 26% |
| 36 months | 4 | 11% |

(As at 1 August 2007, high impact firms only: MRGD-26 and WIBD-12)

**Turnover of HoDs experienced by MRGD firms**

| Number of HoDs (1 Jan 05 – 9 Aug 07) | 1 HoD | 2 HoDs | 3 HoDs |
|---|---|---|---|
| Number of high impact firms | 18 | 6 | 2 |
| | 69% | 23% | 8% |

**C&C meetings** - estimates made by staff based on various sources for high impact firms

| | 1 Jan - 9 Aug 2007 | 2006 | 2005 | Period Total |
|---|---|---|---|---|
| Average for WIBD firms | 13 | 24 | 18 | 55 |
| Average for MRGD firms | 22 | 29 | 23 | 74 |
| Average for MRGD excl 5 largest banks | 17 | 22 | 19 | 58 |
| Average for 5 largest retail banks | 43 | 59 | 41 | 143 |
| Northern Rock | 7* | 1 | 0 | 8 |

* Out of which five meetings were held on one day and two were by telephone

**Risk mitigation programmes (RMP)** - data taken from IRM

| | |
|---|---|
| Number of firms with RMP | 37 |
| Number of firms without RMP | 1 |

45. The table indicates that, in the number of C&C meetings, Northern Rock was an outlier. On HoD continuity, there was only one other firm which was supervised by three HoDs. Regarding the length of supervisory periods, only four firms fell into the 36 months category. And Northern Rock was the only firm without an RMP. Taking these indicators together, this wider comparison supports our conclusion that the supervision of Northern Rock was at the extreme end of the spectrum.

## Recommendations from this review

46. The report makes seven high level recommendations, with associated recommended actions, arising from our findings in relation to all the elements of the Terms of Reference. They go further than addressing the principal weaknesses found in the supervision of Northern Rock and reflect examples of good practice we found. They are designed to enhance the FSA's supervision of high impact firms generally. The high level recommendations are:

- FSA senior management to have increased engagement with high impact firms;
- FSA to increase the rigour of its day to day supervision;

- FSA to increase its focus on prudential supervision, including liquidity and stress testing;
- FSA to improve its use of information and intelligence in its supervision;
- FSA to improve the quality and resourcing of its financial and sectoral analysis;
- FSA to strengthen supervisory resources; and
- FSA senior management to increase the level of oversight of firms' supervision.

47. In framing the recommendations, we have taken certain aspects of the FSA's existing structure as given. These include the split between predominantly wholesale and retail firms. So, while there may be some good reasons for supervising, for example, the high impact overseas investment banks alongside those that are part of major UK groups, our recommended actions seek rather to engender more peer group emphasis than structural re-organisation.

48. In the paragraphs that follow, we highlight the recommended actions that we consider to be the most important:

- For high impact firms, there should be an on-going supervisory assessment of all appropriate core ARROW risk areas, including capital. Capital and liquidity should have specific focus for high impact deposit-takers and investment firms and should not, in future, be de-prioritised below a certain level (Recommended Action 3.1). To monitor this:

- HoDs responsible for supervising high impact firms should formally review the supervision of each firm every six months. This review should act as a 'checkpoint' about the FSA's view of the firm, and take stock of the changes since the last formal ARROW risk assessment and last HoD review. It should cover both progress against the C&C schedule and MI relating to RMP actions. If the firm does not have an RMP, this review should assess whether that remains appropriate. It should be used as an opportunity to review the quality of MI received from the firm and to assess its continuing appropriateness, in particular as a complement to the standard regulatory returns. And the review should also be used as a means of assessing manager performance and engagement. As a result, formal ARROW risk assessments should become more of a stocktake, given more frequent challenge and escalation of issues as part of on-going supervision (Recommended Action 7.1).

- For high impact firms, ARROW Panels must consider all relevant core risk areas. For high impact deposit-takers and investment firms, the Panel should particularly probe on capital and liquidity. Panel packs for high impact firms should include more substantive, in-depth comparative financial analysis, the parameters of which would change with market conditions. This analysis should always cover the business model of the firm in question and its peers (Recommended Action 5.1).

- Supervisors should perform an annual review of the business/strategic plans for each high impact firm. This should take into account the stress testing carried out by the firm, the assumed management actions, and the firm's view of the likeliest scenarios that could threaten its viability. Supervisors should assess the robustness of the firm's plans to maintain adequate financial (capital and liquidity) and other resources. This review should encompass a discussion with the firm, chaired at HoD level or above. Issues arising should feed into the supervisory programme (Recommended Action 1.2).

- A strategy should be developed to ensure that the priority risks identified in the Financial Risk Outlook (FRO) are effectively 'operationalised', through firm and thematic work that addresses the risks, and through strategic consideration of the balance and allocation of resources across the organisation when the FSA changes its view of which risks are highest priority (Recommended Action 4.1).

- There should be a clear assignment of the responsibility for peer analysis of firms and for identifying those that are outliers in an aspect of their business or business model. We recommend recruiting additional staff for the development of sub-sector resource, who would be located in the most relevant supervisory department. This resource should have responsibility for identifying outlier firms in its sub-sector. Adoption of the sub-sector resource model could also be used to address a number of other intelligence issues identified in this review (Recommended Action 5.2).

49. To support the above:

- As a key tool, we recommend that Interim Risk Manager (IRM) should be updated to reflect issues as they emerge. Principles for updating IRM should be established that are consistent across all supervisory divisions – both in terms of the type of information included and the frequency of update (Recommended Action 2.4).

50. We have taken account of the on-going work to develop liquidity policy, including the Discussion Paper published in December 2007[5]. We have a number of recommendations designed to assist this work. Underlying these:

- The FSA should as a priority develop clear timetables for the implementation of changes to the qualitative and quantitative Handbook material on liquidity. Changes to the qualitative material are likely to build on existing material, and so should permit early implementation (Recommended Action 3.5).

[5] DP07/7 'Review of the liquidity requirements for banks and building societies' (December 2007).

51. We make findings on both the quality and quantity of supervisory resources, of which key are:

   - A bottom-up approach was used for the FSA's annual plan for 2008/09. This should be developed for future years and a 'zero-based budget' constructed for areas dealing with high impact firms. This should allow senior management to monitor the balance of resource planned against key supervisory activities/priorities for each firm, with subsequent regular MI to check the position (Recommended Action 6.1).

   - The current training arrangements should be significantly enhanced to ensure that staff receive training appropriate for their roles, and that the roles they are assigned match their skills and experience and the training they have received and assimilated. Resource planning in the divisions should take account of this (Recommended Action 6.6).

52. However, resourcing is an area that needs further work. We recommend that a bottom-up assessment is made of both the skills-sets and the number of staff needed to implement the recommendations of this review in addition to the current business-as-usual work and other agreed priorities.

**Overall conclusions and implications of the recommendations**

53. We are aware that implementing the recommendations of this review will require additional resourcing and the executive team will have to decide on relative priorities in the light of FSA's total budget.

54. Much of this report's package of recommendations implies more systematic implementation of frameworks that are already in place, e.g. ARROW II or stress testing, and more formal methods to enable Managing Directors, Directors and HoDs to inform themselves of progress being made in their areas. Whilst we fully support FSA's risk-based approach, that is not inconsistent with having minimum acceptable standards for high impact firms. We believe that the package, when implemented, will support the FSA's move to More Principles Based Regulation.

**Next steps**

55. We consider that the responsibility for implementing the recommendations in this report lies with the Chief Executive. A project will need to be established with a detailed implementation plan and timetable.

# B1 Responsibility for the supervision of Northern Rock

## 1.1 Introduction

1. In this chapter we cover where the supervision of Northern Rock was located (Section 1.2). We describe the background and experience of those most closely associated with its supervision (Section 1.3) before introducing other resources that made a contribution (Section 1.4). We then review the amount of resource dedicated to the supervision of Northern Rock (Section 1.5) before drawing conclusions (Section 1.6).

## 1.2 Supervisory division

*Major Retail Groups Division (MRGD)*

2. In April 2004, the FSA effected a major re-organisation. The principal outcome was to create different Business Units for the supervision of wholesale and retail firms. As part of this exercise, responsibility for the supervision of Northern Rock was transferred from the former Deposit Takers Division (DTD) into MRGD.

3. Northern Rock was initially located in MRGD Department 1 (MRGD1), which was primarily responsible for supervising insurance groups. Some of those insurance groups had banking subsidiaries, for example Prudential and Egg. The FSA had, by then, introduced 'group supervision' whereby all authorised companies within a group were supervised together. We were told that responsibility for Northern Rock (and Bank of Ireland) was moved into MRGD1 as it was considered important that the banking subsidiaries of insurance groups were supervised in a department alongside some other banks, and to bring about an even distribution of firms between departments.

4. We believe that supervising a major UK retail bank within a predominantly insurance department had implications for the effectiveness of its supervision. The supervisory team suggested to us that this arose from the lack of regular dialogue within the department on business and market issues in the banking sector. It also made it more difficult (outside the formal channels for cross-divisional communications) for the banking sector supervisors to pick up and be alert to emerging issues affecting their firms. **Lesson 1**

*Firm distribution within MRGD*

5. Within MRGD, senior management carried out periodic reviews of the distribution of firms across its three departments. These resulted in responsibility for Northern Rock being transferred within the division on two further occasions, in June 2006 and in February 2007. A summary of the changes is shown below and is illustrated in Appendix 3, which shows MRGD's organisational structure at different points during the period covered by our review.

| Date | Department |
|---|---|
| Prior to April 2004 | Deposit Takers Division (DTD) |
| April 2004 - June 2006 | MRGD Department 1 (MRGD 1) |
| June 2006 - February 2007 | MRGD Department 2 (MRGD 2) |
| February 2007 - present | MRGD Department 3 (MRGD 3) |

6. We were told that the rationale for moving Northern Rock to MRGD2 was to locate the firm in the same department as groups such as However, we note that, as the supervisory manager had responsibility only for AXA (in addition to Northern Rock), the team itself did not benefit from direct oversight of other banks.

7. The redistribution of firms in 2007 saw responsibility for Northern Rock move to MRGD3, which supervised banking groups and building societies.

### 1.3 The Relationship Management team

*Head of Department (HoD)*

8. The moves between departments meant Northern Rock was the responsibility of three different HoDs during the period of the review. Shortly after Northern Rock's move to MRGD3 in February 2007 came of the third HoD, who therefore had responsibility for Northern Rock in practice for only three months. There were two periods, of around one month in 2006 and three months (May to August) in 2007, when there was no HoD in post.

9. The three MRGD HoDs who had responsibility for Northern Rock during the period of this review had different backgrounds.

*HoD engagement with Northern Rock*

10. None of the HoDs responsible for Northern Rock met the firm in the period reviewed. We were told that plans for two of the HoDs to do so were put on hold. In one instance, this followed the announcement of the firm moving departments within MRGD and, in the other, it followed

11. We are aware that this was against a background of significant activity by many of the other MRGD firms for which the HoDs were responsible. This included issues with the Santander takeover of Abbey, the Standard Life demutualisation, issues with and the bids for ABN Amro by Barclays and RBS. In addition, there were demands of

ARROW Panels, Basel and insurance ICA-related meetings and internal management issues such as the 'Reg E' exercise (see paragraph 16).

12. We conclude that the relatively short tenure that two of the HoDs had with Northern Rock made it difficult for them to build up a detailed understanding of the firm's strategy or the risks and issues it faced. **Lesson 2** We believe that this also impaired their ability to provide on-going and effective engagement with the supervisory manager and team. **Lesson 3**

*Manager*

13.

14.

15.

*Changes at manager level*

16. The FSA had, for some time, recognised that it needed to increase the skills of staff generally. In 2006, one aspect of this was to create a new grade of manager in the Regulatory Job Family, known as 'Reg E'. Incumbent managers were assessed for the Reg E positions. At the same time, a number of criteria were used to assess which firms would be supervised by a team headed by a Reg E manager.

17. It was determined by FSA senior management that Northern Rock would not need to form part of an 'E' portfolio[1]. Following the assessment of managers within MRGD in early 2007,

[1] Northern Rock scored on only 1 of the 5 criteria (that FSA was consolidated supervisor) used to determine which groups would form part of an 'E' portfolio. It did not score on the criterion as a 'significant retail operator', even though at end-2006 it had around £85bn of retail assets, over £22bn of retail liabilities and publicly stated ambitious growth plans.

*Manager engagement with Northern Rock*

18. We have examined the engagement of the manager with Northern Rock. Our review showed that:

•

•

•

•

•

19.

20. We have heard from other interviewees that the training support framework was weak

*Lead associate*

21.

22. The person also had responsibilities for other firms (see table at Section B1.5), as many as four at one time during the period. We also observed that the level of support to the lead associate varied considerably (see Section B1.4).

23.

24.

25.

We explore at Chapter D6: Supervisory resources the optimum time that an individual should retain the relationship with a firm. **Lesson 6**

## 1.4 Other resources

*Supervisory associates within MRGD*

26. During the early part of our review period when Northern Rock was located in MRGD1 (i.e. January 2005 to June 2006), additional resource was available to support the lead associate. This was from a mix of experienced specialist hires (but without supervisory backgrounds) who were new to FSA and some less experienced staff. In summary, the additional resource included:

- an associate with commercial banking skills, who led the ARROW visit to Northern Rock's commercial finance business;

- an associate with conduct of business experience, who led on those aspects of Northern Rock's business related to the mortgage operation; and

- a graduate who joined the team for the final rotation of the graduate development programme.

27. This resource did not follow Northern Rock to MRGD2 in June 2006. However, an additional associate did join the supervisory team in October 2006 in order to provide support on Basel work, initially on Northern Rock and subsequently to other firms as well. This individual remained on the team until September 2007.

28. We conclude (and received feedback) that the high turnover of supporting associates hindered the development of a substantive relationship between them and the firm. With the exception of areas where specialist skills were required, such as the use of the experienced hire to assess the commercial loan book, we question whether most of the supporting associates had sufficient engagement with Northern Rock to build up good, all-round knowledge of the firm. We were told 'not all the people in the supervisory team were involved in Close and Continuous meetings' (see Chapter B4: Close and Continuous supervision).

*Specialists*

29. We observed extensive use of specialists to support Basel-related work, both for review of the Pillar 1 waiver application and to support the Pillar 2 Internal Capital Adequacy Assessment Process. These involved around ten visits to Northern Rock's offices and a similar number of meetings at the FSA.

30. There was also good use of specialists for prudential visits. Risk Review Department (RRD) specialists participated in the on-site ARROW discovery work by leading a visit to Northern Rock's Treasury Department in February 2006. The Risk Mitigation & Securitisation team from Prudential Standards Department also led a visit to review Northern Rock's securitisation operation in May 2007. Associates from the supervisory team attended both of these visits.

31. Local expertise from within MRGD was utilised for a liquidity visit in April 2007, which was supported by a representative from RRD, and for an on-site assessment in June 2007 of Northern Rock's proposal to establish a trading book.

32. Northern Rock was also included in a number of conduct of business thematic workstreams, including work on Payment Protection Insurance (July 2005), Buy-to-Let (2006) and Lifetime Mortgages (May 2006). Resource for these was drawn from Retail Themes Department.

*Banking Sector and other staff*

33. We saw little evidence of any input to day to day firm supervision by either the Banking Sector team or the Retail Management Services Unit's (MSU) Risk team. There was greater dialogue with the deputy local banking sector lead in MRGD, who attended results presentations and collated certain data for supervisors in the division. However,

as we explore at Chapter D5: Intelligence and information flows, this could have added more value by being more in depth and focusing on wider areas.

## 1.5 Amount of resource devoted to Northern Rock

34. In identifying the level of resource devoted to Northern Rock, we note for information in the table below the other firms within the portfolios for which the manager and lead associate were responsible:

| | Manager | Lead Associate |
|---|---|---|
| MRGD1<br>(April 2004 - June 2006) | Bank of Ireland<br>BUPA<br>Friends Provident | Bank of Ireland<br>Egg<br>Dunbar Bank<br>GE Capital Bank |
| MRGD2<br>(June 2006 - February 2007) | AXA | - |
| MRGD3<br>(February 2007 - present) | Bank of Ireland<br>Bradford & Bingley | Bank of Ireland |

35. The table shows that the demands of other firms on the time of the lead associate were greatest in the period to June 2006. However, this was compensated by assistance from other associates, who supported on the ARROW assessment and with other work on Northern Rock (see Section B1.4).

36. In theory, the lead associate should have been able to devote a greater proportion of time to Northern Rock after June 2006 when, for some months, it became the only firm within the portfolio, and increasingly so when support from the other associate, recruited to assist with Basel work, arrived in October 2006. However, as indicated at Section B1.3, Basel work still had a major impact on the lead associate's time.

## 1.6 Conclusion

37. In conclusion, we believe that the initial location of Northern Rock within a predominantly insurance focused department was not helpful as the supervisory team did not have the benefit of seeing issues emerging at peer firms. We recognise that this was acknowledged by the subsequent restructuring of MRGD. However, the frequent changes led to a lack of knowledge of Northern Rock by the senior management team. This was exacerbated by the absence of any formal checkpoint, following the ARROW Panel in February 2006, at which the HoDs or director reviewed the supervisory strategy and assessment of Northern Rock to confirm that it remained appropriate and that issues were being dealt with in the right way[3].

38.

We consider that senior management should have been

[3] Although the supervisory team conducted a set of meetings at end-April 2007, there was no indication of any formal involvement by the HoD in this process.

actively managing these issues through more formal firm-specific reviews of the supervision of Northern Rock.

39. Where the lead associate was assisted by other associates on the team, the tenure was such that the individuals did not appear to have the opportunity to establish sufficient relationship with Northern Rock to build up the required knowledge to add full value to the team.

40. Overall, we conclude that the level of resource allocated to Northern Rock was not always sufficient to perform the minimum amount of work required. We note that additional resource was provided in October 2006 to meet the demands of Basel work but observe the Basel work also had a considerable impact on the role of the lead associate. It is, in particular, during the period when the Basel waiver was being assessed that we consider resource to have been most stretched.

41. We believe that, as issues emerged and the risk profile of Northern Rock increased (see Chapters B5: Emerging business risks and B6: Emerging control risks), the amount of resource was a factor in the degree to which issues were probed with rigour. that there was little pushback from teams generally on the level of resources. We infer that senior management believed that the resources allocated to Northern Rock were in line with the firm's risk profile. However, more pro-activity on (see Chapter D6: Supervisory resources and Chapter D7: FSA senior management).

42. However, our finding that some of the fundamentals of work on assessing risks were squeezed out (see Chapter D1: Risk framework) leads us to a view that resource was not increased to the level required for a high impact firm pursuing an aggressive strategy.

# B2 ARROW assessment

## 2.1 Introduction

1. In this chapter, we describe the events related to the formal ARROW process for Northern Rock. It starts with the on-site discovery work (Section 2.2) followed by the communications with Northern Rock ahead of the Panel discussion (Section 2.3). It then covers the outcomes from one specific ARROW visit, held with the treasury area just prior to the Panel date (Section 2.4).

2. In Section 2.5, we cover aspects of the Panel itself (composition and papers presented) before commenting (in Section 2.6) on what other material might have been helpful. In Section 2.7 we cover the Panel discussion and in Section 2.8 the Panel's decision. Our conclusions are contained in Section 2.9.

## 2.2 Discovery work for the ARROW risk assessment

3. At the start of our review period, Northern Rock was subject to a Risk Mitigation Programme arising from an ARROW assessment conducted in December 2003. The supervisory period (time between formal risk assessments) was set at two years, with an interim review (including an on-site visit) conducted in December 2004.

*Timetable*

4. The next ARROW assessment was scheduled for end-2005. This assessment was conducted under the ARROW I regime[1]. The timeline for the assessment was as follows:

| | |
|---|---|
| Visits: | October to December 2005 and 7-8 February 2006 |
| Panel: | 20 February 2006 |
| Letter issued: | 13 March 2006 |
| Presentation to board: | 28 March 2006 |

5. In addition to interviewing a range of personnel in the firm's Head Office in Newcastle, visits were made to the following business units and functions in Newcastle, Leeds and St Albans:

| | |
|---|---|
| 31 October 2005 | Commercial Finance |
| 1-2 November 2005 | Unsecured Lending |
| 21 November 2005 | Commercial Lending |
| 7-8 February 2006 | Treasury |

6. We conclude that the supervisory team saw an appropriate range of personnel to reach an informed view of the firm.

[1] A key difference between the ARROW I and ARROW II regime (which was introduced in 2006) is that, under the latter, a Planning Validation meeting exists to provide challenge and approve the structure of the risk assessment and the scope of the discovery plan before starting the visit(s).

7. We saw agendas for some but not all ARROW discovery meetings. We noted that a number of meetings were not written up and therefore no record existed in either the FSA's Northern Rock paper or electronic records. These included meetings with Northern Rock's Chief Executive, Deputy Chief Executive, Head of Internal Audit and the external auditors (PwC). We were told these meetings were led by the and that they were to have been written up by the We regard the absence of formal records (even if only in bullet point form) as contrary to standard practice. **Lesson 7**

*Supervisory team's findings from the ARROW discovery work*

8. Following the bulk of its on-site work, the supervisory team set out its findings in a memo dated 12 January 2006 to the then Director of MRGD, the HoD for MRGD1 and to an independent HoD, who was to be the ARROW Panel Chair.

9. The findings highlighted by the supervisory team in the memo were:

   a) the strength of the Northern Rock management team and its positive attitude to regulation.

   b) The supervisory team felt this could be monitored under a 'very light touch' Risk Mitigation Programme (RMP), using data submitted through returns, management information (MI) and published results;

   c) The supervisory team anticipated remaining close to this aspect of the business through reactive supervision 'as and when new issues are presented to us for non-objection';

   d) that the Treasury function had not been reviewed in detail for four years but would be assessed through a visit (as part of the ARROW assessment) in early-February 2006; and

   e) that Northern Rock had submitted a Basel waiver application that would demand a considerable amount of resource and would keep the supervisory team close to the firm through visits and meetings on Basel issues.

10. The supervisory team proposed maintaining a two year supervisory period.

*Other considerations ahead of ARROW Panel*

11. We have seen an e-mail from the independent HoD, which offered comments on the supervisory team's findings from a banking sector point of view. This noted that 'Northern Rock was known as and very fast

12. The supervisory team confirmed, as part of this e-mail correspondence, that resource was not a factor in the reduced level of engagement it recommended.

13. Following the involvement of the it was agreed to recommend to the Panel that there did not need to be an RMP and that the supervisory period should be two years. **Lesson 8**

14. We were told that this would be the only time an RMP had not been drawn up for a high impact firm in MRGD, although we understand an RMP has, on occasions, not been applied to some material business units within other groups. We are not aware of any pressure on the supervisory team to propose not having an RMP. We observe that the recommendation was against a backdrop of the FSA's publicly stated objective that 'we should create incentives for firms to do the right thing in return for a regulatory dividend'. **Lesson 9**

### 2.3 Early communication to Northern Rock

15. The plan to recommend to the ARROW Panel that there should not be an RMP was communicated to Northern Rock ahead of the Panel in an e-mail to the Company Secretary on 19 January 2006. The e-mail explained that 'the objective is to move, by making progress through our risk assessment, mitigation and relationship work, to a situation where we can step back from proactive risk mitigation work and place reliance on the firm to identify and manage risk in the business and to continue to meet regulatory requirements without significant regulatory intervention'. The supervisory team explained that this was the position the FSA considered it had reached with Northern Rock.

16. We were told the reason for communicating the proposed outcome to Northern Rock in advance of the ARROW Panel was to assess their buy-in to the approach given that it would entail heavy reliance on the firm to be open with the FSA. We accept this but conclude this was an unnecessary risk bearing in mind:

    - the significance of the message;
    - the recommendation remained subject to the outcome of the Treasury visit, which it had not been possible to schedule until early-February; and
    - the recommendation was subject to agreement by the Panel.

17. Indeed, RRD specialists told us that, during the February visit to the Treasury operation,

**Lesson 10**

## 2.4 ARROW Treasury visit

18. The Treasury visit on 7-8 February 2006 was led by specialists from RRD accompanied by an associate from the Northern Rock supervisory team It identified seven areas where action was required. RRD met the supervisory team on 16 February to discuss the findings of the visit ahead of the ARROW Panel. The RRD report was finalised on 10 March 2006.

19. The findings of the visit were communicated to Northern Rock by letter on 21 March. These included the need to address issues in Treasury Risk Management and the senior management's understanding of Structured Investment Vehicles, where RRD questioned whether the Assets and Liabilities Committee (ALCO) or the Northern Rock Board fully understood the risks embedded in these vehicles. We noted the supervisory team did not propose that the issues raised from the visit should be taken forward as part of an RMP and therefore maintained the view that no RMP was required.

20. We have been told by the that the involvement of in the recommendation not to have an RMP and the discussions that had already taken place with the firm on this approach were not a factor in determining the supervisory team's response to the Treasury visit's findings.

## 2.5 The ARROW Panel

21. The supervisory team's recommendations were presented to Panel on 20 February 2006.

22. The purpose of a Panel is to 'help ensure that the risk framework is applied consistently to provide a challenge process to the conclusions of individual supervisors.'[2] Its objectives include 'review and challenge of: the scope of assessment, the individual and overall probability scores and assessment in order to ensure that it is adequate and appears to capture all relevant risks; the length of the supervisory period and the risk mitigation programme in order to ensure that it is adequate in the light of the risks identified'.

*Composition*

23. We regard this as unusual and received feedback to this effect from . ARROW I guidance stated 'The manager is responsible for the accuracy of the probability assessment, the appropriateness of the risk mitigation programme and its effective implementation after agreement at the Panel'.

24. We also noted that the circulation list for the papers suggested a different Panel composition to the minutes. In pursuing this discrepancy, we discovered two different versions of the panel minutes in the electronic filing structure, one of which was labelled

[2] ARROW I: Guidance for Firm Specific Risk Assessment and Risk Mitigation, version 8 (2003).

'draft' in the title, and both of which had the 'DRAFT' watermark on the documents. These showed different panel members. We were unable to locate the final minutes in the electronic filing system or in the paper files reviewed. After questioning those listed as attendees in the draft minutes, we eventually located an e-mail containing the final minutes. This was stored in the Outlook folder of a former member of the Northern Rock supervisory team, rather than in the corporate filing system. This third version of the minutes was identified as 'final' in the covering e-mail, but still displayed the 'DRAFT' watermark. Failure to save the final minutes to the electronic directory was contrary to Records Management Guidelines. **Lesson 12**

25. From these minutes we saw that the Panel met the required standards of composition for a high impact firm: it was chaired by an independent HoD and included two independent representatives (an independent manager and a grey panther) plus a representative from the Risk Management Unit (RMU). Neither the presenting team nor the Panel included specialists.

26. An e-mail had been sent to all MRGD managers ten days before the Panel asking for a volunteer to attend as an independent manager. Although it did not happen in this case, this 'blanket' approach could easily have resulted in a manager without the appropriate experience sitting on the Panel. We observe later in the report (see Chapter D1: Risk framework) that in order to derive maximum value from the process, the ARROW Panel composition should be planned to ensure the Panel has the most appropriate skill-set. **Lesson 13**

*Papers provided to the ARROW Panel*

27. The supervisory team recommended that there should be no RMP. It recognised that this would 'place the onus on the firm to identify and mitigate risk within the business and to inform FSA of any material changes to its risk profile or of any crystallised risk'. It believed the 'risks of moving to this approach with Northern Rock at this time are materially mitigated by the degree of reactive work we anticipate through the year, particularly with respect to Basel'. The recommended supervisory period was two years.

28. The papers presented to the ARROW Panel included, within the Background Note, the supervisory team's overview of the firm's strategy and business, its principal activities, capital strength, liquidity ratio and nature of funding as well as a summary of management and the control environment. The papers were in line with the documentation requirements of ARROW I[3].

## 2.6 Other information that would have assisted the Panel

29. We identified three areas that we consider should have been explored further (and where we consider it would have been proportionate for a high impact firm).

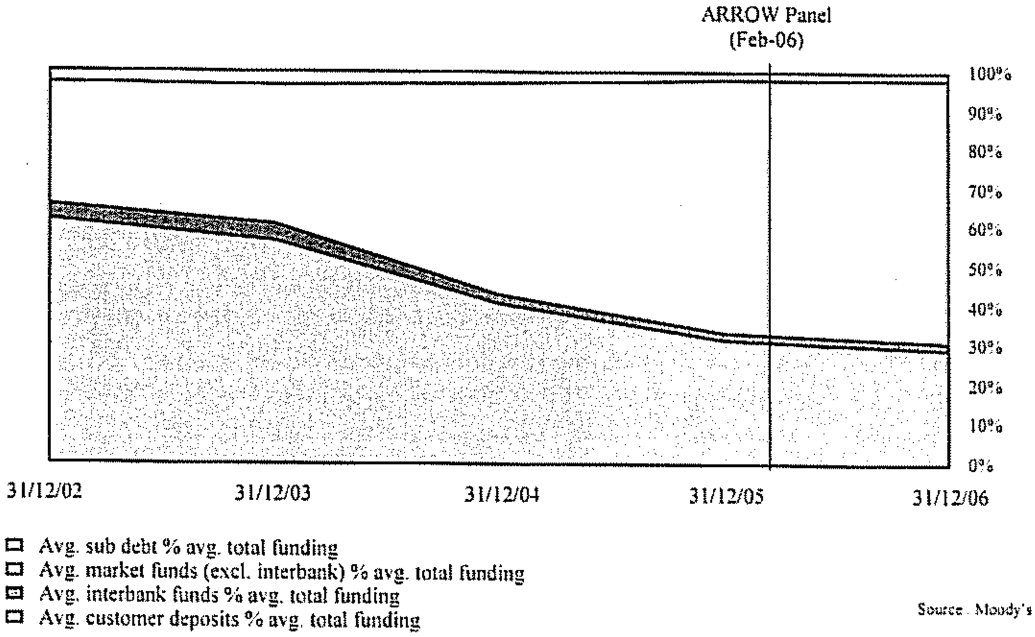
[3] The only area where we identified the documentation did not meet the standards required of ARROW I was the absence of a group organisation chart. However, Northern Rock's operation was straightforward and reference was made in the papers to the operations in Dublin and Guernsey.

(i) Detail of Northern Rock's business model. It was reported in the papers to the Panel that Northern Rock had a high public target for asset growth (15-25% year-on-year) and for profit growth, and 18-21% target growth in its return on equity. The firm had balance sheet assets of £83bn at end-2005. No commentary was provided by the supervisory team on whether it was anticipated this growth could be financed in line with the existing mix of funding or, if not, how this might cause the mix of liabilities to change.

(ii) Financial analysis. This could have been used to demonstrate the implications of the significant growth and the challenges this presented. This had already caused the firm's risk profile to change and might have indicated an even greater reliance on wholesale funding going forward. For example, greater reliance on wholesale funding would impact on pricing; and the need to have enhanced hedging due to exposure to interest-rate risk if Northern Rock relied more on market-priced liabilities and to a lesser extent on products where it set the rate.

The following chart shows how Northern Rock's funding profile had changed in the period since 2002.

**Northern Rock**




(iii) Peer group comparison. The only peer comparison provided was from the Retail MSU Risk team setting out comparative ARROW probability scores for

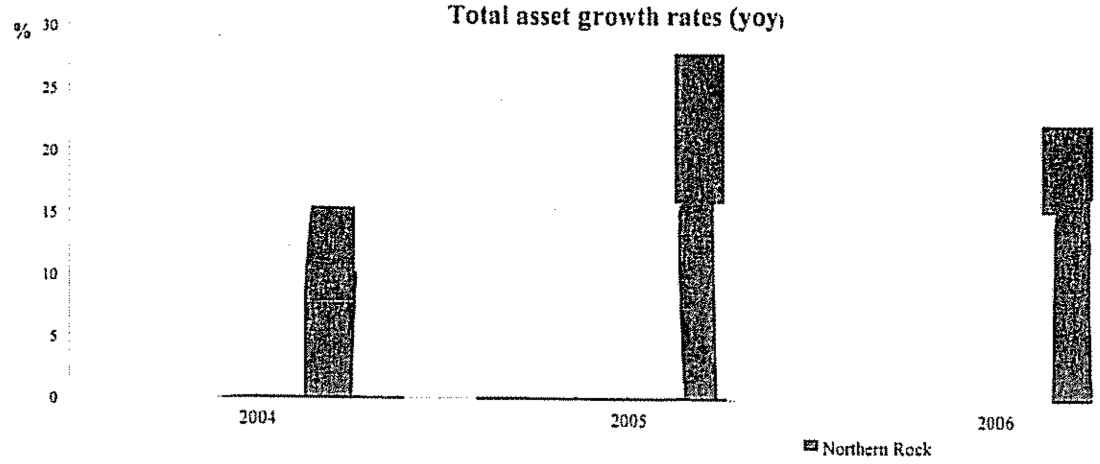
Analysis

of publicly available data shows that, relative to a peer group of

Northern Rock would

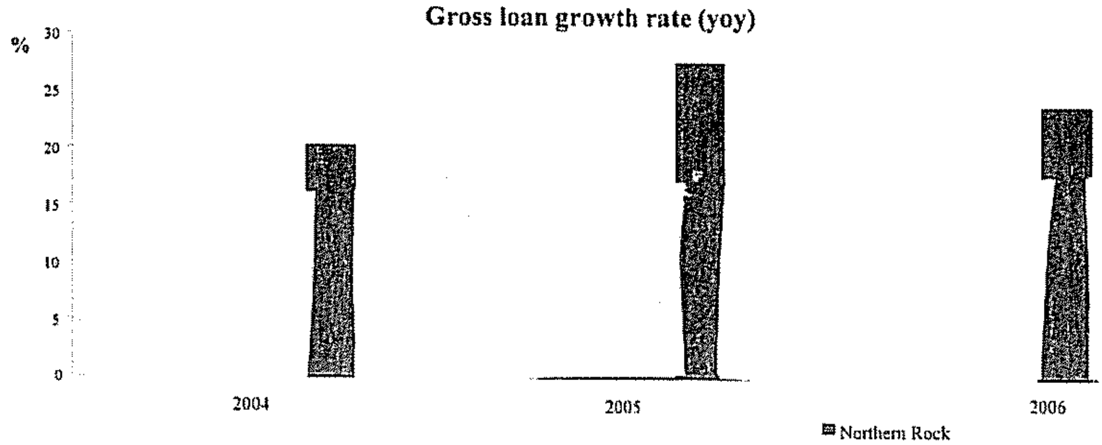
have...

… recorded the highest year-on-year (yoy) growth in total assets:



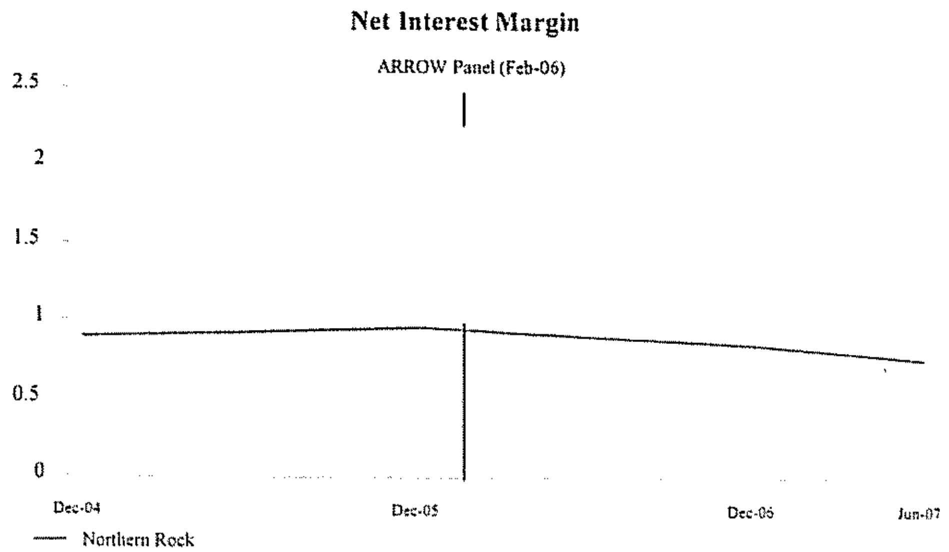

Source: Bankscope. Growth for 2004 calculated on UK GAAP basis; growth for 2005 and 2006 on IFRS basis

… had the highest year-on-year growth in gross lending:



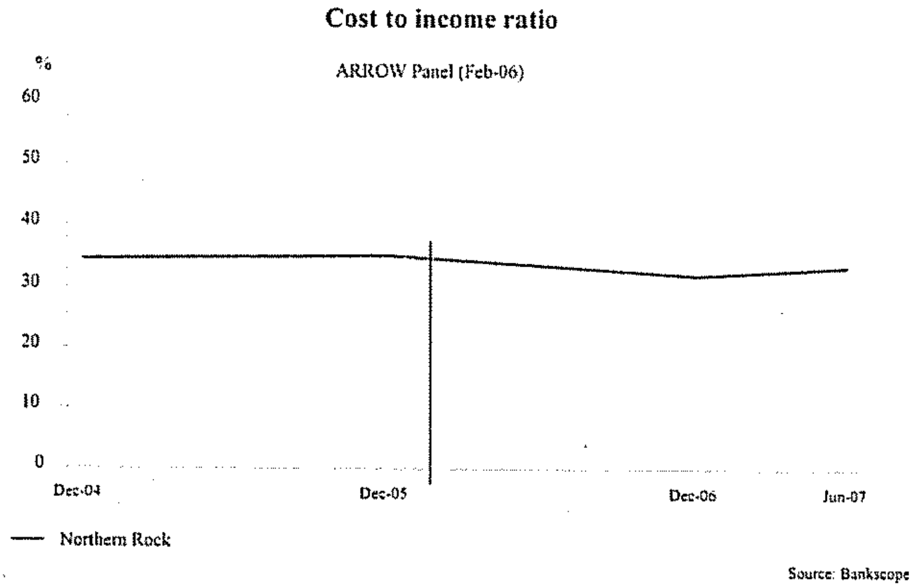

Source: Bankscope. Growth for 2004 calculated on UK GAAP basis; growth for 2005 and 2006 on IFRS basis.

… had the lowest net interest margin:




Source: Bankscope

… and had the lowest cost:income ratio (this was well known in the market and the ratio was noted in the Panel papers, but not its relativity to peers):




30. Had the ARROW panel been provided with this type of peer data, we consider it would have been much better equipped to assess Northern Rock, its business model and the sustainability of its strategy. However, we noted this was not required under the standards of ARROW I nor is it required for ARROW II. We therefore support recent initiatives by the Retail MSU Risk team and grey panthers to enhance Panel papers through greater use of financial analysis and to highlight outliers through peer group analysis. **Lesson 14**

## 2.7 Panel discussion

31. The minutes show that the Panel's discussion covered a number of issues:

- the market speculation of a bid for Northern Rock, which had caused a rise in the value of its shares the previous week;
- the impact of a downgrade of Northern Rock's credit rating;
- the quality of Northern Rock's management information;
- 
- why interest-only mortgages were not flagged under Treating Customers Fairly in the papers presented to the Panel;
- the firm's business continuity plan arrangements given its concentration in the Newcastle area; and
- stress testing.

There is no evidence from the Panel papers or minutes that the findings of the RRD visit to Treasury were reported to, or discussed by, the Panel.

32. The Panel also asked if the team would provide Northern Rock with a list of the issues it intended to cover under Close and Continuous supervision (C&C). We noted that an outline of the content of the proposed C&C programme was not included in the ARROW panel pack. This was in contrast to other firms in the sample for our review, where a schedule and frequency of meetings with senior business management and key control function holders was put forward (either in the draft RMP or as part of the draft letter to the firm's board) and discussed by the Panel.

33. The minutes also showed that the Panel asked a general question as to whether the supervisory team would test the firm's controls as part of the C&C relationship. The minutes record that the team 'was not convinced that testing would provide any further evidence in addition to what is already known'. This was explained to us by the team as reflecting the fact that they were comfortable that the programme they envisaged gave opportunity for on-going assessment, and that there were no additional areas of major focus. **Lesson 15**

*Impact of the Financial Risk Outlook (FRO) on the Panel's discussion*

34. The FRO was published on 25 January 2006, shortly before the ARROW Panel. A major theme of the FRO was stress testing for extreme but plausible risks, partly based on the risk of disruptive 'events'. The other relevant priority risk for a firm such as Northern Rock was increasing consumer bad debt and how this might lead to increased arrears.

35. Based on a review of the minutes, we noted that the relevant themes of the 2006 FRO were discussed during the Panel. Mortgage arrears appear to have been discussed in some detail. There is also a reference to stress testing, albeit only to note that

### 2.8 Panel decision

36. The ARROW Panel upheld the recommendation not to employ a RMP. It considered the team's recommendation for a two-year supervisory period but decided this should be extended to three years. The minutes did not record the rationale for this. We understand the decision was based on a comparison with other high impact firms. (We note guidance was subsequently issued in November 2007 by Strategy & Risk Division (ARROW Bulletin Vol.6) indicating that it would 'generally expect the supervisory periods for high impact firms to be between 12 and 24 months'.) **Lesson 16**

37. The Panel recommended that the letter to the firm be amended 'to highlight the issues the team wished to address under C&C supervision'. The letter was subsequently amended to highlight the issues on which it was 'anticipated' that C&C monitoring work would focus. These are described in further detail in Chapter B3: Taking forward issues from the ARROW letter.

*Communication of the outcome to Northern Rock*

38. The letter confirming the outcome was issued to the board of Northern Rock on 13 March 2006. This described the probability that the firm would pose a risk to the FSA's statutory objectives as 'low'.

39. In line with ARROW I (and II) practice for high impact firms, the results of the assessment were presented by the manager and lead associate to Northern Rock's board on 28 March 2006. We note, as an anomaly that could not be explained to us, that the slides for the presentation described the probability as 'medium-low', notwithstanding the FSA's communication of the risk in the letter of 13 March as 'low'.

*Wider sample of data*

40. We were provided, by the Retail Management Services Unit, with data for the high impact firms supervised in MRGD and Wholesale Investment Banks Department. These are summarised in Appendix 4. They showed that Northern Rock was the only such firm not to have an RMP during the review period. They also showed that four of those firms had a supervisory period of 36 months at the end of the period.

## 2.9 Conclusion

41. The ARROW Panel's decisions, including not to have an RMP and to extend the supervisory period, were understandable given the profile of Northern Rock as presented to it. However, the Panel would have had a fuller insight into the firm if it had received from the supervisory team, or probed in the meeting for, a more comprehensive analysis of the risks inherent in the business model at the time. However, at the very least, we consider that there was sufficient evidence that the ambitious growth plans of the firm, and the risks that they presented, warranted formal tracking and assessing through an RMP.

42. Moreover, we believe it would have been appropriate for the Panel to have required the supervisory team to explore further the sustainability of the strategy and the impact of the business plan required to deliver it.

43. We consider that a more formal dialogue with the board on the implications and risks of its strategy would also have been in keeping with the principle of senior management responsibility.

# B3 Taking forward issues from the ARROW letter

### 3.1 Introduction

1. In its letter to the Northern Rock board, the supervisory team listed five key issues on which they intended their Close and Continuous (C&C) work to focus. The letter did not specify how these issues would be pursued. In this chapter, we describe, in turn, how the supervisory team addressed each issue; we draw a conclusion on its actions and decisions at each one.

### 3.2 Issue one

> *'the viability of the firm's strategy in the prevailing market conditions. This includes consideration of the capacity of the firm to deliver its strategic objectives whilst ensuring that its credit risk profile is consistent with its risk appetite and access to funding, particularly through securitisation, is maintained.'*

*Credit Risk*

2. Credit risk was monitored through the extensive work on the Basel waiver and through reviewing management information, which was received on an ad-hoc basis. The Basel Pillar 1 work captured issues such as operation and stress-testing of the models, and risk management. Issues such as liquidity and concentration risk would be covered as part of the Basel Pillar 2 assessment in 2007.

3. We conclude that there was focus on credit risk during the post-ARROW period, principally in connection with Basel work. However, we noted that the Basel work did not cover all aspects of Northern Rock's mortgage operation nor its credit risk management. The absence of more formal monitoring of MI and of C&C meetings (see Chapter B4: Close and Continuous supervision) to focus on issues beyond the operation and governance of the models therefore suggests the approach to credit risk was not as comprehensive as we would expect.

*Funding*

4. During the period we reviewed, the supervisory team recognised the importance to Northern Rock of its wholesale funding; indeed its increasing diversification, across markets and currencies, was seen as a strength. The supervisory team received Northern Rock's Funding Plan but we did not see evidence of any detailed work on this topic nor dialogue to suggest that the limitations of its strategy were recognised until the review of the Pillar 2 Internal Capital Adequacy Assessment Process (ICAAP) which took place throughout Q2 2007. The findings and outcome of the Pillar 2 work are covered at Section B7.3.

5. We observed that the supervisory team was sensitive to the risk that a deterioration in asset quality could impair Northern Rock's ability to securitise mortgage assets. However, we did not see evidence until the ICAAP work in Q2 2007 that they discussed with Northern Rock whether a downturn in the market more generally could reduce the

appetite for mortgage-backed securities and therefore compromise the sustainability of their strategy.

6. Our conclusion, which was confirmed in feedback from the supervisory team, is that there was not any detailed assessment or focus on Northern Rock's funding strategy or requirements prior to the ICAAP in Q2 2007. We consider that an earlier discussion, in the context of the firm's strategy, could have explored in more detail Northern Rock's capacity to continue funding such rapid growth through existing means. This would have been in keeping with a principles or outcomes-based approach.

### 3.3 Issue two

> *'the adequacy of stress testing against the background of developments in the book, for example higher levels of Together and Buy-to-Let lending and increases in interest only and flexible lending'.*

7. The focus on stress testing communicated in the ARROW letter to the Northern Rock board appears to have been on credit risk. We note there was no reference in the letter to the need, which the ARROW Panel minutes show was highlighted by the Panel, for Northern Rock to *improve* stress testing and to provide an annual stress testing report. confirmed to us that the last time an 'annual report' had been received was in 2005 (before the ARROW assessment). After that, the stress testing that was performed was in the context of Basel work.

8. As part of the ARROW assessment, the supervisory team had also identified weaknesses in stress testing in commercial lending. An internal memo[1] summarising findings from the visit on 31 October 2005 highlighted how 'a clear picture of this [stress testing] process did not emerge'. It was not evident that this was taken forward.

9. It is clear that a considerable amount of work was conducted on stress testing credit risk as part of the Basel waiver application, and that stress testing more generally was captured in Q2 2007 as part of the Basel Pillar 2 process in connection with the review of Northern Rock's ICAAP. This work is described in further detail at Section B7.3.

10. However, we remain unclear that stress testing was dealt with in the way that the Panel expected or that the ARROW letter suggested. In particular, we question whether it was envisaged that the only work on stress testing conducted in 2006 would be as part of the Basel waiver application and that work beyond those Pillar 1 models would not take place until 2007. In the area of liquidity, where the short-term impact is much greater, we believe that work should have been undertaken earlier (see Section B7.5). **Lesson 17**

[1] Memo of 14 November 2005, 'Northern Rock ARROW Preliminary Risk Assessment: Commercial Finance Overview'.

## 3.4 Issue three

> *'on-going development of the Risk Management Framework, particularly with respect to Northern Rock's capacity to meet the requirements of the Capital Requirements Directive.'*

11. As part of Basel work (Pillar 1 and Pillar 2), there was considerable engagement with Northern Rock's risk management functions. However, it was not clear to us that any specific work was undertaken by the supervisory team beyond the work on Basel. This was illustrated by the lack of follow-up to the points raised by the Risk Review Department (RRD) visit with regard to the risk management function in Treasury.

12. The Treasury function was visited in July 2006 and March 2007 as part of the assessment of the Basel Pillar 1 waiver. These visits focused on the use of rating systems used by the function. Further visits took place in April and May 2007 to review liquidity and securitisations respectively as part of the Pillar 2 ICAAP.

13. Meetings with risk management (or, indeed, other control functions) were not included on the agenda of meetings held on 30 April 2007 as part of the 'annual' Close and Continuous (C&C) review (see Section B4.3), although 'review of response to 2006 treasury visit' was on the agenda for discussion with the Treasurer. No write-up was made of that meeting so we cannot assess whether it was discussed.

14. We conclude that development of the risk management framework was subject to review principally as part of the Basel work. We consider this focus was too narrow to enable an assessment of the function in the context of the need for continuous risk assessment. This was particularly relevant to the Treasury function where the supervisory team had indicated that, prior to the February 2006 visit, the function had not been reviewed in detail for four years and a number of issues had been identified by RRD

## 3.5 Issue four

> *'the operational risks arising from a rapid pace of growth, particularly the ability of the firm to continue to deliver its customer service and TCF* [Treating Customers Fairly] *objectives given its growth profile'*

15. The supervisory team was alert to the sustainability of Northern Rock's growth[2]. However, we did not see evidence that the supervisory team considered that growth during the period 2005-07 warranted more careful scrutiny. For example, there was no substantive engagement to explore the acceleration in lending early in 2007 nor were issues escalated to senior FSA management.

16. TCF was reviewed primarily through thematic work. The supervisory team also dealt with a number of ad-hoc requests arising from regular enquiries and complaints made to the FSA by Northern Rock customers. We noted that agendas for the C&C meetings on

[2] Memo to the Director of MRGD on 6 July 2007, 'Northern Rock Profits Warning: What's Happening?'

30 April 2007 included reference to TCF issues; this shows that TCF remained a focus of the supervisory team's agenda. Of the five meetings held on that day, only part of one was written up so we cannot assess the extent of discussion on TCF.

17. We found that the supervisory team conducted work on TCF through the use of thematic work and was alert to TCF issues in its discussions with Northern Rock's management.

### 3.6 Issue five

*'the mitigation of the internal and external risks associated with the impending retirement of the Finance Director.'*

18. We were not clear exactly what was intended by this statement. that it related to the need for Northern Rock to identify a suitable replacement and to ensure that, whoever was appointed, there would be sufficient resources in Finance to manage the Basel process.

19. The supervisory team told us that, following the board presentation in 2006, the Chairman of Northern Rock discussed with them the succession to Bob Bennett as Group Finance Director and the suitability of Dave Jones for the role. that the supervisory team had indicated that this was a matter for Northern Rock. The team took the opportunity to point out that that it would be appropriate to benchmark externally to see if he was the best candidate. The firm did this but the supervisory team did not know whether the subsequent decision to appoint Jones reflected any inability to recruit externally or not. The supervisory team reported to us that they would have preferred an external candidate with finance or treasury experience who would have been better placed to challenge the business.

20. In conclusion, we saw that there was some discussion on the appointment of the new Group Finance Director. It is not clear, however, whether the risk of insufficient resources was mitigated to the level the supervisory team intended. Although we were told that some recruitment took place, we observed that there was still evidence of stretch in the Finance function (see Section B6.2).

# B4 Close and Continuous supervision

## 4.1 Introduction

1. Close and Continuous supervision (C&C) is the approach for the on-going monitoring of high impact firms. In summary, C&C is to assist in the identification of emerging risks and the re-assessment of the business risks and the control framework of the firm at regular checkpoints between full ARROW assessments. It therefore involves regular communication including meetings with firms throughout the supervisory period.

## 4.2 Content of C&C programme

2. The absence of a Risk Mitigation Programme (RMP) combined with a long supervisory period elevated the importance of C&C supervision for Northern Rock. This became the primary means of assessing the firm, supplemented by thematic work when it included Northern Rock and major projects such as Basel-related work.

3. As we explore in Chapter D1: Risk framework, we were offered a number of different definitions of C&C by supervisory and other staff. It was described to us by the Northern Rock supervisory team as an 'open dialogue' through a close working relationship where there were no surprises. This definition excluded a key element which was encompassed in the MRGD guidelines: to enable continuous risk assessment of the firm to occur.

4. The Guide for MRGD Line Supervisors highlighted the 'need to make explicit assessments, that are kept under regular review as part of the ARROW process (the continuous part of C&C), of the adequacy of management; the compliance culture; and each of the control functions – internal audit, compliance, risk management, finance and, where relevant, actuarial'. The guide also states that it is 'essential that Supervisors ... validate their decision to place this reliance [on management and controls] on an on-going basis. This should involve periodically examining the work carried out by each control area'. **Lesson 18**

5. The ARROW letter had not specified how issues would be taken forward under C&C. Instead, it described how 'the focus of our activity will be on maintaining our C&C relationship through the regular monitoring work we currently undertake (notably through the receipt of regulatory returns and MI [management information]) and through meetings with senior management at regular intervals during the supervisory period'. **Lesson 19**

6. We noted that no schedule of meetings nor regular MI requirements (for example board MI) was sent to Northern Rock in the ARROW letter (or subsequently). This was contrary to our observations of some of the other firms we reviewed. We explore this issue further through the role of HoD challenge in Chapter D7: FSA senior management.

## 4.3 Implementation of C&C

7. Moving to a predominantly C&C relationship with Northern Rock meant that the FSA became heavily reliant on the openness of the firm to keep it informed of changes to its business model, changes in the effectiveness of its control environment, and new risks and issues arising.

8. We observed that Northern Rock notified the FSA of issues such as and of its breach of Individual Capital Requirement at end-March 2007 (see Section B7.4). However, it is not clear that all relevant issues were communicated. For example, we understand Northern Rock did not inform the supervisory team of the temporary resignation of Rosemary Radcliffe from its Audit Committee. Neither did it signal the deterioration in its financial performance following the trading statement in April 2007, which was ultimately to cause it to inform the FSA and the market at end-June 2007 that its profitability would be at the bottom end of its target range. It was this statement that the market interpreted as a profit warning.

9. During the supervisory period, we identified that, following the board presentation in March 2006, only one set of C&C meetings occurred – on 30 April 2007. This was 16 months after the bulk of the ARROW discovery work took place. This included five meetings: with the Chief Executive, together with the Deputy Chief Executive, Group Finance Director, Treasurer, Commercial Director and Operations Director. We noted that the write-up of the meeting with the Chief Executive and Deputy Chief Executive had not been finished; there were no records of the discussions of the other meetings. The only other meetings with Adam Applegarth during this period were as part of visits by the Director of MRGD in August 2006 and by the associates on the supervisory team in October 2006, when looking at senior management understanding within the context of Basel work.

10. In addition, we saw minutes of a C&C telephone call in conference with the Deputy Chief Executive, Company Secretary and Finance Director Designate in January 2007 and another with the Company Secretary in February 2007.

11. that it was sufficient to meet Northern Rock for C&C meetings at annual intervals. This was on the basis that there was the opportunity to meet many of the management team as part of the work on the Basel waiver during this period. The Basel work included eight visits to Northern Rock and around ten meetings with the firm at the FSA to review the Pillar 1 waiver as well as two visits to review the ICAAP (see Sections B7.2 and B7.3).

*Wider sample of data*

12. We were provided, by the Retail Management Services Unit, with data for the number of C&C meetings across the high impact firms supervised in MRGD and Wholesale Investment Banks Department (WIBD). These are summarised in Appendix 4. They showed that the average number of C&C meetings for such firms during the review period was higher than the number for Northern Rock.

## 4.4 Conclusion

13. We found that the supervisory team did not evidence, in its application of C&C, that it understood the substance of the approach to be used for continuous assessment, in particular the assessment of the adequacy of controls. After the ARROW Panel, in the period under review, there was only one set of C&C meetings and that did not include meetings with the heads of key control functions. This fell far short of the level of C&C contact for most of our sample firms (see Chapter D1: <u>Risk framework</u>). We did not regard the level of engagement as sufficient to validate the effectiveness of Northern Rock's key controls.

# B5 Emerging business risks

## 5.1 Introduction

1. In this section we describe how the Northern Rock supervisory team reacted to emerging business risks after the formal ARROW assessment. We cover: Northern Rock's business strategy (Section 5.2) and emerging signs of strain from this strategy (Section 5.3). We also review the supervisory team's response to this strain (Section 5.4) and set out our conclusions (Section 5.5).

2. For each issue, we believe that, as a minimum, the supervisory team should have assessed:

    - whether the firm was being open with the FSA;
    - whether the firm's response was sufficient or warranted regulatory intervention or other action;
    - whether the issues, either in isolation or aggregated with others, should have led to the FSA revising its view of Northern Rock's risk profile and the effectiveness of its controls; and
    - the appropriateness of re-introducing a Risk Mitigation Programme (RMP) and/or bringing forward the next formal re-assessment[1].

## 5.2 Business strategy

*Supervisory team's view*

3. The supervisory team's prevailing view was that Northern Rock's business strategy was not changing over the period of our review. We were told that Northern Rock's business plan was not routinely reviewed (although a copy of its 2007 plan was subsequently identified and provided to us) and that the firm's planning framework had not been considered.

*Product range - Together*

4. A key element of Northern Rock's product range was the 'Together' product, which represented 31% of gross mortgage lending by the firm in 2006 and 26% in the first six months of 2007. The key features of Together were that it offered a secured loan of up to 95% loan to value (LTV) coupled with an unsecured loan of up to 30% LTV all at a single rate and serviced by one monthly payment. Together was essentially targeted at first-time buyers and the unsecured element was designed to finance associated house-purchase or home-making costs. The scope for a loan of up to 125% LTV meant the product was regarded by many as particularly high-risk

[1] ARROW Theory & Practice manual Version 2.0, Section 6.2.

5. We saw that Northern Rock supervisors had paid specific attention to Together. It was a well-established product and most of the detailed work on it had occurred prior to the period of our review (for example, a RRD Credit Risk Review visit in 2002). However, we observed recognition of the need for on-going monitoring of the performance of the product using the firm's MI and an understanding of Northern Rock's approach to managing its credit exposure from the product. In TCF work in the period, we also saw that implications for Responsible Lending had been captured through thematic work on Affordability.

*Product range – Lock-in features*

6. Northern Rock had, in the past, used extended lock-ins on discounted mortgage products. The borrower 'benefited' from a reduced rate for an initial period before reverting to the lender's higher, standard rate. A redemption penalty was payable if the mortgage was redeemed before a certain date. In the case of an extended lock-in the penalty period continued after the discount period ended.

   Extended lock-ins were more prevalent prior to the introduction of mortgage regulation in 2005 and have not been a feature of the recent lending of the firm.

*Issues that arose*

7. A number of signals were apparent that individually (and in aggregate) should have provided a trigger for a review of the structure of the balance sheet and the appropriateness of controls, either to keep pace with continued rapid growth or to manage emerging risks. In this category, we have identified the following.

   - The public announcement in January 2007 of Northern Rock's ambition to become the third largest mortgage lender in the UK.

   - 

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   - Northern Rock's opening, in February 2007, of a retail savings bank in Denmark, This was primarily an on-line operation, a gateway to Scandinavia and a means of increasing the firm's retail funding base.

   - not least in Q1 2007 where Northern Rock recorded net lending 34% higher than the corresponding period a year earlier (and net residential lending up 42%).

- The sale of £833mn commercial loans to Lehman Brothers in June 2007 (and conditional agreement to sell a further £732mn of commercial loans in H2 2007).
  under Basel 2.

- 

- Most importantly, the change in dividend strategy. Northern Rock signalled to the market in January 2007 that as the anticipated benefits of Basel 2 'start to become realised our dividend policy will be reviewed with the expectation that dividend growth will exceed underlying profit growth'. However, it was not clear that this review was acknowledged in papers to the Pillar 2 Validation Panel in June. These showed that the firm currently 'aims to distribute circa 40% of underlying profits attributable to shareholders'. In July, the firm announced that it intended to increase the distribution to 50%. It also announced a proposal to increase its 2007 interim dividend by 30.3% (over 2006) and that future capital planning included share buybacks.

### 5.3 Signs of strain on Northern Rock's performance

*Northern Rock's pricing strategy*

8. Northern Rock's increased reliance on wholesale funding meant that its pricing became subject to more extreme pressures than its competitors. It was exposed to the risks from a model that relied on different bases for the pricing of assets and liabilities. This was evident in its interim results for the half year to end-June 2006, published on 26 July 2006, when, commenting on the fall in spreads, it told the market that:

   'This reduction is primarily attributable to the costs of the Whinstone[2] transactions and the effect of the Libor Bank Base Rate differential. .... During the first half of 2006, 3-month Libor remained on average 14bps higher than Bank Base Rate compared with 7bps in the second half of 2005 and so has continued to adversely affect the price of our securitisation and non-retail funding'.

9. One year on, at the publication of its interim results for the half year to end-June 2007, on 25 July 2007, it stated that:

   'The rapid increase in swap rates has also resulted in a negative drag on our net interest income as fixed interest rate swaps were transacted as mortgage lending completed' (thereby exposing Northern Rock to rising swap rates between offer

[2] Northern Rock entered into a contract with Whinstone Limited, a special purpose entity, whereby it transferred some of the 'first-loss' risk Northern Rock had retained on the Granite securitisation entities.

and completion) and that 'as the majority of [Northern Rock's] funding is priced by reference to money market rates, increases in Libor have also had a negative impact on our net interest spread'.

10. We regarded these consequences as foreseeable given the nature of Northern Rock's business model. Indeed, we observed that Northern Rock announced as part of its 2007 interim results that it was instituting a change in its hedging strategy to improve its effectiveness and minimise the risk of timing mismatch.

11. The impact of the shift in market rates was that Northern Rock's margins fell sharply in the first six months of 2007. It reported a net interest margin of 86bps and a net interest spread of 68bps, markedly lower than its competitors. To meet its stated targets for profit growth, Northern Rock therefore had to generate a significant volume of lending.

*The 'profit warning'*

12. Northern Rock's trading statement made on 27 June 2007 indicated that 'Northern Rock expects its underlying attributable profits to increase by around 15% when compared to 2006'. This was at the bottom end of its target range and reflected pressure arising from mortgage pricing that lagged increases in money market rates, and 'hedging ineffectiveness'. The market interpreted this statement as a profit warning given that it came less than three months after Northern Rock's Q1 trading statement (made on 2 April) in which it said it was content with the consensus mid-point of 18% growth, as forecast by analysts.

**5.4 The supervisory team's response**

13. that, over the review period, the supervisory team was mindful of changes to Northern Rock's business risk profile. However, we saw no evidence of increased scrutiny by the team (for example by way of additional meetings being instigated to probe issues) nor escalation of issues to senior management, either in meetings, or by updating Interim Risk Manager[3] (IRM) prior to the trading statement made on 27 June 2007. No changes to the scoring of the firm's business risk elements were made, nor did we see any output from an interim review to suggest the supervisory team's view of Northern Rock had changed.

14. After Northern Rock's trading statement, the supervisory team set out its assessment of the situation in a memo to the Director of MRGD dated 6 July 2007. This followed telephone discussions between the team and Northern Rock's Group Finance Director. The memo proposed areas for further discussion with Northern Rock and suggested these be dealt with through C&C. A meeting was arranged with the Group Finance Director for 10 July (which coincided with his visit to the FSA for a Basel meeting) and the team stated this would put it in a better position to judge whether a formal RMP was needed.

[3] The IS system, implemented as part of ARROW II, on which the supervisory team's assessment of a firm should be captured. This includes scoring of business and control risks and logging of key issues.

15. The team updated the position to the Director on 16 July following the meeting with the Group Finance Director. In a memo, it set out its proposed supervisory action: to write to the Chief Executive (after the interim results were published on 25 July) about the and market perceptions of Northern Rock as the FSA saw them; and to highlight some wider issues about the business model and risks posed by the deteriorating credit conditions. The memo also brought out other issues from the team's supervision that it intended to raise. For example, it intended to highlight concerns about the 'analytical capability' of the firm (which was an issue arising from Basel work that had already been discussed with the Chief Executive and Group Finance Director), and to endorse the review of hedging policies. It proposed meetings with the Chief Executive and with the Chair of the Audit and the Risk Committees during Q3 2007. The team concluded that it saw no need to introduce a RMP, but advised that this would be kept under review.

16. In an e-mail on 19 July, the Director asked that the issue be added to IRM and that the 'controls element' be revisited as a result. The Director also highlighted how an 'unusual business model' used to be one of the criteria for including a firm on the 'Watchlist' and asked the team to continue to test and probe. The team replied that it would revisit the scoring of the firm's risk profile but said that 'holding back on instituting a formal RMP is about challenging [Northern Rock's] management to recognise the issues for themselves in the first instance and demonstrate that they can steady the ship'.

17. We are aware that subsequently attempted to update IRM but failed as (see Section B1.3). IRM had not been updated at all by 9 August 2007, the close of our review. It is not clear to us why there was no assistance from colleagues who had received the necessary training and were familiar with the system.

## 5.5 Conclusions from emerging business risks

18. It is our view that there were a number of indicators emerging that could have prompted the supervisory team to re-assess its view of Northern Rock's business risk much earlier. These included the signs of rapid expansion and . The emerging indicators suggest to us that a return to more pro-active supervision was required, including earlier formal discussion with Northern Rock on the sustainability of its strategy and funding model. We also think there should have been discussion with the HoD about the appropriateness of reducing the 36-month supervisory period. **Lesson 20**

19. We recognise that many of the issues were discussed with the Director of MRGD in the weeks following the trading statement and that this dialogue showed that an appropriate regulatory response was being considered. However, we believe the trading statement was not so much a sign of emerging issues but rather a sign that they had crystallised. We consider therefore that they should have been escalated to FSA senior management a number of months earlier.

20. We also question whether the absence of from the meeting on 10 July with the Group Finance Director to discuss the trading statement, and the

decision to delay for a month writing to the CEO to highlight concerns, might have suggested to Northern Rock that this was not regarded by the FSA as a major issue.

21. Finally, we noted that, by not updating IRM, the prevailing view of Northern Rock by those outside the supervisory team (including FSA senior management) was that of the scores recorded on the system. This showed only the profile of a 'typical' bank in Northern Rock's sub-sector. It had not been updated between 15 November 2006 (when Northern Rock's risk assessment was migrated from the ARROW I IS system) and the end of our review period, to reflect these emerging risks.

# B6 Emerging control risks

## 6.1 Introduction

1. In this section we describe how the Northern Rock supervisory team reacted to emerging control risks following the formal ARROW assessment. We cover: management and governance (Section 6.2); challenge to the Northern Rock Executive by the FSA (Section 6.3); and control functions (Section 6.4). Our conclusions follow in Section 6.5.

2. For each issue, we believe that, as a minimum, the supervisory team should have made the same assessment as outlined in Section 5.1.

## 6.2 Management and governance

*Non Executive Directors*

3. The Northern Rock board contained a number of non executive directors (NEDs) drawn from the finance sector. These included Sir Derek Wanless (former Group CEO of National Westminster Bank plc) who was Chairman of Northern Rock's Audit and Risk Committees, Nichola Pease (CEO of JO Hambro Capital Management Limited), Michael Queen (Finance Director of 3i) and Rosemary Radcliffe (former Chief Economist of PwC and former Independent Complaints Commissioner for the FSA). Other NEDs were Sir Ian Gibson (formerly a member of the Court of the Bank of England) who became the Senior Independent Director on the retirement of Sir George Russell (see paragraph 4) and Adam Fenwick (Group MD of Fenwick Limited).

4. We observed that two of the NEDs were long-standing[1]. Dr Matt Ridley (a scientific writer, former American Editor of The Economist, and Chairman since 2004), had originally been appointed to the board of Northern Rock Building Society in 1994. Sir George Russell (former Chairman of 3i), had served as a director first of the Building Society from 1985 and subsequently of Northern Rock plc before retiring in 2006 when he reached the firm's retirement age of 70[2]. Sir George Russell had been the Senior Independent Director prior to his retirement.

5. We consider that the evolution of Northern Rock's business, not least the sustained high level of growth and changes in the structure of its balance sheet, needed significant oversight. This required the supervisory team to carry out assessments to look at the balance of the board to determine whether members, as individuals and in concert, remained suited to the role and equipped to provide the challenge that Northern Rock's evolving strategy required. **Lesson 21**

6. We believe that Northern Rock's board had good representation and experience from the financial sector. We consider, though, that there was scope to question the Chairman's profile. On the one hand, his career had not been in the finance sector prior to joining

[1] Source: Northern Rock plc Annual Report and Accounts 2005.
[2] We note that Northern Rock justified not aggregating service on the former building society board with that on the plc board due to the different legal structure and business objectives of the two entities.

the board of Northern Rock, and he was, arguably, less suited to providing balance to a strong Chief Executive pursuing the strategy of 2007 than he had been to his role on the board in 1994. On the other hand, we recognise that the supervisory team commented favourably to the ARROW Panel on his work to enhance the effectiveness of the Board, which had included appointments designed to enhance the financial and regulatory experience and degree of challenge it offered.

*Executive Directors*

7. The Northern Rock executive was a largely home-grown and long-standing team. Adam Applegarth had been employed by the firm since 1983, David Baker (Deputy CEO) since 1977, Keith Currie (Treasurer) since 1980, Dave Jones (Group Finance Director) since 1997 and Andy Kuipers (Commercial Director) since 1987.

8. We believe that this lack of wider market experience had the potential to weaken management's effectiveness in key areas. This is particularly so for evolving areas such as risk management and treasury or in control functions where recruits from other firms bring different experience and perspectives. We believe this becomes more important if geographic location means staff do not have frequent opportunities to mix, formally and informally, with counterparts from other firms.

9. The supervisory team was alert to the value of external hires. They were encouraged by Northern Rock's decision to recruit externally for a position in Operational Risk which, As described at Section B3.6, the issue was relevant to the succession of Bob Bennett as Group Finance Director. In the event, an internal candidate was appointed (Dave Jones).

*Management stretch*

10. The supervisory team reported in the papers to the ARROW Panel that the triumvirate of executives (Applegarth, Bennett and Baker) had 'micro-managed' the business, We also saw recognition of management stretch

11. Further evidence of stretch was reported to us by the supervisory team during the period we reviewed. We were told this was particularly evident in the Finance Department, where 'stretch' was suggested to us by supervisors as the primary reason for Northern Rock prior to the breach of its Individual Capital Requirement at end-March 2007 (see Section B7.4). It was also highlighted as a factor in the time it took Northern Rock to fulfil the requirements for its Basel waiver (see Section B7.2).

*Use of external advisors*

12. Possibly due to stretch but, in our view, more likely to reflect insufficient depth of technical knowledge in key areas of Northern Rock's business, we observed the extent to which it was reliant on external advisors.

- In the Securitisation team, feedback from an FSA visit[3] to the firm in May 2007 expressed the view that the firm did 'not have the same level of all-round expertise that could justify the statement as being the best in the market'. We were told that when the FSA Policy team wished to discuss detailed structural features and innovative transactions with the firm, it was often the advisers not the management who could provide a full explanation. Indeed, we were told of one meeting where no-one from Northern Rock attended.

- In the review of the Basel waiver, RRD reported that Northern Rock was reliant on its advisors in the development and documentation of its models, and in responding to some of the questions on its scorecards and models.

13. When taken with the rate of growth, we believe the indicators of stretch, coupled with the reliance on external advisors, could have been pursued more formally by the supervisory team during 2006. This should have included a more formal assessment of key controls to ensure Northern Rock's management team and control environment could keep pace with growth. **Lesson 22**

### 6.3 Challenge to Northern Rock Executive by FSA

14. We received feedback from a number of interviewees that there were strong and aggressive characters within Northern Rock's management team.

The ARROW submission had suggested this was balanced

We acknowledge that the identification of aggressive or dominant characters in senior management of firms is a difficult and sensitive matter which we explore further in Chapter D4: <u>Firms' governance and management</u>. **Lesson 23**

15. Interviewees also told us that treasury management did not respond well to challenge from the FSA.

16. We received feedback from a number of parties that

However, we did not see evidence of any formal challenge on the issues and risks arising from the existence of strong personalities. We believe that, given the nature and sensitivity of issues surrounding senior management competence and behaviours, these issues should have been escalated within the FSA by the supervisory team and then led by someone more senior at the FSA, possibly at head of department (HoD) level. This, in turn, might have created greater impact at the firm.

[3] Visit of 16-17 May by Risk Mitigation & Securitisation Team.

## 6.4 Control functions

17. As part of the ARROW assessment, there was interaction between the FSA and Northern Rock's Treasury Risk Management. However, we observed little specific contact by the supervisory team with Northern Rock's other control functions following the ARROW assessment. The principal interface became the meetings to progress the Basel waiver or in the margins of other visits. Unlike the other firms in our sample for this review, there were no regular meetings with Internal Audit or Risk Management.

*RRD Review of Treasury Risk Management*

18. The RRD ARROW discovery visit to Northern Rock's Treasury in February 2006 found the 'responsibilities and scope ... [of the Risk Management Unit (RMU)] to be largely passive and restricted to interest rate risk modelling and reporting'. RRD's report to the supervisory team said that 'The RMU did not appear to have authority to investigate and report on all risks run as a result of the bank's product lines'

19. The RRD report also highlighted the 'lack of external and technical skills by the Northern Rock RMU. By way of background, RRD explained to us that the As a consequence, this undermined the effectiveness of the Treasury RMU.

20. RRD's report also highlighted that the firm already had exposures to some complex and sophisticated instruments such as Home Equity Release Products and Structured Investment Vehicles (SIVs). Given their complex modelling requirements, there was a need for a strong risk management function. This became an even more important point given that the RRD report highlighted that they were not sure that 'the Assets and Liabilities Committee or the Board fully understands the risks embedded in the SIVs'

*The FSA's response to Treasury Risk Management issues*

21. We saw that the supervisory team submitted a request to RRD in April 2007 seeking resource for a treasury visit. The primary objective was to assess Northern Rock's but the scope also provided for follow-up of issues from the visit conducted by RRD 14 months earlier in February 2006. The specialists that conducted the initial visit were not available so the supervisory associate was supported instead by another supervisor from MRGD.

22. We noted that the issues flagged had not been fully addressed by the time of the RRD visit in February 2006. We note that follow-up to the RRD February 2006 visit was flagged as an item for discussion with the Treasurer

in one of the C&C meetings on 30 April 2007 and as part of the visit, which took place in June 2007, However, we believe that the supervisory team should have put more emphasis on following up Northern Rock's response to the issues raised by RRD in February 2006, and in a shorter timescale.

23. We are aware that the treasury function was visited in July 2006 and March 2007 as part of the Basel waiver application but this was to review rating systems. We believe that the issues raised in the February 2006 visit warranted specific follow-up work. This could also have covered other issues in the Treasury function at the time, The case for follow-up was particularly strong as the FSA had not reviewed the Treasury function in detail between 2002 and 2006 (see Section B3.4).

*Internal Audit*

24. We have also seen evidence that internal audit reports were provided to the supervisory team when requested. However, we noted that there were no meetings scheduled with Internal Audit as part of the C&C visit in April 2007.

*External Audit*

25. We understand that, prior to the recent crisis, the last dialogue with the external auditors had been the meeting in December 2005 as part of the ARROW discovery work. This long period was out of line with the other firms we assessed in our sample for this review. Moreover, the supervisory team did not request the management letter. The supervisory team instead relied on feedback (from Northern Rock)

26. We consider that greater engagement with the external auditors and an understanding of the issues being raised by them would have been a useful insight into the firm's control environment from an independent third party and relevant in assessing the level of reliance the FSA could place on the key controls at Northern Rock.

*Other functions*

27. There was frequent contact with Colin Taylor, Northern Rock's Company Secretary, who appeared to be the principal point of contact for the supervisory team.

### 6.5 Conclusions from emerging control risks

28. We observe that there were a number of indicators of control risk, including the existence of management stretch and strong personalities among Northern Rock's management team. Given the aggressive growth strategy and we consider this warranted a greater assessment of controls in key areas by the

supervisory team as well as more bilateral engagement with the key control functions. It is our view that the level of contact did not allow the supervisory team to make an effective assessment of the adequacy of controls nor of the functions that were primarily responsible for providing comfort to Northern Rock's own management that the control environment was robust.

29. As with business risks, we noted that no issues were added to IRM and the control risk scores had not been updated since the ARROW assessment. It is our view that there were indicators emerging that should have prompted the supervisory team to re-assess its view of Northern Rock's control environment much earlier, particularly in the light of the increasing business risk. **Lesson 20**

# B7 Capital, liquidity and stress testing

## 7.1 Introduction

1. In this chapter we cover three specific elements of the FSA's risk assessment framework. First we review capital, focusing first on the Basel Pillar 1 waiver (Section 7.2); then the Pillar 2 Internal Capital Adequacy Assessment Process (ICAAP) in Section 7.3; and finally Northern Rock's management of its capital position (Section 7.4). We then focus on liquidity management (Section 7.5); the FSA's Sterling Stock Liquidity regime (Section 7.6); and liquidity reporting within the FSA (Section 7.7). Section 7.8 covers how the supervisory team followed up on stress testing.

## 7.2 Basel waiver

*Impact on Northern Rock*

2. Northern Rock submitted a Basel Pillar 1 waiver application

Ultimately, the waiver was granted in June 2007.

3. We observed that the intensity and scale of the work impacted on Northern Rock. We were told by the supervisory team and RRD that it led to stretch in key areas, particularly Finance, and also where some of those assigned to the project had to continue to do their 'day-job' as well – including senior staff in the firm's credit risk function.

*Impact on FSA*

4. Within the FSA, from mid-2005 to 2007, a substantial amount of work was being undertaken to prepare for and review Northern Rock's waiver. This included eight visits[1], led principally by RRD. The supervisory team (mainly the lead associate) attended all of these visits. Northern Rock's application was taken to formal Panels on four occasions and there were two internal challenge panels. This clearly represented a significant demand on the time of the lead associate.

5. There was an expectation, reported to us by FSA senior management, that Basel work would be integrated with day to day supervision. The supervisory teams were expected to have the primary role in presenting findings and recommendations to panels, supported by the specialists from RRD. This was designed to ensure that the supervisor's knowledge of the firm was fed into the Basel assessment and that issues arising from the Basel work would, in turn, inform the supervisory team's overall view

[1] June 2005, February 2006, July 2006, October 2006 (twice), February 2007, March 2007 and April 2007.

of the firm. Some additional supervisory resource was recruited to MRGD to increase the capacity to deal with this work.

6. We saw extensive evidence of the involvement of the supervisory team in the Basel work; however, it is not clear that the findings or issues that emerged led to any change in the assessment of the firm. For example, from the Pillar 1 waiver, we did not see that points around management stretch, reliance on specialists, the possible lack of senior management engagement

weaknesses in stress testing or the quality of project management were reflected in the FSA's risk assessment of the firm. We understand these were fed back in the context of the firm's Basel work, but they did not lead to any regulatory response on the wider implications for the firm's risk profile.

*Conclusion*

7. Although considerable work took place on Northern Rock's Basel Pillar 1 application, indicators from this were not captured in the on-going risk assessment of the firm by the supervisory team. No changes were made to the firm's risk profile and no issues were added to IRM. **Lesson 24**

### 7.3 Internal Capital Adequacy Assessment Process

8. Northern Rock submitted its Basel Pillar 2 ICAAP to the FSA There was a general intention that ICAAP reviews would, in due course, be carried out alongside ARROW II risk assessments. For this initial round of ICAAP reviews, this was not achievable for many firms, Northern Rock included. Northern Rock's next risk assessment was not due until the end of 2008.

9. A work plan for review of the ICAAP was approved by the Pillar 2 Planning Panel on 2 April. This included two on-site visits: on 25-26 April (to cover governance of the ICAAP, credit risk, stress testing, pension risk, liquidity risk and capital planning) and on 15-16 May (for a review of Northern Rock's securitisation operation as part of a thematic exercise). In addition, two conference calls, on 3 and 10 May, were held to discuss interest-rate risk.

10. The ICAAP provided for a detailed review of two of the areas that had been identified for coverage under Close and Continuous supervision following the ARROW Panel in February 2006 (see Section B3). These are described below.

*Stress testing*

11. Stress testing (including on liquidity) was a key feature of the Basel Pillar 2 work. The visit on 25-26 April 2007 looked at stress testing scenarios, the capital impact of those scenarios and management actions.

12. As part of this review, the Strategy & Risk Division (S&R) was asked to consider the plausibility of recession scenarios used by firms which had applied for Pillar 1 waivers, including Northern Rock. S&R's analysis indicated that Northern Rock's use of its experience of the early 1990's for its mortgage portfolio was appropriate. However, it

also highlighted that the work was incomplete,

13. In a letter dated 2 July 2007, the FSA gave feedback to Northern Rock from the Pillar 2 review. This highlighted that, whilst management actions on stress testing seemed plausible and deliverable in a stress event, there were weaknesses in its processes. In the same letter, the FSA also signalled its intention to carry out further work on liquidity in Q3 2007.

14. The letter of 2 July 2007 also indicated that, as part of its C&C programme, the supervisory team intended to arrange a follow-up meeting at which the timetable for delivery of the remedial actions would be agreed.

*Funding*

15. We describe the findings of the work on liquidity at Section B7.5. In the wider context of funding, we noted that Northern Rock, in its ICAAP,

*The supervisory team's findings from the ICAAP process*

16. The detailed findings of the team's review were presented to the Pillar 2 Validation Panel on 21 June 2007; these were supported by notes of all key meetings with Northern Rock personnel. As part of its introduction to the Panel, the supervisory team highlighted Northern Rock's dependence on securitisation.

17. The Panel discussion focused on a number of areas: stress testing, credit concentration risk, persistency risk, securitisation and the draft letter to Northern Rock providing Individual Capital Guidance. The conclusions were communicated to Northern Rock in the letter of 2 July 2007.

*Conclusion*

18. It is our conclusion that the ICAAP was effective in focusing attention on key risks facing Northern Rock and highlighting areas where action was required. We believe that the engagement with the firm, not least in areas such as liquidity, securitisation and stress-testing, flushed out where remedial work was required.

19. We also believe that this gave clear indications of a need by the supervisory team to revisit the risk assessment of the firm.

20. We recognise the conclusion of the ICAAP fell at the end of our review period and that the Validation Panel on 21 June was the week before Northern Rock issued its trading statement. In keeping with the intention of integrating the ICAAP into day to day supervision, we consider that the findings might have been used to re-assess whether the 36 month supervisory period remained appropriate. In the event, this was overtaken by the market disruption.

### 7.4 The breach of Northern Rock's Individual Capital Requirement

21.

22.

, Northern Rock reported a capital position of 9.74% as at end-March 2007. This was in breach of its regulatory requirement.

23. The breach was reported to FSA on 19 April

24. The breach was rectified by the disposal of £833mn of secured commercial loans to Lehmans, which was completed on 22 June 2007, and by the issue of $650mn (£328 mn equivalent) of subordinated debt on 25 June 2007.

*The supervisory team's response to the capital breach*

25. Following notification, the supervisory team discussed the matter with the Group Finance Director during its C&C visit on 30 April 2007. No write-up of this meeting was produced. An explanatory letter was sent by the firm the following day. A memo to the HoD dated 8 May reported that the supervisory team had asked for a full investigation into the reasons for the breach.

26. However, we observed that, contrary to MRGD guidelines[3] and guidance in the ARROW manual[4], the breach was not reported to the Firms and Markets Committee

[3] Draft Guidance to Supervisors – Matters for inclusion in the Firms and Markets Committee Report. This shows under matters that should be reported, '***Material breaches of rules and guidance*** by firms and progress made by firms to address these, e.g. breaches of capital requirements.'

[4] Examples of issues that should be reported to FMC include 'material breaches of rules or guidance by firms' and 'significant concerns about processes, and systems and controls in firms, e.g. concerns over monitoring of capital adequacy'.

(FMC) by the supervisory team although, as shown in paragraph 25, it was flagged to the HoD. **Lesson 25**

*Conclusion*

27. Notwithstanding the circumstances, we believe that this breach of the capital requirement was a serious matter

Supervisors also attributed this to stretch in the Finance Department's ability to manage capital. We note that there were no amendments to IRM as a result, either in scoring of the firm's risk profile or by creating an issue.

**7.5 Liquidity**

*Northern Rock's liquidity management*

28.

29.

The FSA's requirement for a CFP is to show how a firm would maintain sufficient liquidity should any of the stresses considered materialise.

30.

31.

32.

Handbook guidance, in SYSC 11.1.19G outlined that, in developing any scenario of extreme market-wide stress, it might be appropriate for a firm to make assumptions about central bank intervention; this general issue is discussed further in Chapter D3: Liquidity.

33.

*FSA work on liquidity (including liquidity stress testing)*

34. New liquidity rules and guidance were introduced into the FSA's Handbook in December 2004 (see Chapter D3: Liquidity). We were told by the supervisory team that, in response to this, it required Northern Rock to enhance its approach to liquidity stress testing but we have been unable to evidence this point. **Lesson 26**

35. We know that, although liquidity was included within the February 2006 ARROW visit to Northern Rock's treasury, it was not explored fully; the visit did not, for example, review the firm's stress testing. The RRD specialists who undertook the visit explained in their report that this was because the supervisory team had said that they were pursuing this issue separately. However, we remain unclear on this. The supervisory associate said that the intention was to include it in the Pillar 2 ICAAP work, but this was not scheduled until the first half of 2007. In the event, liquidity was included as part of the visit to Northern Rock of 25-26 April 2007, as part of a wider liquidity thematic exercise for MRGD firms.

*April 2007 liquidity visit*

36. The thematic visit of 25-26 April 2007 also formed part of the assessment of Northern Rock's ICAAP. It was led by supported by a representative from RRD and included the The objectives for the review were to assess the qualitative aspects of liquidity risk management, for example the extent to which firms conducted stress testing specifically in relation to liquidity events; the linkage between stress testing and the firms' CFP and liquidity policy; and firms' governance around the outcomes of stress testing and their mechanisms for adjusting their capital or CFP/policy in the light of them. The objectives of the review did not include wider questions about the implications or adequacy of the liquidity component of firms' business models.

37. The visit to Northern Rock identified the need for further work by the firm on a number of points.

38.

39. On the stress tests themselves, it was noted that liquidity stresses were not distinct within the overall stress testing regime in the firm's ICAAP and that the documentation of the stress tests was not in accordance with the provisions of the FSA Handbook. It was suggested in response that Northern Rock should be asked to carry out further distinct liquidity stress testing, given the high level requirement in the Handbook, in GENPRU 1.2.42R, that a firm must carry out stress testing for each of the major sources of risk identified. A number of particular points were raised on one of the stress tests (the liquidity gap and ratio test) used by Northern Rock.

40. The overall assessment from the visit was that Northern Rock's 'liquidity risk management framework exhibits no material weakness'. This judgement was explained to us by the as based on the fact that the place . though there were deficiencies (summarised above) in their implementation.

41. The supervisory team indicated in its letter to the firm of 2 July that it would take the issues forward in Q3 2007.

## 7.6 Sterling Stock Liquidity

*The FSA's Sterling Stock Liquidity regime*

42. The report from the thematic visit on 25-26 April 2007 also identified a number of issues regarding the application of the Sterling Stock Liquidity regime to Northern Rock. It:

- questioned the appropriateness of the regime for Northern Rock;
- noted that Northern Rock's sterling stock liquidity ratio was high relative to major commercial banks; and
- noted that the firm's Wholesale Sterling Net Outflow Limit was but that its actual net outflow for the following 5 working days was reported as This raised questions about whether Northern Rock We note the wholesale sterling net outflow limit was increased

43. The supervisory team flagged its intention to review these issues in Q3 2007.

*Northern Rock's management information on liquidity*

44. Northern Rock's monthly MI on liquidity included

45. We note the MI was not received by FSA every month. It appears to us that this would have been appropriate in order to mitigate the shortcomings of the Sterling Stock Liquidity regime to a firm with a liquidity profile such as Northern Rock's. **Lesson 27**

### 7.7 Liquidity reporting in the FSA

46. Under a formal service level agreement with MRGD, Contact, Revenue and Information Management Department (CRIM) was responsible for monitoring capital adequacy and liquidity returns submitted by MRGD firms for breaches of regulatory limits. The returns were submitted first to the Bank of England for data input. They were then sent to the FSA electronically whereupon an automated alert was triggered to highlight that the data were available. At this point, CRIM undertook its routine checks. Once these were complete, an e-mail alert was sent to the supervisor to confirm that the returns were available for their use.

47. However, for Northern Rock, the alert indicating that the data had been loaded was (erroneously) sent direct to the supervisor rather than to CRIM. Indeed, CRIM was not notified at all that the data were available for checking. As a consequence, CRIM does not appear to have checked any of the capital or liquidity returns submitted by Northern Rock during the period of our review. Moreover, the Northern Rock supervisory team was under the mistaken impression that the returns were being checked by CRIM so, in the event, no-one was actively monitoring for breaches.

48. For Northern Rock, we have reviewed all the capital and liquidity returns submitted during our period of reference. We can confirm that only one capital breach occurred; we have commented on this at Section B7.4.

49. Our review also showed that, even if the returns for Northern Rock had been reviewed, there were other weaknesses in the process:

- CRIM did not contact firms when capital and liquidity returns were submitted late (we were told this decision had been made following a feasibility study in 2006 of whether chasing late returns was cost effective. We were told that such procedures will be in place for the new strategic reporting system, 'GABRIEL' that will be implemented in 2008); and

- CRIM did not have responsibility for performing plausibility or reasonableness checks on the data, for example to identify significant changes from the previous quarter (although CRIM advised that a report is sent to supervisors highlighting changes).

50. We conclude that improvements are needed in the process between MRGD and CRIM for reviewing returns submitted by firms. **Lesson 28**

## 7.8 Stress testing

51. We have already described the discussion on stress testing at the ARROW Panel (see Section B3.3) and how this did not appear to be followed up beyond the work required as part of Basel. We discuss the coverage of stress testing for Basel work at Section B7.3. We could find no evidence that any specific work took place by the supervisory team to follow up the Dear CEO letter issued in October 2006.

52. By the end of the period we reviewed, weaknesses in stress testing of liquidity had emerged. We consider there was certainly enough to warrant greater supervisory attention to the issue and to raise this with Northern Rock as a wider topic outside the Basel work. We noted the communication to Northern Rock on 2 July 2007 that FSA would follow up on liquidity stress testing in Q3 2007 but consider it should also have been recorded as an item on a Risk Mitigation Programme. **Lesson 29**

# B8 Use of intelligence

## 8.1 Introduction

1. In this chapter we look briefly at other intelligence that was available at the time. This is from: external sources (Section 8.2); internal sources (Section 8.3); and peer analysis on mortgage assets (Section 8.4). We offer some conclusions at Section 8.5.

## 8.2 External sources

*Bank of England*

2. As part of its working relationship with the Bank of England, the FSA receives a number of papers on different topics.

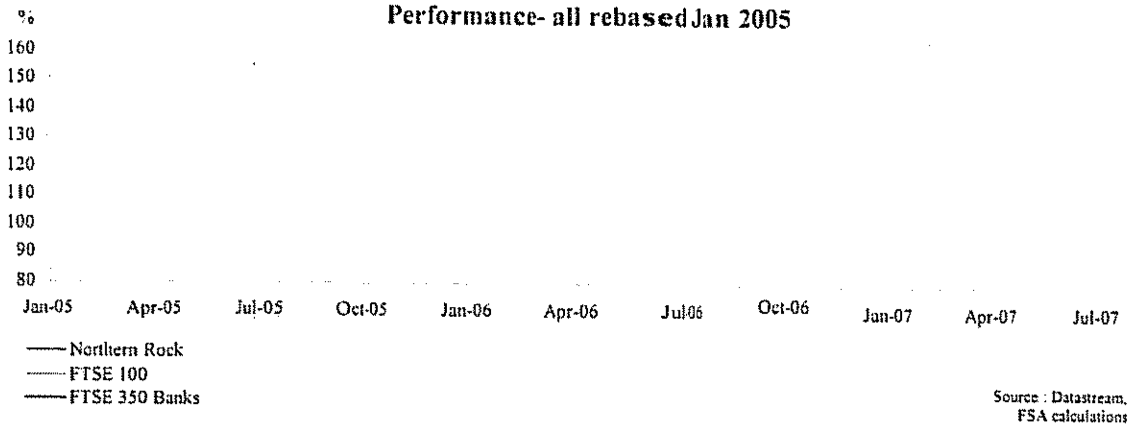
3. The Financial Stability Sector Leader distributed the paper. It was received by the MRGD HoD responsible for Northern Rock who forwarded it to all of his management team. We consider this was in keeping with the relevance of the analysis. As part of the discussion generated by the paper, one of the MRGD HoDs said in an e-mail that 'Northern Rock's business model means it should certainly receive additional scrutiny'.

4. For Northern Rock, follow-up was combined with the Basel Pillar 2 Internal Capital Adequacy Assessment Process (ICAAP) and the thematic work within MRGD on liquidity. This led to a visit to Northern Rock in April 2007 (see Section B7.5). Although we recognise the value of combining these two pieces of work, we noted that it was six months after the issue was discussed.

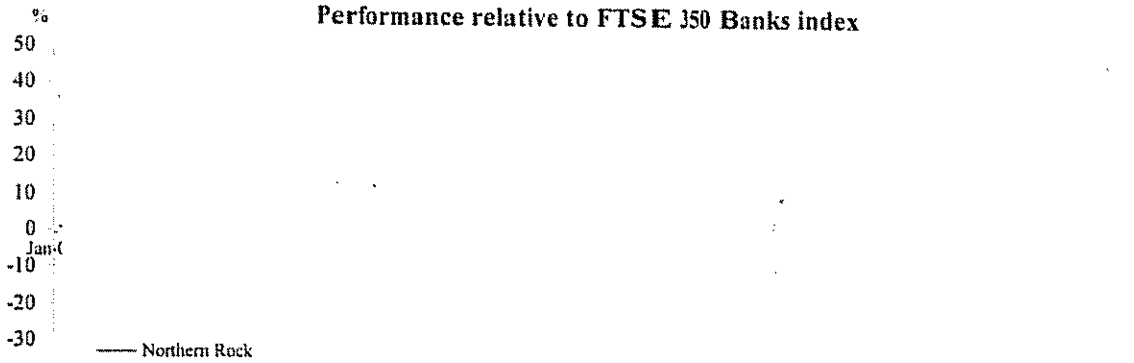
*Share prices*

5. We noted the Treasury Select Committee (TSC) highlighted the decline in Northern Rock's share price as a leading indicator. We observed that data on share prices were available to MRGD supervisors. We also saw e-mails which showed that the supervisory team had sight of market analysis[1] on Northern Rock's share price in April 2007. This highlighted that notwithstanding the interest rate environment, Northern Rock was 'still a fantastic long-term story'.

[1] Analysis by Merrill Lynch, 20 April 2007.



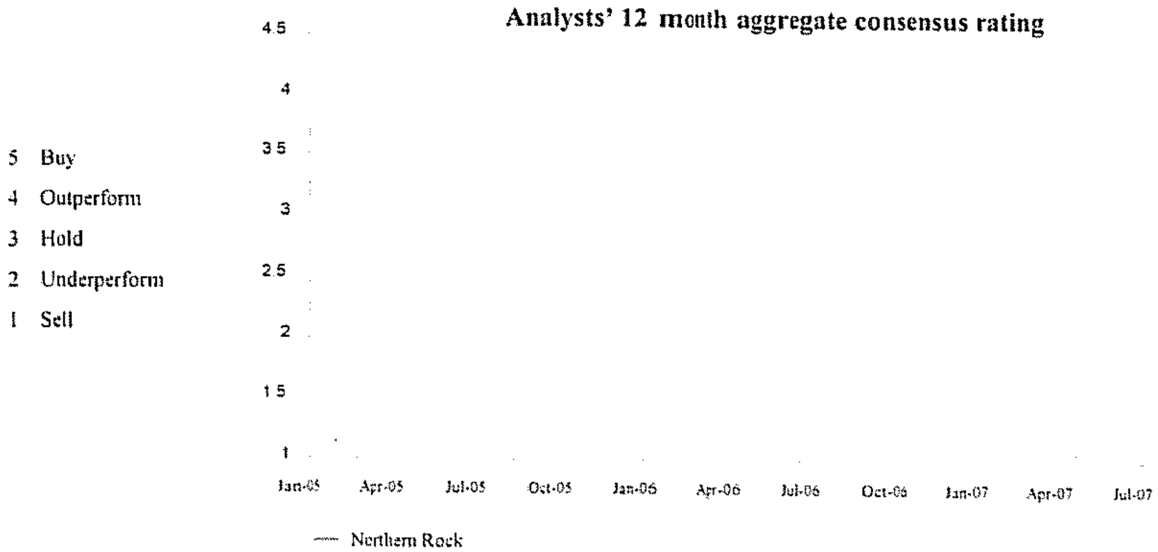

Source : Datastream, FSA calculations




Source : Datastream, FSA calculations

*Analysts' reports*

6. Throughout the period of our review, market analysts were generally bullish about Northern Rock and its strategy. The table below maps buy/sell recommendations by analysts, as reported by Bloomberg. It shows analysts were more positive about the prospects of Northern Rock's share price than those of a number of other retail banks.



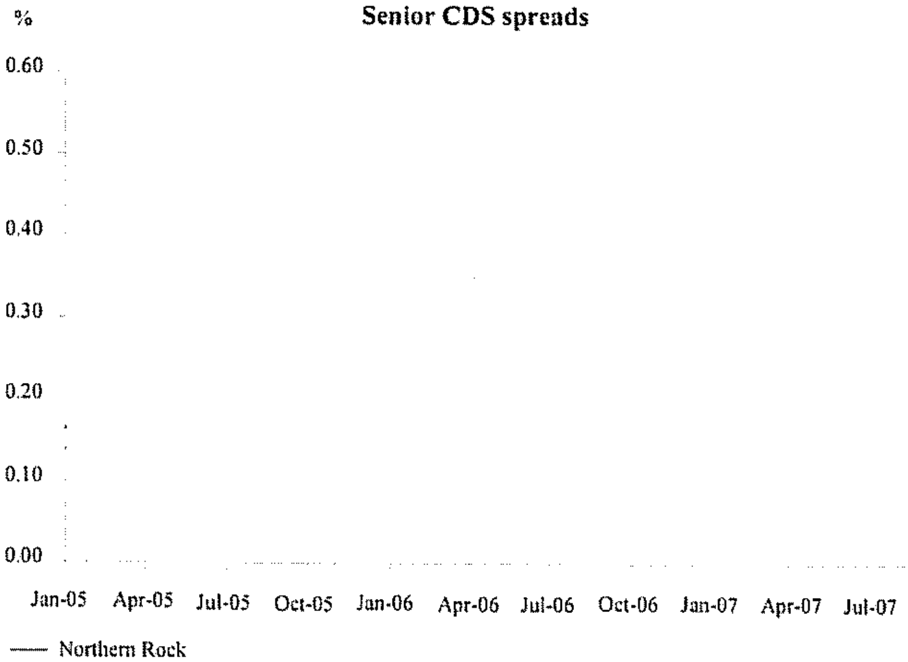
7. However, although the market as a whole appeared to have a positive view of Northern Rock, two houses were more negative, Credit Suisse and Citigroup.

8. Credit Suisse analysts had marked Northern Rock as 'underperform' since November 2006 and cited a number of competitive pressures on the firm. These included likely shrinkage in the remortgage market and greater competition in the Independent Financial Adviser channel where Northern Rock distributed many of its products.

9. Citigroup was concerned at Northern Rock's business model, particularly 'the rise in funding costs and/or a decline in the market's desire to buy mortgage backed securities, perhaps in response to credit quality concerns or fear of a rating downgrade'. However, we noted this sentiment was only expressed in June 2007 following the firm's trading statement.

*Other market intelligence*

10. For completeness, we considered senior credit default swap (CDS) spreads (see the chart below) and one year expected default frequencies.




11. The chart above shows Senior CDS spreads rose steeply on the back of Northern Rock's pre-close trading statement in June 2007. The spreads of followed suit. Although more reactive than credit rating agencies' ratings, CDS spreads were nevertheless reactive not predictive.

12. We also looked at a model owned by Moody's (KMV) that calculates the expected one year default frequency. This gave no indication of potential issues with Northern Rock. As of April 2007, it suggested that Northern Rock was the bank least expected to default among a sample including

13. We conclude that the type of issues that Credit Suisse were raising were relevant to the FSA's consideration of Northern Rock. We believe, however, that it would be too strong to suggest that this type of intelligence alone should have caused the supervisory team to review the firm's risk profile. **Lesson 30**

14. We conclude that, taking the analysts' reports and equity prices in general, there was no strong signalling by the market that Northern Rock's business model was flawed, although there was an indication that some analysts were alert to the weaknesses and strains that were beginning to emerge.

*Warning signals in the securitisation markets*

15. During 2007, early warning signals began to emerge of the implications for Northern Rock of its dependence on securitisation markets for funding. This was due to the heightened risk in this market from problems emerging in the US sub-prime mortgage sector.

## 8.3 Internal sources

*Peer analysis from Sector teams*

16. As we discuss at Chapter D5: Intelligence and information flows, the Banking Sector team provided no input to the supervision of Northern Rock in terms of peer analysis, nor the identification of outlying firms.

17. We also observed that, during the period, the supervisory team did not import any of the sub-sector risks relevant to Northern Rock into its assessment. This issue is also addressed at Chapter D5: Intelligence and information flows.

## 8.4 Peer analysis on mortgage asset quality and arrears

*Northern Rock's position*

18. Northern Rock stated in its interim results for the half year to end-June 2007, published on 25 July 2007, that it had 'residential arrears around half the industry average'. This was based on Council of Mortgage Lenders (CML) Residential Average Arrears data, which showed that at end-June 2007, 0.47% of Northern Rock's residential loans were three months or more in arrears, compared to CML Residential Average Arrears of 0.89% (as at end-December 2006, the latest available data for the rest of the market).

*Data collected by FSA from MLAR returns*

19. A new regulatory return, the MLAR (Mortgage Lending and Administration Return), was introduced by the FSA in July 2005, with deposit-takers (including Northern Rock) captured from 2007. The returns are completed quarterly and the first return by

Northern Rock was submitted on We saw no evidence that these data were used by the supervisory team during the period of our review.

*Data collected by Risk Review Department (RRD)*

20. RRD provided to the Northern Rock supervisory team (and other supervisors) mortgage peer data that it gathered from a small number of lenders on a quarterly basis until the end of 2006. Discussions took place at the end of 2006 and into 2007 between and RRD because was not able to reconcile the MI that Northern Rock submitted to the supervisory team, with the data supplied directly to RRD. RRD's data showed Northern Rock as an outlier, both on the scale of growth and the proportion of lending that exceeded a loan to value of 90%. The variance was never resolved. We are unclear why not, but it may have been because RRD's collection of data ceased at end-2006 upon the introduction of the MLAR.

## 8.5 Conclusions

21. We observed that the Northern Rock supervisory team did receive some analysts' reports but seemingly on an ad-hoc basis. We explore the issues regarding the receipt of such reports at Chapter D5: Intelligence and information flows.

22. The RRD data and the MLAR illustrate how data collected by FSA might be used to inform supervisors' views of trends and performance, and the value of the peer group analysis it can provide. However, we found that the tools to analyse the MLAR were not available until around mid-2007. Moreover, data in general was not routinely provided to supervisors; it was a case of 'pull' rather than 'push'. We consider that much more use should be made of such data as a prompt for discussion with firms.

[2] Although lenders are required to submit MLAR data within 20 business days of the period end, those that also submit RMAR forms (which allows 30 business days) via Firms Online have an extra ten business days for MLAR as one cannot be submitted without the other. Data for Q2 2007 were not due until 10 August 2007, outside the period of our review.

# C Lessons to be learned

1. To help readers to see the linkages between the discussion of the Northern Rock events (in Part B of this report) and the wider analysis of issues arising from it (in Part D), we have included the table below.

2. The report makes seven high level recommendations, with recommended actions in relation to each. (These are listed in Appendix 2.)

3. The second column of the table below summarises the lessons to be learned from the supervision of Northern Rock, as flagged in the text throughout Part B. From our review work as a whole, some of these lessons were seen as specific to the particular case of Northern Rock: the work done on the sample of firms did not indicate that the issue was more general. In such cases, we have generally not recommended any action.

4. Where the review showed an issue was more widespread, in our recommended actions we have gone further than addressing the weakness in the Northern Rock case, looking to enhance the FSA's supervision of high impact firms generally. The third column of the table indicates the main chapter where the issue is discussed in Part D of the report, and lists the main related recommended action(s). Some actions are a response to more than one lesson, and so appear more than once in that column.

5. There are also some lessons to be learned from the sample of firms that do not flow directly from the Northern Rock events in Part B, and we have included them here for the sake of completeness.

| Part B | Lesson | Part D |
|---|---|---|
| | **Lessons from Northern Rock** | |
| **Lesson 1**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | Supervising a high impact firm away from its peers is an obstacle to informal discussion between colleagues and formal peer group comparison. | Chapter D7: FSA senior management<br><br>**Recommended Action: 5.3** |
| **Lesson 2**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | Frequent divisional re-organisations, entailing high impact firms switching between departments, makes it difficult for HoDs to build up a good knowledge of a firm. (The same applies in the case of rapid turnover of managers or associates.) | Chapter D6: Supervisory resources<br><br>**Recommended Action: 6.3** |

| | | |
|---|---|---|
| **Lesson 3**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | It has been possible for<br><br>to have little engagement with one of the high impact firms in their portfolio. (This may have arisen as a consequence of Lesson 2.) | Chapter D7: FSA senior management<br><br>**Recommended Action: 7.1** |
| **Lesson 4**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | There has not been a mechanism to ensure that staff supervising high impact firms have the appropriate training in a timely manner. | Chapter D2: Stress testing<br>Chapter D6: Supervisory resources<br><br>**Recommended Actions: 6.4, 6.6, 6.7** |
| **Lesson 5**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | An assessment needs to be made of the available working hours of supervisors of high impact firms compared with the size, complexity and risk profile of the firms in their portfolio. | Chapter D6: Supervisory resources<br><br>**Recommended Action: 6.1** |
| **Lesson 6**<br><br>Chapter B1: Responsibility for the supervision of Northern Rock | After a number of years, anyone supervising a high impact firm is at risk of becoming over-familiar with the firm. | Chapter D6: Supervisory resources<br><br>**Recommended Action: 6.3** |
| **Lesson 7**<br><br>Chapter B2: ARROW assessment | Formal records (even if only in bullet point form) should be made for all contacts with a firm on material issues. | Chapter D7: FSA's senior management<br><br>**Recommended Action: 7.7** |
| **Lesson 8**<br><br>Chapter B2: ARROW assessment | In the course of preparing for a high impact firm ARROW panel, diligent consideration of the content and recommendations is expected by the supervisory team and its management, but care must be exercised that this does not unduly influence the Panel Chairman or members. | Northern Rock specific |

| | | |
|---|---|---|
| **Lesson 9**<br><br>Chapter B2: ARROW assessment | Particular care must be exercised when granting any 'regulatory dividend' to a high impact firm, such as the absence of an Risk Mitigation Programme, to ensure all aspects of the risk profile have been assessed and that there is a checkpoint mechanism in place for on-going review of the assessment. | Chapter D7: FSA senior management<br><br>**Recommended Action: 7.1** |
| **Lesson 10**<br><br>Chapter B2: ARROW assessment | Care must be exercised by high impact firm supervisors if they discuss with their firms the recommendations they are planning to make to ARROW panels (or other decision-making bodies) so that this does not fetter the Panel's discretion. | Northern Rock specific |
| **Lesson 11**<br><br>Chapter B2: ARROW assessment | The absence of the as part of the presenting team at a high impact ARROW panel does not demonstrate engagement or inspire confidence of panel members. | Northern Rock specific |
| **Lesson 12**<br><br>Chapter B2: ARROW assessment | Panel minutes (and all other firm-related documentation) should be filed in a way that makes them easy to access, and in accordance with agreed records management standards. | Chapter D7: FSA's senior management<br><br>**Recommended Action: 7.7** |
| **Lesson 13**<br><br>Chapter B2: ARROW assessment | The composition of Panels should have the appropriate breadth and balance of skills and experience. | Chapter D7: FSA's senior management<br><br>**Recommended Action: 7.3** |
| **Lesson 14**<br><br>Chapter B2: ARROW assessment | The pack of information presented to an ARROW Panel for a high impact firm should include analyses of how the firm compares with its peers on a range of financial and other | This has been improved as part of ARROW II, but should include more financial analysis.<br><br>Chapter D1: Risk framework |

| | | |
|---|---|---|
| | performance measures. | **Recommended Action: 5.1** |
| **Lesson 15**<br><br>Chapter B2: ARROW assessment | ARROW Panels should consider the need to challenge the team on all the ARROW core risk areas. | Chapter D1: Risk framework<br><br>**Recommended Actions: 3.1, 5.1** |
| **Lesson 16**<br><br>Chapter B2: ARROW assessment | The supervisory period for a high impact firm should not exceed two years. Note: this is currently a guideline in ARROW II. | Chapter D1: Risk framework<br><br>**Recommended Action: 2.7** |
| **Lesson 17**<br><br>Chapter B3: Taking forward issues from the ARROW letter | Panel recommendations or explicit agreed actions must be followed up. | Chapter D1: Risk framework<br><br>**Recommended Action: 2.6** |
| **Lesson 18**<br><br>Chapter B4: Close and Continuous supervision | There should be a clear and consistent definition of 'Close and Continuous' for all high impact firms. | Chapter D1: Risk framework<br><br>**Recommended Action: 2.1** |
| **Lesson 19**<br><br>Chapter B4: Close and Continuous supervision | The meaning of 'Close and Continuous', and its benefits and obligations for high impact firms, should be formally communicated to the firms. | Chapter D1: Risk framework<br><br>**Recommended Action: 2.1** |
| **Lesson 20**<br><br>Chapter B5: Emerging business risks<br>Chapter B6: Emerging control risks | There should be an on-going assessment of all ARROW core risk areas (business risks and controls). | Chapter D1: Risk framework<br><br>**Recommended Actions: 3.1, 5.1** |
| **Lesson 21**<br><br>Chapter B6: Emerging control risks | In assessing the composition of the boards of high impact firms, supervisors should assess each member (individually and in concert with the others) and take account of longevity of service, in particular if the business profile of the firm is changing. | Northern Rock specific |

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|---|---|---|
| **Lesson 22**<br><br>Chapter B6: Emerging control risks | Supervisors should assess the size and competence of the firms' executive team alongside the business plan to ensure that there is no undue management stretch, nor undue reliance on external advisors or specialists. | Chapter D2: Stress testing<br>Chapter D4: Firms' governance and management<br><br>**Recommended Actions: 1.2, 2.8, 2.10** |
| **Lesson 23**<br><br>Chapter B6: Emerging control risks | Supervisors should be alert to the effect of dominant or aggressive individuals among the executive of high impact firms and this should be elevated as a concern both within the FSA and to the firm until there is satisfaction about the mitigation and its on-going effectiveness. | Chapter D4: Firms' governance and management<br><br>**Recommended Actions: 2.8, 2.9** |
| **Lesson 24**<br><br>Chapter B7: Capital, liquidity and stress testing | Supervisors should factor into their general assessment of a firm learning points which arise outside the Risk Mitigation Programme – for example, through special project exercises, e.g. Basel, assessing a firm for suitability to operate a trading book, thematic work, etc. | Chapter D1: Risk framework<br><br>**Recommended Action: 2.3** |
| **Lesson 25**<br><br>Chapter B7: Capital, liquidity and stress testing | All breaches of high impact firms' capital and liquidity requirements should be reported to FMC. | Chapter D1: Risk framework<br>Chapter D5: Intelligence and information flows<br><br>**Recommended Actions: 2.4, 4.3** |
| **Lesson 26**<br><br>Chapter B7: Capital, liquidity and stress testing | As part of the prudential supervision element of the ARROW process, assessment of high impact deposit-takers' and investment firms' liquidity – including monitoring effective compliance with requirements – should be re-prioritised. A minimum level of consideration of liquidity must be maintained. | Chapter D1 Risk framework<br>Chapter D3: Liquidity<br><br>**Recommended Actions: 3.1, 3.2, 6.5** |

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|---|---|---|
| **Lesson 27**<br><br>B7: Capital, liquidity and stress testing | For each high impact firm there should be an analysis of areas where the regulatory returns do not adequately capture the circumstances of the business. In those cases, supervisors should call for relevant MI from their firms on a regular basis and analyse it. | Chapter D1: Risk framework<br>Chapter D7: FSA senior management<br><br>**Recommended Actions: 3.1, 7.1** |
| **Lesson 28**<br><br>B7: Capital, liquidity and stress testing | Arrangements between Major Retail Groups Division and Contact, Revenue and Information Management Department were not effective in ensuring that all regulatory returns were checked. | Chapter D5: Intelligence and information flows<br><br>**Recommended Action: 4.3** |
| **Lesson 29**<br><br>B7: Capital, liquidity and stress testing | More emphasis to stress testing should be given in the supervision of high impact firms. | Chapter D2: Stress testing<br><br>**Recommended Actions: 1.2, 3.6, 6.4** |
| **Lesson 30**<br><br>Chapter B8: Use of intelligence | For high impact firms, internal data sources (such as the Financial Risk Outlook) and external data sources (such as annual report and accounts, results presentat-ions, share prices, debt ratings and analysts' commentaries) can provide an added dimension of knowledge to build the supervisor's understanding of the firm and suggest areas for challenge to the firms. | Chapter D5: Intelligence and information flows<br><br>**Recommended Actions: 4.1, 4.2, 4.6, 5.2** |

| Lessons from wider review work | | |
|---|---|---|
| **Lesson 31** | There is inconsistent use of Interim Risk Manager and Risk Mitigation Programmes. | Chapter D1: Risk framework<br><br>**Recommended Actions: 2.2, 2.4** |
| **Lesson 32** | The FSA should give more consideration to extreme but plausible scenarios on liquidity risk (and on other fundamental risks). | Chapter D3: Liquidity<br><br>**Recommended Action: 3.4** |
| **Lesson 33** | The FSA should improve Handbook material on liquidity risk. | Chapter D3: Liquidity<br><br>**Recommended Actions: 3.3, 3.5, 3.7** |
| **Lesson 34** | Good practice in Retail and Wholesale Management Services Unit Risk teams should be shared. | Chapter D5: Intelligence and information flows<br><br>**Recommended Action: 4.6** |
| **Lesson 35** | Improvements related to Interim Risk Manager and the Watchlist processes should be made. | Chapter D5: Intelligence and information flows<br><br>**Recommended Actions: 2.5, 4.4** |
| **Lesson 36** | Challenge processes for macro-economic environmental scorings should be refined. | Chapter D5: Intelligence and information flows<br><br>**Recommended Action: 4.5** |
| **Lesson 37** | Information sharing culture needs to be emphasised. | Chapter D5: Intelligence and information flows<br><br>**Recommended Action: 4.7** |
| **Lesson 38** | Improvements should be made to the FSA's management of change and contingency planning. | Chapter D6: Supervisory resources<br><br>**Recommended Actions: 6.2, 7.4, 7.5, 7.6** |
| **Lesson 39** | Changes to boost senior management contribution to effective supervision should be made. | Chapter D7: FSA senior management<br><br>**Recommended Actions: 1.1, 7.1, 7.2, 7.3, 7.8** |

# D1 Risk framework

*Conclusions*

- The FSA's firm risk assessment framework incorporates the appropriate risk groups to facilitate effective, risk-based supervision of firms. However, in assessing the core areas, insufficient attention was paid to liquidity. For high impact deposit-takers and investment firms, assessment of liquidity should, in future, always have appropriate priority.

- Information requirements for ARROW Panels improved following the implementation of ARROW II. However, to maximise Panels' ability to provide effective and robust challenge, improvements are required to the depth and quality of information on key areas such as firms' business models, financial indicators and peer comparisons.

- Within our sample, the understanding and application of the Close and Continuous (C&C) relationship was inconsistent both within Major Retail Groups Division (MRGD) and between MRGD and Wholesale Investment Banks Department (WIBD). At times, C&C was cut back and was therefore not a fully effective approach to assess changes in firms' risk profiles. There was also inconsistency in the inclusion or exclusion of issues in Risk Mitigation Programmes (RMPs).

- Within our sample, the IS system, Interim Risk Manager (IRM), was not used consistently within MRGD and between MRGD and WIBD, and often not updated to reflect new issues and data. This was contrary to the understanding of FSA senior management. It followed that, in many cases, IRM was not providing an accurate 'real-time' view of firms' risk profiles, nor generating accurate management information (MI), nor facilitating effective peer comparison.

## 1.1 Introduction

1. This chapter presents our findings and recommended actions on the extent to which the learning points from the Northern Rock events related to risk framework were typical. It looks first at the design of the firm risk assessment model and the application of its core areas of assessment to high impact firms (Section 1.2). It covers the formal risk assessment processes, particularly Panels (Section 1.3). It then reviews RMPs (Section 1.4) and on-going risk assessment, including the C&C approach to supervision (Section 1.5). Finally, it discusses IRM, the IS system designed to support supervisors carrying out risk assessments in ARROW II and to record firms' risk profiles (Section 1.6).

## 1.2 Firm risk assessment framework

*ARROW risk groups*

2. The risk groups from the ARROW firm risk model are contained in the ARROW Theory and Practice Manual (Chapter 4, Section 3.3) and illustrated in the following diagram:

<table>
<tr><th>Environmental</th><th>Business Model</th><th>Controls</th><th colspan="2">Oversight & Governance</th></tr>
<tr><td rowspan="3">Environmental Risk</td><td>Customers, Products & Markets</td><td>Customers Products & Markets Controls</td><td rowspan="3">Control Functions</td><td rowspan="3">Management, Governance & Culture</td></tr>
<tr><td>Business Process</td><td>Financial & Operating Controls</td></tr>
<tr><td>Prudential</td><td>Prudential</td></tr>
<tr><td colspan="2">Business Risks</td><td>Controls</td><td colspan="2">Oversight & Governance</td></tr>
</table>

3. The ARROW manual also lists core areas of assessment (Chapter 4, Section 3.3.9) for different types of firm. These are designed to ensure that, as a minimum, the most important areas are always reviewed. The manual cites those that are relevant for firms covered in this review:

For all firms:

- Control Functions;
- Management, Governance & Culture; and
- Customers, Products & Markets.

In addition, for firms where the FSA undertakes prudential supervision:

- Capital and Liquidity.

4. In our view, the ARROW framework incorporates all relevant key risk areas to facilitate the effective, risk-based supervision of high impact firms.

*Assessment of ARROW core areas*

5. Based on our sample of retail firms, we believe that, of the core areas of assessment, liquidity was generally not being sufficiently assessed. There was one firm in our sample where the supervisory team was proactive at checking liquidity returns regularly and pursuing issues with the firm, including in the ARROW letter. In two of our sample firms, liquidity was overlooked in favour of other areas, notably capital. We believe this was for three principal reasons.

6. First, the analysis by supervisors of regulatory returns, including for liquidity, was consciously de-prioritised The de-prioritisation was partly in anticipation of a computer system, which was to provide automated analysis, but which was not, in the event, introduced. Second, it was due to a lack of resource. Third, due to competing priorities and individuals' workload capacity during the period of the review, supervisors' available time on prudential matters was spent primarily on Basel. Resources are covered in more detail later in this report (see Chapter D6: <u>Supervisory resources</u>).

7. We are aware that Retail senior management started to address the lack of focus on liquidity and a skills gap on this topic in the second half of 2006. To this end, MRGD (and Retail Firms Division) designed and implemented local liquidity training for their staff. For MRGD, this training took place between April and June 2007. Thematic work on liquidity was started but overtaken by the market crisis events (see Chapter D3: <u>Liquidity</u>).

8. Based on our sample of wholesale firms, we observed that liquidity was assessed as a core area. And, outside the formal ARROW risk assessment, time was devoted to liquidity. This was, in part, a consequence of the introduction of the Securities and Exchange Commission's (SEC's) consolidated requirements in this area in 2005. In 2006 WIBD included liquidity as one of the priority risk areas for its firms. This led to thematic work being undertaken by WIBD staff in 2007.

*Desired outcome*

For high impact firms, all appropriate ARROW risk groups are assessed on an on-going basis. For high impact deposit-takers and investment firms, capital and liquidity are given specific focus.

*Recommended action*

HIGH PRIORITY: For high impact firms, there should be an on-going supervisory assessment of all appropriate core ARROW risk areas, including capital. Capital and liquidity should have specific focus for high impact deposit-takers and investment firms and should not, in future, be de-prioritised below a certain level.

In practice, for capital and liquidity, this focus will include:

- applying the prevailing Handbook material;
- checking regulatory returns and analysing changes in data over time;
- considering the appropriateness of the data in the returns to the firm in question and, in light of this, considering what supplementary MI is needed from the firm on a regular basis;
- ensuring that meetings with firms' senior management responsible for capital and liquidity, take place; and
- ensuring that firms have appropriate risk management systems and controls in these areas.

Recommended Action 3.1

## 1.3 Formal ARROW risk assessments

9. For all of our sample firms, we found that the ARROW on-site work, the related Panels and the subsequent communication with the firm led to the supervisory team undertaking a stocktake of the relevant risk groups, with the exception of liquidity for some of the retail sample.

*Formal ARROW risk assessment Panels*

10. During the period reviewed, three of the sample firms, as well as Northern Rock, were assessed using the ARROW I process; two came under ARROW II[1].

11. On Panels, we make two observations from our sample. First, we noted that, even though Panels are an 'executive' (not an 'advisory') body, decisions taken by them were not always carried through by the supervisory teams. This was particularly noteworthy when the decision was, for example, integral to the risk scoring or to the setting of the length of the supervisory period. For example, the Panel decision to lengthen the supervisory period for one firm (from the proposed 24 months to 36 months) was conditional on an interim review occurring after 18 months; this did not happen and we were unable to ascertain the reason why.

12. Second, we observed that, subsequent to ARROW Panels, supervisory periods were extended for some of our sample firms by HoDs (on a case-by-case basis in MRGD, on a Departmental basis in WIBD) which reflected resource constraints rather than changes to the firms' risk profiles (see Chapter D6: Supervisory resources).

*Composition of Panels*

13. For Northern Rock and the sample firms, we reviewed the composition of the relevant Panels to assess whether members had the appropriate background and relevant experience to offer an effective challenge. We found that the composition of the Panels for our sample firms was in line with the prevailing ARROW guidance.

14. However, during this review, concerns about Panel composition and discussion have been expressed to us by several interviewees. Primarily, this has been around inconsistency in the level of scrutiny in the assessment of key areas (notably the core areas of assessment, sub-sector risks and peer comparisons). We understand that this inconsistency arises for two reasons.

15. The first is a timing issue; when constrained for time, apparently only certain core areas are discussed in the Panel meetings.

16. The second relates to the experience of Panel members. We understand that Panels can be composed of members without experience relevant to the particular firm or with limited experience of attending other Panels. Concerns were expressed that Panel

[1] ARROW II was rolled out from March 2006 and all associated changes were implemented by June 2007. The changes made from ARROW I were designed: to more closely align the firm, thematic and internal frameworks within ARROW; to implement better controls over the supervisory process; to help ensure the application of a consistent approach; and to make better use of thematic work and sector intelligence. Also, ARROW II aimed to improve communication to firms.

members were sometimes selected on the basis only of availability, rather than in the light of careful consideration of their areas of experience.

17. Our concern is that such members are less equipped to provide challenge to the supervisory team's conclusions; to identify and raise areas which have been omitted from the Panel pack; and to help ensure that there is consistency of approach in dealing with like issues across firms.

*Specialists on Panels*

18. The ARROW Theory and Practice manual (Chapter 5a(v), Section 4) states that specialists should be invited to Panels if they have been consulted in the planning stage, or involved in the discovery work. We endorse this and conclude that local areas should always consider inviting an appropriate specialist to high impact firm Panels to enhance the challenge provided to the supervisory team and to improve consistency across Panels, and have a robust reason if not including a relevant specialist.

*ARROW Panel packs*

19. We believe that more consistent and comprehensive Panel packs would enable Panel members to provide more effective challenge. For our sample firms that were risk assessed under ARROW I, we do not believe that the Panel members always received sufficient, in-depth and relevant information to provide effective challenge. This was particularly so on one sample firm's business model/strategy and peer analysis. ARROW II includes more peer analysis. However, for high impact firms this should be improved, with the inclusion of more substantive, in-depth comparative financial analysis, the parameters of which would change with the market conditions. This analysis should always cover the business model of the firm in question and its peers.

*Desired outcome*

Effective challenge by a Panel enhances the firm risk assessment process and ensures consistency in the way issues are addressed across high impact firms.

*Recommended actions*

HIGH PRIORITY: For high impact firms, ARROW Panels must consider all relevant core risk areas. For high impact deposit-takers and investment firms, the Panel should particularly probe on capital and liquidity. Panel packs for high impact firms should include more substantive, in-depth comparative financial analysis, the parameters of which would change with market conditions. This analysis should always cover the business model of the firm in question and its peers. **Recommended Action 5.1**

Given that ARROW Panels are executive decision makers (not advisory), Panel recommendations should only be varied with the formal agreement of a director. **Recommended Action 2.6**

ARROW Panels should implement Strategy & Risk Division guidance to have a maximum 24 month supervisory period for high impact firms. Subsequent to the Panel, the period should only be varied with the formal agreement of a director. **Recommended Action 2.7**

### 1.4 Risk Mitigation Programme

20. As explained in Chapter B2: ARROW assessment (Section 2.8), Northern Rock did not have an RMP. We reviewed the content of the RMPs for the sample firms in order to assess whether, when similar issues or risks arose with these firms, they were being captured, tracked and reported consistently using this tool.

21. We drew three conclusions. First, key risks arising between ARROW assessments were being captured on the RMP, communicated to the firm and tracked by both Retail and Wholesale supervisors (for example rapid business growth and business strategy featured on the RMPs for three sample firms). The absence of an RMP for Northern Rock meant that equivalent issues were not being similarly addressed.

22. Second, the RMP acted as a focal point for internal discussion and management information (MI). It enabled others outside the immediate supervisory team (including the HoD) to understand and assess the individual risks and issues – as well as the aggregate picture – of the firm, and compare this with other firms. MI also provided senior management with an overview of outstanding RMP actions. The absence of an RMP led to incomplete MI on Northern Rock.

23. Third, the question whether to introduce an RMP for Northern Rock during the supervisory period became, in our view, a disproportionate hurdle. The supervisory team argued that the 'threat' that an RMP might be introduced gave them useful leverage over Northern Rock in persuading it to address issues as they arose. We believe, however, that the supervisory team took the view, as each issue arose, that it would be disproportionate to introduce an RMP, as it might signal a deterioration or breakdown in the relationship with the firm. This was in contrast to the supervisory approach for other sample firms, where new issues were simply added to an existing RMP.

*Desired outcome*

The RMP is used effectively and consistently to highlight key risks and other issues within firms and monitor progress of their mitigation.

*Recommended actions*

See Chapter D7: FSA senior management – **Recommended Action 7.1**

Across peer high impact firms, similar supervisory issues should be captured in RMPs. This is to maintain a consistent approach to supervision. **Recommended Action 2.2**

Issues not included in the RMP should be monitored and incorporated into an overall view of the firm's risk profile. This requires emerging issues to be entered onto IRM on an on-going basis. **Recommended Action 2.3**

## 1.5 On-going risk assessment

*Definition of Close and Continuous supervision*

24. The ARROW Theory and Practice manual states that C&C aims to 'both fix current problems and, over time, strengthen the way large firms operate to minimise the resource cost of delivering the FSA's statutory objectives for both firms and the FSA'. Strategy & Risk Division (then Finance, Strategy & Risk) agreed this definition with Retail and Wholesale senior management. In practice, C&C involves regular communication with and on-site visits to firms throughout the supervisory period, to supplement the formal ARROW risk assessments.

25. In launching C&C, MRGD produced a document for staff to define what it meant and to explain its rationale. C&C is also covered in the induction programme for staff joining MRGD. In summary, MRGD's definition of the purpose of C&C is to assist in the identification of emerging risks and to re-assess the business risks and the control framework of the firm at regular checkpoints between full ARROW assessments.

26. We asked each supervisor interviewed – and a selection of others – for their view on what C&C was designed to achieve. We collected a number of different definitions from staff in MRGD. These ranged from 'staying close to the firm' to 'testing the supervisor's view of the firm'.

27. We also examined whether, on its introduction, a definition of C&C had been communicated to firms, in order for the FSA's desired outcomes from this approach to be clear. A letter communicating this information was sent to one of the retail firms within our sample but not to others.

28. In WIBD, we did not find a standard departmental definition of the purpose of C&C that had been used during the review period.

*Application of Close and Continuous supervision*

29. We found that the application of C&C in MRGD was not consistent, either by way of frequency of contact, personnel seen or the communication of the programme to the firm. In the Northern Rock case exceptionally, we have not seen a schedule even for internal use.

30. While we accept that a risk-based approach should be used in the application of C&C – which may result in a lower meeting frequency and/or the need to see fewer personnel for some firms – we did expect to see a minimum cycle (possibly quarterly or bi-annually) and a minimum set of personnel to be seen at each point in the cycle. Below such minima, we find it hard to understand how the desired outcome could be achieved from the use of this tool.

31. Despite the differing understanding, supervisors from both the Retail and Wholesale Business Units recognised that C&C was an important part of the overall supervisory framework for high impact firms. In 2005 a standard suite of meetings was agreed for the 'more complex' and the 'less complex' WIBD firms. In accordance with this, C&C schedules were prepared for and communicated to each firm.

32. Notwithstanding this, for the sample firms, C&C was an area of supervision that was squeezed when time or resourcing was tight. For example, the C&C schedule of meetings was cut back for three of the sample firms. We believe that the reduction in C&C meetings pointed to resource capacity and planning issues (see Chapter D6: Supervisory resources).

33. We recognise that inconsistency does not necessarily mean ineffective use of C&C. However, apart from Northern Rock, in our sample, where C&C had been cut back, we observed that it led to a less up-to-date general understanding of the firms' risk profile.

34. We are aware that work has been progressing in both MRGD and WIBD to improve the effectiveness of C&C supervision: MRGD recently completed its own review of the effectiveness of C&C; and in WIBD, a standard purpose for C&C was agreed in February 2008.

*Desired outcome*

The C&C relationship enhances a supervisor's understanding of the key drivers of a firm's sustainability and is a mechanism for maintaining an up-to-date and tested view of a firm's risk profile and control framework.

*Recommended action*

A single C&C approach should be defined and applied to all high impact firms. This should also be consistent across Business Units. It should include the annual review discussion of firms' business/strategic plans. See Chapter D2: Stress testing.

- The C&C approach should include regular meetings with key contacts at firms, although the frequency of meetings may vary between firms and some meetings/contacts may not be applicable for certain firms.

- It should set out the minimum level of engagement to occur; this should only be reduced with the formal agreement of the HoD.

- The purpose of C&C should be clearly defined and communicated to firms, together with a schedule setting out the programme.

- If a pattern emerges of the FSA being first to identify issues in a firm or, if a change in the assessment of the control environment occurs, the C&C relationship should be reappraised.

**Recommended Action 2.1**

*Reviewing firms' risk profiles between formal ARROW risk assessments*

35. We were concerned that issues arising between formal risk assessments were not always triggering a review of the firm's risk profile. An example was one firm's decision to implement a new IT system, which was described by the supervisory team as 'the single

biggest operational risk facing the group'. We could find no evidence of it triggering a review of the firm's risk profile.

36. We recommend a formal review by the HoD of each firm in his or her portfolio once every six months (see Recommended Action 7.1).

## 1.6 Interim Risk Manager

37. IRM, an IS system developed as part of ARROW II, was rolled out from March 2006 in order to provide a 'real-time' framework to record a firm's risk profile and to facilitate effective peer comparisons. It is the main data source from which the majority of firm-specific MI is extracted, including reports for senior management, as well as providing comparative peer data for the ARROW panels. It also generates input for other MI, such as Firms and Markets Committee (FMC) reports and the Watchlist.

38. All senior management interviewed emphasised the importance of IRM being kept up-to-date. Most believed it was being kept up-to-date. However, we found that in many cases it had not been regularly updated since its introduction during 2006[2], contrary to ARROW procedures.

39. On the introduction of IRM, each firm's risk profile was automatically transferred to IRM from the previous system (Risk Assessment Framework). Given that IRM introduced new features (such as the sub-sector analysis and, more latterly, environmental factors), the supervisor was required to review the imported risk profile and scorings for each firm, update them to reflect the impact of the sub-sector issues and then 'confirm' the revised profile. In practice, however, we found that the confirmation had not occurred for one of our sample firms, in addition to Northern Rock.

40. On an on-going basis, supervisors tended to update the system with new issues either when an ARROW assessment or interim stocktake took place or when an FMC report was needed (the significance of FMC reports was such that they were likely to give rise to an RMP action as well). Given the elapsed time between ARROW assessments, the system was not being updated pro-actively as issues arose, as was intended.

41. We were told that WIBD had set its own materiality threshold for updating IRM. This was reviewed with the Wholesale MSU.

*Implications of IRM not being updated*

42. The absence of an up-to-date picture on IRM prevented us from quickly and easily understanding the risk profile, scorings and current issues with most of our sample firms. It would similarly have prevented management from having such understanding. There was also a lack of information on how risks and issues were being mitigated and addressed. We could place reliance on it to provide a complete picture of all identified issues for only one firm within our sample where we observed good practice, with all identified issues being captured, and actions and mitigation being updated on a monthly basis.

[2] However, market events from August 2007 have since generated a significant amount of updating of the information on the system.

43. We are aware that MRGD is already considering how, on an on-going basis, to assess and challenge the information within IRM.

*Desired outcome*

IRM is used consistently across the organisation, in line with the ARROW Theory & Practice manual, to provide a live view of a firm's risk profile and to facilitate effective peer comparison.

*Recommended action*

HIGH PRIORITY: IRM should be updated to reflect issues as they emerge. Principles for updating IRM should be established that are consistent across all supervisory divisions – both in terms of the type of information included and the frequency of update.
**Recommended Action 2.4**

# D2 Stress testing

*Conclusions*

- For the firms within our sample, the main focus of supervisory engagement with stress testing was through Basel work rather than as part of the day to day, including Close and Continuous (C&C), supervision.
- The focus of Basel Pillar 2 work on stress testing was the 1:25 recession scenario rather than more extreme scenarios. There was limited consideration and challenge of extreme but plausible stresses on the sample firms' business models as a whole, and too great a degree of separation of work on stress testing from day to day supervision.

## 2.1 Introduction

1. From the Northern Rock case, and on the basis of the findings from our sample of firms, this chapter makes detailed recommendations on how best to give more emphasis to stress testing in the FSA's supervisory approach. In Section 2.2, it looks first at the standards the FSA is seeking to attain and the means chosen to attain them. In Section 2.3, it then considers how stress testing is handled within supervision.

## 2.2 Standards for stress testing

*Background*

2. In recent years, the FSA has given priority to, and produced a number of initiatives in, the area of firms' stress testing. Requirements on firms to perform stress testing are incorporated in various parts of the Handbook. Its importance was highlighted in the Financial Risk Outlook in 2005, 2006 and 2007. It has been the theme of workshops and conferences with the industry. A Discussion Paper (DP) on the subject, DP 05/2, was published in May 2005, and this was followed by a number of updates (discussed below).

3. As in DP05/2, this report uses the shorthand 'stress testing' to cover both stress testing[1] and scenario analysis[2]. Scenario analyses, as the DP points out, are often used to examine the impact of catastrophic events on a firm's position, and can be developed with varying degrees of depth and precision.

4. The FSA's approach to improving standards of stress testing has been a mixture of some Handbook requirements and some encouragement of good practice, including by stimulating debate and exchanges of view.

[1] 'Stress testing' is, broadly, shifting of the values of individual parameters that affect the financial position of a firm, and determining the effect on that firm's business.
[2] 'Scenario analysis' typically refers to the variation, at the same time, of a wider set of parameters (as the expression of an assumed scenario).

*Handbook material*

5. The Handbook material is founded on Principles 3 and 4, which set out the fundamental obligations on firms to organise and control their affairs responsibly and effectively, and to maintain adequate financial resources. SYSC then imposes a range of requirements on firms' stress testing[3]. GENPRU 1.2.42R sets out the specific obligation on firms to perform stress testing; additional guidance is given in GENPRU 1.2.63G – 1.2.78G. This is supported by the requirements in BIPRU 2.2, which implement the Pillar 2 obligations from Basel.

6. During the period reviewed, there was significant work within the FSA to implement Basel and the related Internal Capital Adequacy Assessment Process (ICAAP) and insurance Individual Capital Adequacy Standards regimes. These substantially increased the focus on the area of stress testing covered in the Handbook requirements.

*Encouraging good practice*

7. Beyond the areas covered in the Handbook material, DP05/2 set out the concept of the 'Comprehensive Approach' as a way of representing the main characteristics of good practice in firms, in order to embed good stress testing principles and practices within their overall risk management frameworks. The six main characteristics of the Comprehensive Approach are:

   - senior management will be able to identify and articulate a firm's risk appetite, and understand the implications of stress events within this context;
   - senior management will take an active part in identifying potential stress scenarios;
   - outputs from stress testing will be communicated to senior management in a comprehensible format;
   - senior management will have an overview of firm-wide risks and stresses and a concept of total risk even where precise aggregation is not possible;
   - senior management will consider formally the implications of stress testing for a firm's strategy or business profile; and
   - IT systems, resources and procedures will allow senior management to identify, quantify and manage efficiently the stresses that affect a group.

8. The follow-up work to DP05/2 included a Feedback Statement in December 2005[4], and a thematic review of stress testing at ten firms in 2006, which led to the issue of a Dear CEO letter[5]. That further work produced a number of key findings, including that:

[3] SYSC 11 includes specific guidance in relation to stress testing for liquidity risk (see Chapter D3: Liquidity).
[4] FSA Feedback Statement 05/2 'Stress Testing: Feedback on DP05/2', December 2005.
[5] FSA Dear CEO letter, 'Stress Testing Thematic Review', October 2006.

- close engagement by senior management resulted in the most effective stress testing practices;

- good practice was observed where firms conducted firm-wide stress tests of scenarios which were plausible, yet under which profitability was seriously challenged, key business planning assumptions were flexed or scope for mitigating action was constrained; but, at some firms within the sample, the firm-wide stresses used were relatively mild;

- communicating results clearly and accessibly to their senior management was important for many firms; and

- good practice entailed using group-wide stress testing and scenario analysis to challenge business planning assumptions.

9. The Dear CEO letter drew out the mildness found in some of the firms' stress-testing, and asked firms' management to take 'severe but plausible' scenarios into account in strategic or risk management decisions.

*Impact of recent market events*

10. The 2006 thematic review did not lead to any change in the balance, established by DP05/2, between what was required by Handbook material and what was encouraged as good practice. Following recent market events (which have extended beyond the period of our review), it is important in our view that the FSA should re-confirm its approach: both whether the Comprehensive Approach remains a complete exposition of the main characteristics of good practice, and the decision not to add to Handbook rules or guidance in this area.

11. One option which should be explored as part of the reconsideration is whether there would be value in conducting a further thematic review, before reaching conclusions about adding further rules or guidance. This would enable the FSA to assess firms' progress since 2006 and make any changes in the light of recent market events. That sequence would also allow time for this review's other recommended actions to be implemented and the further roll-out of Basel work to occur, before those conclusions were drawn.

*Desired outcomes*

Challenge by firms' senior management (as well as by supervisors) contributes to robust stress testing in each firm, and so to the overall robustness of the financial system.

Firms' stress testing practices are consistent with the Handbook and the Comprehensive Approach (or any updated benchmark), and as part of this there is sufficient consideration by firms of extreme stresses.

Handbook material on stress testing that is clear and easily navigable.

*Recommended action*

The FSA should:

- re-confirm the approach to stress testing taken following its 2006 thematic review, including the decision not to add further Handbook rules or guidance; and

- consider the case for amendment of the Handbook to make it easier to understand the body of material on stress testing and how its parts fit together.

Thereafter, it should communicate the results of this to firms (probably in the form of a follow-up Dear CEO letter), setting out what further work the FSA proposes in the area. If appropriate, the communication should make clear the FSA's intention to add further rules and guidance at a later point, in the event that firms' progress in reaching good practice levels is judged insufficient. **Recommended Action 3.6**

### 2.3 Stress testing within supervision

*Impact of Basel work*

12. Our testing of the sample firms revealed that, in the review period, stress testing was mainly discussed as part of Basel/capital requirements work. As a result of this, the discussions were around 1:25 year events, which is the focus of Pillar 2 capital planning stress testing, rather than more 'extreme but plausible' events that may seriously challenge a firm's profitability or some of its key business assumptions.

13. While we recognise that the FSA's approach to stress testing was in the course of development, there was nevertheless an opportunity for Basel Pillar 1 and Pillar 2 related stress testing work to be used as a way into wider stress testing discussions, or to feed into wider supervisory work. In the Northern Rock case, for example, the ICAAP process raised a number of important issues, for example on liquidity. Often (as in that example), the most effective response to the issue raised required a wider consideration than just how it should affect the FSA's use of its capital tools. Basel work was handled generally as a specific project. One consequence appears to have been that there was too great a degree of separation of work on stress testing from day to day supervisory work.

*Close and Continuous supervision*

14. For our sample firms, there were very limited discussions, as part of day to day supervision and C&C meetings, of the vulnerabilities of firms' business plans and the impact that certain stresses or scenarios might have on a firm's overall financial position. C&C meetings did include discussions of firms' strategic plans but those were usually at a high level.

15. For our sample firms the Basel work – focusing on the technical aspects of stress testing, the modelling of specific Pillar 1 and Pillar 2 risks and on capital planning aspects – appears to have crowded out discussion of the wider aspects of the 2006 thematic work and the Comprehensive Approach. Supervisors either did not consider specific follow-up to the October 2006 Dear CEO letter or there was a view, given the Basel work, either that there was little need, or insufficient time, for it. So among our sample of firms, there was only limited progress, in day to day supervision, of aspects of stress testing wider than Basel.

*Sub-sector issue work*

16. A sub-sector risk, 'stress testing and risks to financial stability', was identified and introduced within the Interim Risk Manager system in mid-2006 (the specification of the risk was subsequently updated and modified during the review period). The risk covered some of the wider stress testing issues. Only one supervisory team in our sample included the risk within its firm's Risk Mitigation Programme. Only in the latest versions of their risk assessments was the sub-sector risk added for the other firms in our sample, and in no cases were specific actions defined. These findings are perhaps not surprising, given that we found the usual practice was for sub-sector risks to be considered only at the time of a firm's formal risk assessment (see Chapter D5: Intelligence and information flows). But they are still relevant to the rate of progress on the wider aspects of stress testing.

*Training and information sharing*

17. The limited supervisory engagement on stress testing issues may partly have been explained by the fact that there were few training opportunities on the topic. On the issue of the Dear CEO letter, engagement with supervisors not involved in the thematic review was limited to a single one-hour presentation on the results of the thematic review. The Basel Advanced Pillar 2 training included an element on stress testing and capital planning, but that was not its main focus. While some supervisors benefited from on-the-job training from Risk Review Department (RRD) and Policy specialists involved in their Pillar 1 and Pillar 2 reviews, this addressed the priorities of the Basel work, rather than the wider objectives of the Comprehensive Approach.

18. The most recent initiative to identify and share good practice in firms' stress testing was the joint FSA and Bank of England workshops with a number of firms. These took place roughly quarterly from early in 2007. They were co-chaired by the MRGD Director and attended by representatives from RRD, Strategy & Risk Division, and the Banking and Financial Stability Sector teams. No feedback to supervisors had yet emerged from these workshops (we were told this was because it was felt conclusions

were not yet sufficiently developed), and we found that supervisors were largely unaware they were taking place.

*Summary*

19. There is a need for more effective supervisory engagement with firms across the range of issues on stress testing. In our view, this should be tied in with firms' annual planning schedules, in which (good practice suggests) stress testing should be an integral element. Firms' senior management need, in their review and challenge of their annual business and strategic plans, to ensure that sufficient consideration is given to the impact of extreme but plausible stresses. This is to ensure that they have an overview of their firm-wide risks and an understanding of risk at an aggregate level.

20. On the FSA side, such engagement could serve as a regular formal check point for supervisors to reassess the risk profile of the firm. There should be senior representation – HoD or above – to allow high-level peer comparison of firms' stress testing practices and, specifically, of the extent of firms' senior management engagement in that process.

21. Such a step would require additional training to be developed and rolled out; this should incorporate experiences from the 2006 thematic review, from ICAAP review work and from the joint FSA/Bank workshops on good practice in stress testing.

*Desired outcomes*

Supervisors at every level understand the vulnerabilities of their high impact firms' business models, and are equipped to challenge and review them with appropriate frequency.

*Recommended actions*

HIGH PRIORITY: Supervisors should perform an annual review of the business/strategic plans for each high impact firm. This should take into account the stress testing carried out by the firm, the assumed management actions, and the firm's view of the likeliest scenarios that could threaten its viability. Supervisors should assess the robustness of the firm's plans to maintain adequate financial (capital and liquidity) and other resources. This review should encompass a discussion with the firm, chaired at HoD level or above. Issues arising should feed into the supervisory programme. **Recommended Action 1.2**

Training for supervisors on the FSA's approach to firms' stress testing should be made available as soon as possible and undertaken by staff as a matter of priority. This should enable supervisors to engage effectively with firms to provide challenge on the robustness of their stress testing practices. **Recommended Action 6.4**

# D3 Liquidity

*Conclusions*

- In the period under review, liquidity risk did not receive sufficient emphasis. This was seen in various aspects of the FSA's regulation: in risk identification; in supervision itself; and in Handbook development. Greater emphasis needs to be given to liquidity risk both in immediate steps and in developing the FSA's approach.
- The FSA should as a priority develop clear timetables for making changes to the Handbook material on liquidity, both on the qualitative side where fast-track implementation should be achievable, and on the quantitative material where there may be a need to co-ordinate progress with the Bank of England.

## 3.1 Introduction

1. A central lesson from the Northern Rock case is that the assessment of liquidity risk issues needs to be given greater priority and, for high impact deposit-takers and investment firms, must not be allowed to fall below the minimum level (described in Recommended Action 3.1). This chapter develops our findings and recommended actions on liquidity risk in three areas: the significance given to liquidity in the FSA's regulation in general (Section 3.2); supervisory engagement (Section 3.3); and improving the Handbook material (Section 3.4).

## 3.2 Significance given to liquidity in the FSA's regulation

2. We found that, in the period under review, across the various aspects of the FSA's regulation, insufficient weight was given by the FSA to liquidity risks in firms. This was more striking in the first part of the period. From the second half of 2006, the Major Retail Groups (MRGD) and Wholesale Firms Division Directors worked together to increase the attention given to liquidity risk. This led, for example, to the development of training for supervisors and thematic work on liquidity risk (which provided an example of the value of comparative work in the area).

3. The priority given to making progress with the implementation of the Basel capital reforms affected the attention given to liquidity. In prudential policy development, the capital accord had priority for most of the period. The Discussion Paper (DP) on liquidity published in December 2007[1] noted that the FSA had begun its current review of liquidity standards for deposit-takers at the start of that year. This followed a period from about the end of 2004 when domestic moves towards liquidity reform were de-prioritised and progress sought only via the track of international work, which has historically been slow.

4. The low prioritisation reflected the house view on the risk. The likelihood of a deposit-taker or other firm suffering a significant liquidity risk problem was seen as relatively low. Despite the indications that Basel 2 would have an effect on capital, the robustness,

[1] DP 07/7, 'Review of the liquidity requirements for banks and building societies' (December 2007).

specifically, of major deposit-takers' capital positions seems to have led to a sanguine view of the probability of any risk crystallising that would seriously threaten the viability of a firm. For the retail firms in our sample, the combination of the FSA's liquidity risk identification, including that by the relevant sector teams, and on-going supervision were not sufficiently effective as mitigants for the level of risk. Chapter D5: Intelligence and information flows covers the relatively low significance given to liquidity risks, particularly those towards the extreme but plausible end of the risk spectrum.

*Desired outcome*

As a risk-based regulator, the FSA gives proportionate consideration to liquidity risk as a significant risk incurred by deposit-takers and other high impact firms for which it is relevant.

*Recommended action*

The FSA should give more consideration to extreme but plausible scenarios on liquidity risk (and on other fundamental risks). **Recommended Action 3.4**

### 3.3 Supervision of firms' liquidity risk

5. The value of good preparation for the eventuality of a liquidity stress is widely accepted. In our judgement, the supervisors of two of the retail firms in our sample did not give it sufficient emphasis in risk assessments in the review period; that element of supervision was below expected practice. One main reason, as discussed above, was that in the prudential area attention and resource was taken by Basel/capital issues. There was, nevertheless, an example of good practice, where for one retail firm the supervisory team exercised its judgement in raising the priority of firm-specific liquidity issues. (As mentioned in Chapter D1: Risk Framework, liquidity was assessed as a core area in our sample of wholesale firms.)

*Monitoring compliance with qualitative Handbook material*

6. New 'qualitative' rules and guidance for liquidity risk – that is material relating to the systems and controls that firms should have to manage their liquidity risk – took effect in the FSA's Handbook in December 2004. This material included requirements to carry out stress testing and scenario analysis[2] in relation to liquidity risk, outlining that a firm should consider scenarios of varying degrees of stress, and covering both firm-specific and market-wide difficulties. It required a firm to have a contingency funding plan (CFP) covering how the firm would maintain sufficient liquidity should any of the stresses considered materialise.

7. The specific material on liquidity risk systems and controls was set out, on implementation, in PRU 5.1, and subsequently in SYSC 11; the main requirements on

[2] As in Chapter D2, the term 'stress testing' is used throughout the rest of this chapter to cover both stress testing and scenario analysis.

which that material is dependent are in GENPRU 1.2 – in particular, the requirement to carry out stress tests for each major source of risk (in GENPRU 1.2.42R).

8. Following its introduction, supervisory teams' monitoring of compliance with the new Handbook material was variable within our sample. We saw limited evidence of assessment, individually or comparatively, of the adequacy of scenarios used by firms or investigation of the plausibility of their CFPs. This included, for example, considering the effect of off balance sheet vehicles in the event of stresses crystallising.

9. We observed that arrangements accompanying the implementation of the material did not appear to have been fully effective. Both the availability of training and its take-up seem to have been limited. When there were moves to increase the attention given to liquidity issues from the second half of 2006, we note that an immediate need identified was to provide training for supervisors.

*Monitoring compliance with quantitative Handbook material*

10. During the period under review, there were accepted limitations to the FSA's prevailing quantitative frameworks for liquidity risk – that is the Handbook material setting limits on the extent of liquidity risk a firm may assume. In particular, the FSA had acknowledged a number of limitations with the Sterling Stock Regime (SSR), introduced in 1996, including in its October 2003 Discussion Paper, DP24 'Liquidity risk in the Integrated Prudential sourcebook: a quantitative framework'. For example, the regime did not reflect off balance sheet items. Guidance in the Handbook itself suggested that, given another major limitation of the SSR – that it covered only sterling assets and liabilities – supervisors might consider monitoring the risk arising from the foreign currency business of 'SSR banks' using the main alternative, the Mismatch framework.

11. Because of these limitations, supervisory judgement needed to be exercised in the application of the SSR. For some of our sample firms, that need was not met. The SSR was designed for major UK-incorporated retail banks. For those in our sample where there was a greater dependence on wholesale funding, the question of whether it was the appropriate regime to apply was either not raised at all or not in a timely fashion. Where there seemed to be a case for doing so, we observed that no framework was put in place for the monitoring of the currency elements of firms' business, using either the Mismatch framework or firms' management information (MI) as a means.

12. So, the limitations of the regime meant that, for SSR banks, there was a particular reason to consider a variety of information sources on liquidity risk, including firms' own MI and supervisory reporting forms. While we saw evidence that these were effectively used for some of our sample firms, in at least one case (apart from Northern Rock) they seem not to have been used at all.

13. Given that the limitations recognised in the SSR applied to most high impact deposit-takers, and the decision in autumn 2004 not to proceed with the ideas in DP24 for the reform of the quantitative framework, we consider there was additional reason for effective and early monitoring of compliance with the new qualitative material, for SSR banks.

14. In addition, it transpired that, between the Contact, Revenue and Information Management Department (CRIM) and MRGD, some liquidity returns submitted by a number of firms were not checked for breaches throughout the period (See Chapter D5: Intelligence and information flows).

*Desired outcomes*

Supervisors give appropriate consideration to the liquidity risk incurred by all high impact firms and their management of that risk, reflecting the nature, scale and complexity of their business.

Firms comply with Handbook material, and that compliance is assessed and monitored effectively by supervisors.

*Recommended actions*

See Chapter D1: Risk framework – **Recommended Action 3.1**

See Chapter D5: Intelligence and information flows – **Recommended Action 4.3**

At the earliest opportunity, the FSA should confirm firms' effective compliance with existing Handbook liquidity risk material, qualitative and quantitative. In particular, the FSA should ensure that:

- in relation to the qualitative material, each firm is considering a range of scenarios of different severity, both firm-specific and market-wide, and has a plausible CFP; and

- in relation to banks subject to the SSR, there is proper assessment of foreign currency aspects of a firm's liquidity and consideration of the appropriateness of the SSR.

**Recommended Action 3.2**

The FSA should ensure that any necessary training for supervisors in the area of liquidity risk has been made available as soon as possible and undertaken by staff as a matter of priority. **Recommended Action 6.5**

### 3.4 Amendment of Handbook material

15. As noted above, at the start of 2007 the FSA began its current review of the Handbook material on liquidity risk for banks and building societies. This led to the publication of DP07/7 in December 2007. The case for reform of the quantitative material has been acknowledged for a number of years. Our review supports the case for this initiative. From the perspective of our review work, we offer a number of brief comments and recommended actions, both on the directions taken so far and on processes related to amending the Handbook more generally.

*Timescale for work*

16. DP 07/7 gave limited detail on the timetable envisaged for amendments to the Handbook material, saying only that the FSA would produce more definite proposals during the summer of 2008. We understand that, internally, the policy team is working to a challenging schedule, but there are a number of potentially complicating factors. These include the general preference, if possible, to develop the FSA's approach in line with any directions on liquidity emerging in international fora.

17. We understand that, on the qualitative side, timetable co-ordination with developments internationally may be possible. For the quantitative material, however, there is an emerging view in the FSA that, if changes are to be effected in the short term, they may need to be pursued unilaterally.

18. Another factor may be the interdependencies with the Bank of England's arrangements regarding its market operations, and any changes to those arrangements. In deciding the quantitative framework, the FSA needs to take account of the central bank's arrangements. Our understanding is that the FSA's approach to liquidity during the review period reflected a presumption that, in the event of a crisis like that experienced in August 2007, general market liquidity provided by the Bank of England would be increased and, *in extremis*, liquidity would be provided for systemically important institutions. So, in reforming the quantitative framework, there will be a continuing need to co-ordinate with the Bank on the coherence of the two sets of arrangements. An acceptable timetable for that reform needs to be maintained.

*Qualitative material*

19. The qualitative material, as implemented in December 2004, included guidance covering each of the principles for firms laid out in the Basel Committee's 'Sound Practices for Managing Liquidity in Banking Organisations' (February 2000). In January 2007, when the relevant part of the Handbook was restructured and the bulk of this material placed in SYSC 11, parts of that guidance material were deleted. For example, material on managing market access (including counterparty relationships) was cut (previously in PRU 5.1.82 and following). The importance of managing counterparty relationships was re-emphasised in DP 07/7 (in paragraph 4.26 and following). We consider there is a need for processes to ensure proper consideration of the reasons behind existing material, before it is removed from the Handbook.

*Quantitative material*

20. DP07/7 was deliberately not very detailed nor specific in its proposals for amended quantitative material. It set out limited objectives: 'to set the scene for a constructive dialogue' (paragraph 1.2), and 'to review some of the lessons to be learned from the recent market turbulence and set out preliminary ideas for reform' (paragraph 1.8).

21. So while giving the preliminary view, for example, that the FSA should prescribe the stress factors to be applied in the short (one-week) horizon of the envisaged quantitative test, the DP said relatively little about the sort of stress scenario that test would be designed to approximate. Some elements central to producing the new framework were, however, suggested. In particular, the DP proposed that the risk appetite to be translated

into the stresses used in the quantitative requirements should not be different from that underpinning the capital adequacy regime – that is equivalent to a 1 in 200, or greater, chance of a firm becoming insolvent in the following year (DP07/7, paragraph 6.6 and following). There was little further detail, however, of how to achieve this equivalence to a probability of insolvency in the case of a liquidity problem.

*Desired outcomes*

There is a well-balanced use of available tools to address liquidity risk – notably between what is in rules and guidance, and what is covered in supervisory practice rather than included in the Handbook.

Rules and guidance in the Handbook are well-balanced between qualitative and quantitative material and, overall, proportionate to the significance of the risks in the area.

*Recommended actions*

HIGH PRIORITY: The FSA should as a priority develop clear timetables for the implementation of changes to the qualitative and quantitative Handbook material on liquidity. Changes to the qualitative material are likely to build on existing material, and so should permit early implementation. **Recommended Action 3.5**

In relation to liquidity, more detail should be provided to firms:

- to explain the linkage between the level of stress to which the quantitative framework is designed to test a firm's resilience, and the FSA's risk appetite; and

- to explain the relationship between the proposed quantitative framework (in which firms would be required to hold liquidity sufficient to cover the test's implicit level of stress), and the qualitative material, particularly the requirement to have a contingency funding plan covering the preservation of a liquid position in extreme stresses.

**Recommended Action 3.3**

In the development of Handbook material generally:

- when changes (particularly deletions) are proposed, policy divisions should operate appropriate controls to ensure there is adequate investigation of the reasons why the existing material was previously included; and

- the development cycle should include a timely post-implementation review of significant new material to test whether firms have put effective arrangements in place and to check the effectiveness of FSA arrangements to monitor firms' progress.

**Recommended Action 3.7**

# D4 Firms' governance and management

*Conclusions*

- Supervisors generally had good engagement with firms over the effectiveness of their governance arrangements.
- The level of challenge provided to firms by the FSA regarding the competence or behaviours of their management could have been stronger.

## 4.1 Introduction

1. The supervisory assessment of governance and management competence within firms is fundamental to the FSA's risk framework. The formal requirements are set out in the FSA's Handbook High Level Standards: Senior Management Arrangements, Systems and Controls (SYSC).

2. In this chapter, Section 4.2 sets out our findings on the FSA's approach to assessing governance arrangements in firms. Section 4.3 looks at the FSA's assessment of a firm's management competence, and Section 4.4 considers firms' interaction with the FSA.

## 4.2 Firms' governance arrangements

3. Governance should be assessed regularly through all contact with the firm. This includes evaluating the effectiveness of the board, both as individuals and in aggregate; committee structures; roles, responsibilities and reporting lines; and high-level systems and controls.

4. In our sample, some supervisory teams carried out regular Close and Continuous (C&C) meetings to assess changes to governance and the effectiveness of associated controls, and to review any related outstanding risk mitigation actions. This was effective use of the C&C approach.

5. Outside C&C supervision, the FSA has contact with firms in a number of ways. In the review period, this included substantial Basel work, which involved an assessment of firms' governance, especially around the boards' understanding.

6. Engagement with the external auditors can provide a further view of governance within a firm. We saw examples of annual meetings with external auditors but the Management Letter was not routinely received by all supervisors.

7. Our testing showed that, as part of C&C supervision, Internal Audit reports were received and reviewed by supervisors of all firms in our sample. We also observed good practice of annual meetings with chairs of Audit Committees.

8. Where we discovered that supervisors had identified weaknesses within a firm's governance arrangements within two of our sample firms, these weaknesses had been suitably addressed. This was through use of Risk Mitigation Programmes, other regulatory tools and sufficient challenge to the firms. We also note here one of our main recommended actions for supervisors to perform an annual review of high impact firms' business/strategic plans. We believe this will provide a further way of testing firms' governance arrangements.

9. Overall, we conclude that supervisors generally had good engagement with firms over the effectiveness of their governance arrangement. However, we make one Recommended Action, to strengthen the level of contact with external auditors.

*Desired outcome*

Firms' governance arrangements are sufficiently understood, and are subjected to robust scrutiny and challenge. Weaknesses with firms' governance arrangements are addressed in a timely manner.

*Recommended actions*

See Chapter D2: Stress testing – **Recommended Action 1.2**

Supervisors of high impact firms should meet the firms' external auditors at least once a year. **Recommended Action 2.10**

## 4.3 Assessment of competence of firms' management

10. The supervisory assessment of management competence within firms is fundamental to the FSA's risk framework. This assessment has become even more important as the FSA seeks to embed More Principles Based Regulation (MPBR). Central to MPBR is giving firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes the FSA has specified. The extent to which the FSA can place reliance on senior management will inform its view of the firm's risk profile, and the way it interacts with the firm.

11. The competence of senior management is formally assessed through the Approved Persons' process. A key consideration for assessing a person's fitness and propriety is the 'competence and capability'[1] of the person to perform a particular controlled function. However, this process considers each person individually; it is the responsibility of the supervisor to consider and assess the overall balance of skills on the executive/senior management team.

[1] Other criteria are 'honesty, integrity and reputation' and 'financial soundness'.

12. We acknowledge that an initiative has very recently begun to improve the FSA's scrutiny of those holding 'significant influence functions'; we have not evaluated these proposals as part of this review.

*Identification of issues*

13. Supervisors assess management competence through contact with management itself and in the light of firms' activities. In addition, they hold meetings with independent parties such as the chair of the Audit Committee, non-executive directors and the head of Internal Audit function. Intelligence may also come from the firm's external auditors or from other external sources such as market reports, other regulators, complaints and any whistleblowers. In order to maintain a well informed view, regular contact with all relevant parties is essential, as is a reasonable level of continuity within the supervisory team. In one of the firms reviewed, we found that the assessment of the firm's management was weakened due to high turnover of supervisory staff.

14. For Northern Rock and our sample firms, we found some examples where supervisors had identified weaknesses in firms' management. In one of our sample firms, there was uncertainty about the competence of staff within a key control area. Initially the supervision team agreed to monitor the issue for a period rather than escalate immediately with the firm. They were ultimately satisfied that the individuals met the demands of their roles.

*Escalation of issues*

15. Once an area of potential weakness in the competence of a firm's management has been identified, the supervisory team is responsible for taking this forward. This involves supervisors judging whether to raise the concern with the firm themselves or to escalate the issue within the FSA, for advice or for a more senior person to lead.

16. We saw examples where supervisors, having identified weaknesses or having had doubts about the competence or behaviours of a firm's management, had pursued these with the firm.

### 4.4 Firms' interaction with the FSA

17. In two of our sample firms, we discovered an unwillingness of the firm to engage with associate level staff within the FSA. In the cases identified, we felt that more could have been done to challenge the firms' behaviour. However, we also recognise the frustration that some of the firms felt given that they experienced a turnover of staff at manager level and/or periods of manager vacancy due to the 'Reg E' process. This was exacerbated by turnover at HoD level.

18. We concluded that the level and adequacy of challenge provided to firms by the FSA regarding the competence or behaviours of some firms' management was mixed.

*Desired outcome*

Firms' management are subjected to robust challenge. Weaknesses in management competence within firms, and issues that impact on the effectiveness of the supervisory relationship, are addressed in a timely manner.

*Recommended actions*

Where weaknesses, or potential weaknesses, are identified in the competence or behaviour of firms' management, these concerns should be discussed by supervisors with the firm (or escalated to the board as appropriate). **Recommended Action 2.8**

Any reluctance of firms to engage with particular FSA staff, or any lack of openness of the firm in the supervisory relationship, should be challenged. **Recommended Action 2.9**

# D5 Intelligence and information flows

*Conclusions*

- Based on the work of this review, there were significant weaknesses in the effective flow of information between, and use of intelligence by, different parts of the FSA.
- None of the teams reviewed (supervisors, Sector teams, Local Sector Leads (LSLs) or Management Services Unit (MSU) Risk Teams) understood its role to include identifying outlier firms from peer analysis of business models.
- Inconsistent and sometimes poor use was made of available market data, such as analysts' and credit ratings reports.
- The sub-sector issues process for handling risks and provoking supervisory action was not responsive to new risks.
- The risks identified in the Financial Risk Outlook (FRO) were not effectively 'operationalised'.

### 5.1 Introduction

1. This chapter presents our general findings on intelligence linkages, as a result of a number of interviews with key participants in intelligence gathering, sharing and use including: the supervisory teams for the sample firms covered by the review; the Sector teams; MSU Risk teams; and a number of the Local Sector Leads (who acted as the principal conduit between supervisors and Sector teams).

2. Section 5.2 brings out a number of findings related to the interlocking set of current roles and responsibilities in the intelligence area; Section 5.3 recommends a development of the FSA's current structure as a result. Section 5.4 presents findings and recommended actions in relation to a number of the mechanisms for sharing intelligence. Section 5.5 touches on cultural issues.

### 5.2 Current roles and responsibilities

*Sectors*

3. We found that the different Sector teams had the same set of objectives in broad terms but pursued them in different ways. There seemed to be a general perception that Sector teams focused predominantly on their external stakeholder relationship management objective. Handling risks through the sub-sector issues process in Interim Risk Manager (IRM) was also a significant part of their remit but, as set out in Section 5.4 of this chapter, this process was not highly responsive to new risks and was used to varying degrees by supervisors.

4. The Sector teams that have high impact firms within their remit (Banking, Insurance and Capital Markets) all understood their role to include work on typical sub-sector business models. But none believed it to include identifying outlier firms[1] or had that included explicitly in its objectives. Neither did the MSUs nor supervisory staff interviewed consider themselves responsible for taking the lead role in outlier firm identification. The resulting situation, where no team or individual within the FSA had the objective or resource to identify outlier firms based on financial analysis or any non-ARROW generated metric, meant there was a gap in the intelligence available to supervisors.

5. The location and function of research capability within the FSA was covered in a first ExCo paper in August 2005 and a subsequent one in October 2005. In summary, this work was designed to reallocate resource from the centre (Strategy and Risk Division (S&R), then known as Finance, Strategy & Risk Division) to the Sector teams. The reallocation was based on the objective of allowing the FSA to produce more forward-looking and in-depth research, and the need for collaboration and increased focus on research within Sector teams was also stressed. It was not clear from the evidence collected for this review that the overall objectives of the ExCo papers were followed through.

6. We believe that the 'forward-looking and in-depth research', which was an objective of the ExCo papers, should have led to a model where, for deposit-takers, the Banking Sector team was conducting peer analysis of business models and key indicators of performance or risk.

7. As part of the rolling programme for Sector teams to engage directly with ExCo, the Banking Sector's work programme was presented to ExCo in March 2007. This identified issues such as the margin pressure on UK banks. The Sector team did not identify outlying firms in this regard as it did not consider this was its responsibility, and this approach was not challenged. The presentation did include a slide entitled 'Mitigation' in which the first item was '1. Prudential – preparing for the storms ahead'; however the minutes do not show any discussion on this point.

*Local Sector Leads*

8. The Sector teams normally had relationships with supervisors primarily focused through a Local Sector Lead (LSL), designed to act as a conduit between the two. The LSL staff would be staff from within the supervisory division. The quality of the relationship between Sector teams and supervisors, throughout the LSL, varied and depended on the individuals involved.

9. The LSL role was better defined and resourced in some Sectors (for example Insurance) than in others. The model employed differed between divisions, with the Major Retail Groups Division (MRGD) using their banking sector LSL resource in a narrow way relative to the Wholesale Investment Banks Department (WIBD). We consider that the desired state of affairs would have been for Sector teams to absorb the valuable frontline knowledge of supervisors, and feed some of that back to supervisors in aggregated forms; but that does not generally seem to have occurred.

[1] A firm may be an 'outlier', in this sense, as a result of one of various aspects of its business model (for example, its funding) or other feature of its business.

10. The MRGD LSL for the banking sector produced simple analysis and collation of banks' results and share price movements. These were distributed to supervisors and to the Banking Sector team. The work does not appear to have been well used by supervisors and appears to have been considered a low priority as the LSL resource was reduced in February 2007 and then, in August 2007, was reallocated temporarily (because of other priorities resulting from prevailing market conditions).

As the LSL resource was diverted, the disconnection of the Banking Sector from MRGD was exacerbated.

11. In WIBD, the LSL resources were broadly tasked with peer analysis and thematic work, and they tended to lead on some initiatives where the Banking Sector team might have been expected to be the natural lead. This was consistent with the WIBD approach for LSLs and, importantly, it appears to have resulted in good outcomes at least in terms of the local intelligence available within WIBD. This model is developed as part of the basis for Recommended Action 5.2.

*Supervisors*

12. Our work showed that there was no clear mechanism for ensuring that a supervisor received all relevant credit ratings and analysts' reports for their firms. Neither the Sector teams nor the MRGD LSLs collated such information or disseminated it comprehensively during the period covered by this report. Staff in WIBD did use credit ratings and analysts' reports which were centrally collected and distributed.

13. There was confusion about responsibilities in MRGD for obtaining and analysing external information, such as credit ratings or analysts' reports. The view conveyed to us by senior management was that consideration of these was part of the supervisors' role, but this was not recognised by most of the supervisors we interviewed. We were also unsure whether some supervisors would have the necessary skills to review such reports (see Chapter D6: Supervisory resources, Recommended Actions 6.6 and 6.7).

14. We suggest that, in order to address this ambiguity, it is essential that supervisors consider market intelligence as part of their role. This will be additional work for some supervisors where they have not been using this material up to now. They would be assisted by a strengthened sub-sector resource helping to filter some of the material; we elaborate further on this in Recommended Action 5.2.

15. We are aware that MRGD is in the process of setting out associate responsibilities in relation to reviewing external data sources and considering some local training. That initiative may be complementary to Recommended Action 4.2.

16. Another area of responsibilities where there was insufficient clarity for supervisors was the monitoring and checking of regulatory returns. As detailed in Chapter B7: Capital, liquidity and stress testing, it transpired that, between the Contact, Revenue and Information Management (CRIM) Department and MRGD, regulatory returns submitted by a number of firms, including Northern Rock, were not checked for breaches throughout the review period.

*Desired outcomes*

External analysis should be considered by supervisors in order to enhance their knowledge of the firms in relation to market sentiment.

Regulatory returns for a firm and its peers should be easily accessible to supervisors and should be used to input to the on-going assessment of the firms.

*Recommended actions*

Management should clarify supervisors' responsibility in relation to the use of analysts' reports and market data in the supervision of their firms. **Recommended Action 4.2**

A clear, detailed division of roles should be agreed between those responsible for the collection of regulatory returns and those responsible for the supervision of firms. Processes followed between the two should be regularly tested to ensure that they operate as intended. **Recommended Action 4.3**

*Management Service Units*

17. We found that the Wholesale MSU produced significantly more ARROW-based analysis than the Retail MSU. The former's work included comparisons of typical sub-sector business profiles for the different sectors covered by the Business Unit. There was a view expressed to us on a number of occasions by interviewees that the Retail MSU was more focused on process than on analysis.

18. That said, there appeared to be examples of good practice in both MSUs, such as the 'Risk Aggregation Report' on the Wholesale side and the prioritisation of sub-sector issues in Retail. The disparity in approach was quite marked and there did not appear to have been a view that consistent products should be delivered across the two Business Units.

19. The reorganisation of MSUs that is in train will affect the MSU risk staff. This may address some of the disparities identified but we recommend an action here in order for good practice that has developed to be considered as part of the current organisational re-structure work.

*Desired outcome*

Sharing of good practices between Wholesale and Retail.

*Recommended action*

A comparative exercise should be carried out to identify good practice from the Retail and Wholesale Management Services Unit Risk teams so that past good practice can be taken into account going forward. **Recommended Action 4.6**

## 5.3 Achieving clarity on roles and responsibilities

20. It is clear that responsibility needs to be formally assigned to a particular area for identifying outlier firms within a sub-sector, including identifying business model outliers. We have reviewed various possible solutions to achieve this, considering also their contribution to other improvements on intelligence flows. The 'sub-sector resource' model we recommend would build on some previous developments, and support or develop others. Most notably, it draws on elements of the approach that have been developed in practice for investment banks, between WIBD and the Banking Sector. That approach has worked well, and has enabled closer FSA management oversight of, and a more comparative approach to, the department's supervision.

*Desired outcome*

Responsibility for conducting on-going peer/outlier analysis is clearly assigned.

*Recommended action*

HIGH PRIORITY: There should be a clear assignment of the responsibility for peer analysis of firms and for identifying those that are outliers in an aspect of their business or business model. We recommend recruiting additional staff for the development of sub-sector resource, who would be located in the most relevant supervisory department. This resource should have responsibility for identifying outlier firms in its sub-sector. Adoption of the sub-sector resource model could also be used to address a number of other intelligence issues identified in this review. **Recommended Action 5.2**

21. In the rest of this chapter we use the term 'sub-sector resource' to refer to this new function.

*Further detail on recommendation of sub-sector resource*

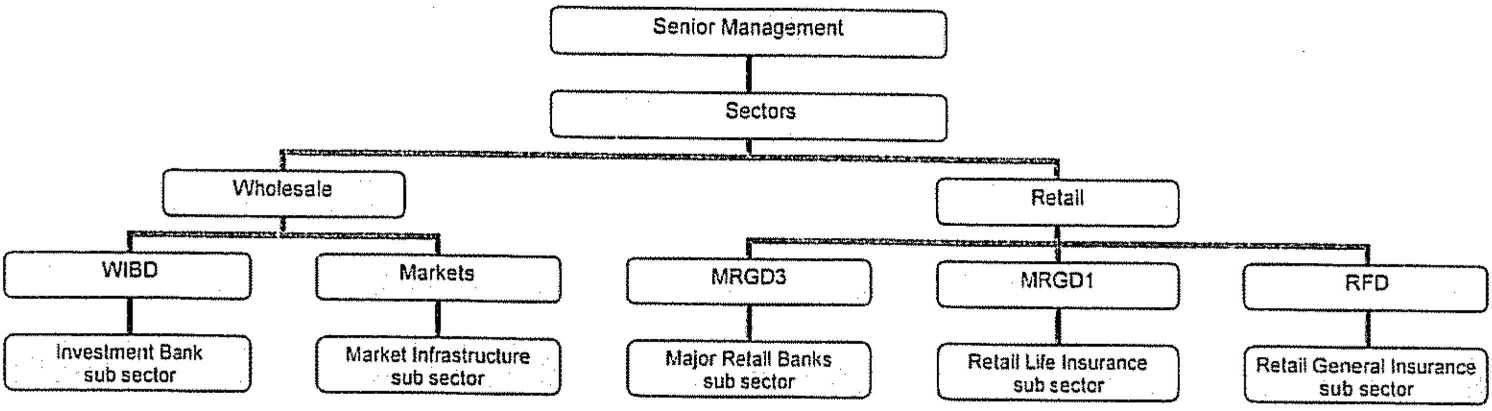
22. As well as having responsibility for the analysis of typical sub-sector business models and the identification of outlier firms, we recommend that the sub-sector resources would also be responsible for leading the risk identification work relevant to their sub-sectors, proposing and developing sub-sector risks, and carrying out other sub-sector research and peer analysis. They would also be available to contribute to projects organised at the overall Sector level. In effect, the model strengthens (and re-brands) the LSL role.

23. The central Sector teams themselves would continue to have responsibility for overseeing overall risk identification and prioritisation for the Sector as a whole, ensuring co-ordination among the sub-sectors, in addition to their existing coherence and representation work.

24. The sub-sector resource would have responsibilities both to its home supervisory department and to the Sector team. Whichever way the reporting lines are established, it is imperative that the sub-sector resource is considered integral to the local supervisory

department, and located with it in order to engender the close working which will be a key success factor.

25. The schematic below, based on an extract of the FSA's organogram, suggests one way in which the relevant sub-sector resources might be allocated among the relevant departments:




*Potential benefits arising from the sub-sector resource model*

26. One important benefit of the sub-sector resource is that it could be used to develop and support a 'more horizontal' emphasis in supervision – greater emphasis on peer comparison and consistency. The closer proximity of the sub-sector resource to the supervisors should also improve the perception among supervisors that the horizontal resource's work is of value to them.

27. Another benefit of this sub-sector solution is that it meshes with developments since the Sector teams were originally set up. In particular, it builds on the sub-sector framework introduced by ARROW II. Some Sector teams have developed their arrangements partly to reflect the sub-sector framework, for example the Insurance Sector's establishment of sub-sector expert groups. And, as mentioned above, our recommended solution reflects how, in practice, the relationship between WIBD and the Banking Sector team has developed, but it enhances this so that the sub-sector resource would also have responsibilities in relation to the minority of firms in other business units – for example WIBD sub-sector staff on investment banking would also cover the wholesale arms of the major retail groups, such as Barclays Capital, which are supervised in MRGD.

28. Work is currently being done in Strategy and Risk Division and in the Banking Sector team to develop a tool to provide 'early warnings' of potential problems with financial soundness in individual firms. Any resulting tool could be employed by this sub-sector resource and may complement the model outlined.

*Potential issues arising from the sub-sector resource model*

29. We recognise a number of possible issues with our proposed sub-sector resource model. It would reduce the responsibilities of the Sector teams, and create a number of small pools of Sector/sub-sector resources. There is a risk that this could lead to fragmentation or lack of coordination.

30. The sub-sector resource would also have to work effectively across Business Units, divisions and departments, as the minority of firms in a sub-sector would not be supervised in the sub-sector teams' home department. Finally, there might be difficulty recruiting and retaining staff with the required expertise in the sub-sector roles, partly as the sub-sector skill-set may be expected to overlap with that of the supervisors but potentially be seen as offering a less clear career path. However the profile of these new roles and the networks that individuals should create in this role as they work across Business Units and potentially have more contact with firms, should help to attract staff.

*Resourcing the sub-sector resource model*

31. It is likely that some of the new sub-sector resource would be at technical specialist level to provide expertise, ability and the clout to challenge and work across supervisory divisions and business units. We estimate a maximum of ten FTE staff, in total, mixed between associate and technical specialist would be needed for these roles. This might be achieved by recruitment, or by some redistribution from Sector teams.

### 5.4 Sharing intelligence

*Watchlist*

32. The Watchlist serves to raise the profile of, and generate more internal challenge on, the supervisory approach for particular firms. The new sub-sector resource should identify outlier firms based on business models. In order to draw attention to firms in this category, there should be a presumption that these firms are added to the Watchlist, subject to supervisors' judgement. This would be in addition to the IRM-generated Watchlist entries. Recommended Action 2.4, that IRM should be updated regularly, will also improve the quality of the Watchlist.

*Desired outcome*

There is a means of escalating, to FSA executive management, firms with outlying business models.

*Recommended action*

In addition to the automated production of Watchlist entries from IRM, the presumption should be that firms identified as having outlying business models, whether through the work of the sub-sector resource or that of supervisors, should be added to the Watchlist. **Recommended Action 2.5**

*ARROW Sub-sector issue mechanism*

33. We found that the sub-sector issue process within ARROW II was based on a Sector team creating a sub-sector issue which, if accepted by Business Unit risk committees, supervisors then imported into the ARROW IS tool, IRM, for their firms. However, risks were not always taken up by each Business Unit risk committee and/or by each individual supervisory team, even when we would have expected them to have been, and as a result the outcomes varied.

34. As noted in Chapter D1: Risk framework, in many cases supervisors within our sample had not been updating IRM on a regular basis. Supervisors tended only to import new sub-sector issues during formal ARROW assessments. As a result of the formal risk assessment frequency (many high impact firms had a supervisory period of 24 months or longer) there was a considerable time lag built into the system. Therefore, the mechanism was not well adapted to handle fast-moving or unfolding events.

35. We reviewed how Sector teams monitored sub-sector issues once they had been put into IRM. We found that the MI available on sub-sector issues was limited and that not all Sector teams had staff capable of extracting the data. Also, the Sector teams did not always have adequate staff resource to consider the detail available.

36. A difficult area for Sector teams to follow up on was the quality of progress made by supervisors in addressing sub-sector risk. We believe it is valuable for a Sector team to consider how many supervisors have taken up a new sub-sector issue for their firm and, in conjunction with this, to identify exceptions where it should have been used. The Sector team role cannot simply be to launch a sub-sector issue without monitoring its progress. Consideration of this valuable intelligence needs to be part of the sub-sector issue work carried out by the Sector teams (or the proposed sub-sector resource).

*Desired outcome*

Sector teams (or the proposed sub-sector resource) should consider the supervisory take-up and progress of sub-sector issues and have access to data that identifies omissions.

*Recommended action*

MI from IRM should be developed to identify exceptions where sub-sector issues are not imported for a firm, so that the Sector teams (or the proposed sub-sector resource) can challenge omissions. The MI development should have regard for ease of use. **Recommended Action 4.4**

*Environmental risks*

37. We found that S&R identified potential dashboard environmental risks which were handed over to the Business Units' risk committees for approval (separately from the Sector risk identification process). But S&R often had no real involvement in the process or notification of whether the risks had been accepted.

38. We discovered that macro-economic environmental scorings in IRM (proposed by S&R) were sometimes altered at supervisors' individual discretion. Whilst it is clear that there can be sub-sector nuances which may require different scorings for environmental issues, it is generally difficult to formulate a justification for supervisors or Business Units altering macro-economic scorings for their individual firms.

39. There is a clear need for challenge of the S&R assumptions but, subsequent to that challenge process, macro-economic environmental scores should not be capable of alteration at the firm level. The potential for a perverse hypothetical outcome such as Wholesale risk committee not accepting an environmental risk score, whilst Retail risk committee does accept the same score, should not be a possible outcome where the environmental risk affects both equally.

*Desired outcome*

Agreed macro-economic scorings should inform supervisors' assessments of their firms.

*Recommended action*

There should be more appropriate challenge processes for macro-economic environmental scorings, through:

- cross Business Unit challenge sessions; and
- exception reports generated when supervisors alter these scorings.

**Recommended Action 4.5**

*Financial Risk Outlook (FRO) and Liquidity*

40. In both 2006 and 2007, a major theme of the FRO was stress testing; and risks to liquidity in various contexts were also discussed. The context was generally of liquidity issues being a potential consequence of other events.

41. The Sector teams were responsible for considering the implications of risks identified by S&R, as set out in the FRO, and how these risks applied to firms within their sector. The Banking Sector team did some work on the impact of a shock (such as a reversion to more normal spreads) leading to illiquidity in newer markets, such as the collateralised debt obligations market, but there was no analysis done of the potential for wider adverse liquidity effects in more established markets.

42. The Banking Sector team did not have liquidity risk in firms as a high priority risk and had not initiated any action on the subject on banks' liquidity although it was a priority in WIBD, partly as a result of overseas regulators' priorities. We noted a widely-held view that firm-level liquidity data from returns was not valuable, and this was part of the justification suggested for the Banking Sector not acting in this area.

43. The Financial Stability Sector team did not identify the extreme possibility of widespread illiquidity having financial stability effects as a priority risk.

44. The extremity of the actual market disruption seen in 2007 was low-probability and generally unanticipated and we do not presume that the Sector teams mentioned above should have been able correctly to foresee the situation that unfolded. There was some work done in advance on wider-ranging wholesale market disruption.

This analysis, arguably, is a good example of forward looking financial analysis/research, that could be carried out within the FSA (See Recommended Action 5.1).

45. The existing sub-sector risk mechanism did not effectively 'operationalise' the priority risks identified in the FRO. We are aware there is work on-going to ensure that the FRO messages flow through to firm-specific and thematic supervision.

*Desired outcome*

FSA priority risks, as identified publicly in the FRO, should be reflected in the FSA's firm-specific and thematic supervisory work and its related supervisory resource allocation.

*Recommended action*

HIGH PRIORITY: A strategy should be developed to ensure the priority risks identified in the FRO are effectively 'operationalised':

- through firm and thematic work that addresses the risks; and
- through strategic consideration of the balance and allocation of resources across the organisation when the FSA changes its view of which risks are highest priority.

**Recommended Action 4.1**

## 5.5 Cultural issues

46. When exploring the cultural aspects of intelligence flows, we discovered evidence, which we consider is worth noting, that some staff behaved defensively or territorially when risks were identified.

47. Firms and Markets Committee (FMC) is one of the key venues for the dissemination of intelligence and acts as a relatively live source for issues to be escalated. We have been told that a note to the FMC in early 2007 led to a defensive and territorial reaction from parts of the FSA who either felt they had ownership of the risk or felt they were the most affected.

48. We were also told by one interviewee that supervisors reacted defensively when they were asked to consider the deteriorating situation in the markets in February/March 2007. Supervisors suggested the issues 'were just a blip' or that their firms were not significantly affected.

49. One of the general findings of this review is that one-way information flows with poor feedback loops are prevalent whereas two-way information conduits were actually the planned model. The LSL role and relationships between the Sector teams and supervisors are examples of where relationships vary but effective two-way information flows have become the exception rather than the norm. In addition, links between supervisors and S&R do not always appear to work well. For example, S&R received limited feedback on macro-economic scorings.

*Desired outcome*

Market and other intelligence enhances the quality of the FSA's supervision.

*Recommended action*

As an important element in developing the FSA's desired culture, alertness to the potential benefits of passing on and receiving intelligence should be reinforced as a principle for all staff behaviour. **Recommended Action 4.7**

# D6 Supervisory resources

*Conclusions*

- The quality of resource devoted to high impact deposit-takers was variable and appropriate training was not always available.
- The quantity of resource devoted to the prudential supervision of high impact deposit-takers is insufficient, if the level of focus on other existing FSA priorities remains as at the time of our review, and the economic environment remains more difficult.
- The absence of effective resource planning in Retail makes it difficult to judge whether it spends the 'right' amount of time on the 'right' things. The absence of good quality management information to assess the results prevents management from making properly informed decisions.

## 6.1 Introduction

1. In this chapter we examine the quality of supervisory resource, including the availability of adequate training (Section 6.2) and the number of staff to see whether there are any indications of excessive stretch on resources (Section 6.3). We also examine the impact of recent structural changes (Section 6.4). Finally, we review the planning and budgeting tools used by senior management to assess and monitor the resourcing requirements for high impact firms (Section 6.5).

## 6.2 Quality of resource

*Skills and experience*

2. When reviewing the quality of resource, we discovered a mixed picture for supervisory staff. This was particularly apparent when we focused on assessing whether staff were knowledgeable and/or experienced in the four key areas that we considered necessary to carry out prudential supervision. These areas were (i) relevant Handbook rules and guidance; (ii) knowledge of markets and sectors; (iii) analysis of financial data, regulatory returns and other key indicators; and (iv) impact and influencing skills.

3. Many staff we interviewed had a good blend of skills and experience, either gained internally or from outside. However, there were others without some of the appropriate skills and knowledge and without any other experience of banking prudential supervision who were assigned to high impact deposit-takers. This was, at times, part of a deliberate strategy to develop staff. In such circumstances, the expectation was that staff would develop quickly, with the lack of experience mitigated by support from others, including their line manager.

4. However, we observed that staff could remain in prudential banking supervisory roles for some time without building up the appropriate level of skills and experience to undertake banking prudential supervision to a satisfactory level. We believe that this

was partly due to workload pressures preventing attendance at training. But, in some cases, we believe that it was due to a lack of appetite to develop the necessary skills coupled with a lack of performance management challenge by line management to ensure that this was addressed.

*Regulatory Curriculum*

5. In order to assess whether the FSA already had the tools in place to address the skill gaps in our four key areas, we undertook a brief review of the Regulatory Curriculum. This was launched in 2005 and does cover the four topics. However, in our view, the training that supports the Regulatory Curriculum was light in three of the four key areas – relevant Handbook rules and guidance, financial analysis and impact and influence. Additionally, some of the courses listed were still not available.

6. This is not to say that there has been a dearth of training for staff. However, the training that has been available has mainly been on processes (for example ARROW, Individual Capital Adequacy Standards) or current FSA themes and initiatives (for example Treating Customers Fairly, Self-invested Personal Pensions). There has been less emphasis on 'business as usual' (such as data analysis or on parts of the regulatory regime that have not changed recently).

7. We acknowledge that work is underway by Corporate Learning to reassess the comprehensiveness and to revitalise both the Regulatory Curriculum and the training that supports it.

*Local training*

8. As a consequence of the gaps in the training available centrally, we understand that divisions have often initiated their own training (instead of using Corporate Learning or working in conjunction with them). Examples here include Major Retail Groups Division (MRGD) and Retail Firms Division (RFD) which both developed and ran their own liquidity training. RFD developed financial training and Small Firms Division (SFD)[1] has developed its own impact and influence training.

9. This approach enabled local staff to develop skills but training was not always relevant (or was too specific) for other areas to take advantage. There were also other implications such as the need to continue to refresh and re-run courses (for example for subsequent new joiners) in order to maintain the level of skills in the division. Likewise, developing and, in some cases, delivering material diverts staff from their core responsibilities although it can be a useful developmental opportunity. There was potential inefficiency due to the increased cost of several areas working on similar projects independently.

[1] Now 'Small Firms and Contact Division'.

*Time in post*

10. We found that high turnover, caused by exits from the FSA or internal moves, has prevented the build-up of experience in banking prudential supervision, including depth of knowledge of both the firms and the market. This was especially acute at manager level, both before and on account of the 'Reg E' process. This is of particular concern given the challenge that the manager should bring both to the supervisory judgements of the associate, and externally to the firms themselves.

11. Conversely, having staff in posts for significant periods of time may lead to an over-familiarity with the firm which, in turn, can lead to a potential lack of alertness to changes, particularly those that are subtle or occur over a period of time. Good practice in this area is illustrated by accountancy practices in which partners rotate every five years in order to mitigate these risks.

**NR and sample firms – turnover of Heads of Department, managers and associates**

| Firm | Number of lead associates during review period | Number of managers during review period | In addition, period of manager vacancy due to Reg E process (in 2007) | Number of Heads of Dept. during review period |
|---|---|---|---|---|
| Northern Rock | 1 | 1 | N | 3 |
| Firm 1 | 4 | 2 | Y | 1 |
| Firm 2 | 1 | 2 | N | 1 |
| Firm 3 | 4 | 3 | Y | 1 |
| Firm 4 | 2 | 2 | Y | 1 |
| Firm 5 | 1 | 2 | Y | 1 |

12. In cases both of high and low turnover of managers and associates, the role of the HoD is key. This is both in staff development and in ensuring the necessary challenge to supervisors' judgements (see Chapter D7: FSA senior management).

*Sector and specialist resource*

13. We reviewed the quality and quantity of resource providing market intelligence, peer data and other analyses to the supervisors and others in Chapter D5: Intelligence and information flows. We concluded that overall the level of resource was not effective in delivering the type of in-depth financial analysis needed for high impact firms.

14. We did not review the quality or quantity of specialist teams such as those within the Risk Review Department (RRD) or within Retail Themes Department (RTD). We did note, however, that considerable use was made of both on large projects (such as Basel and PPI) by the sample firm supervisors.

*Desired outcome*

In order to deliver prudential supervision (see Chapter D1: Risk framework), supervisory associates and managers in the relevant roles should have (or have the ability to secure quickly) a minimum level of skills in (i) relevant Handbook rules and guidance; (ii) knowledge of markets and sectors; (iii) financial analysis and (iv) impact and influencing.

*Recommended actions*

HIGH PRIORITY: The current training arrangements should be significantly enhanced to ensure that staff receive training appropriate for their roles, and that the roles they are assigned match their skills and experience and the training they have received and assimilated. Resource planning in divisions should take account of this.
**Recommended Action 6.6**

Corporate Learning should review the training offering that underpins the Regulatory Curriculum. We believe that, as a matter of priority:

- the training offered in three key areas (namely relevant Handbook rules and guidance, financial analysis and impact and influence) should be improved (in number as well as range of courses); and
- all training listed should be available (or a delivery date for courses under construction specified).

**Recommended Action 6.7**

The presumption of tenure for a supervisory lead associate or manager, for a high impact firm, should be a minimum of two years and a maximum of four years.
**Recommended Action 6.3**

## 6.3 Quantity of resource

*Basel/CRD*

15. The supervisory resourcing situation was pressured by large projects such as Basel. This was exacerbated by the fact that far more effort than anticipated was required, on account of the poor standard of Pillar 1 applications by firms generally, including those within our sample.

16. To address this, some extra supervisory resource was recruited to MRGD and to RRD. For example, within our sample, one team gained an extra person dedicated to Basel work; teams with firms expected to have more straightforward submissions did not. In the event, even submissions by the latter firms needed significant work. The plan was for the extra resource to support all teams but within MRGD we found that not all supervisory teams benefited proportionately.

*Impact on resourcing capacity*

17. We believe that, when set against the priorities, aspects of prudential supervision (such as liquidity and elements of stress testing) were the areas that became squeezed out when capacity became strained. Both the Basel work and formal risk assessments were carried out, albeit after some delays to planned timetables. Contributions to the TCF programme were made where possible. (See Chapter D1: Risk framework.)

*Evidence of resource stretch*

18. We found that resource pressures on the supervision of those sample firms reviewed were, in some cases, excessive. For both the Retail Business Unit and the Wholesale Business Unit, we recognise that significant decisions have been taken to de-prioritise or stop certain work in order to help alleviate this pressure. However, notwithstanding these decisions, there still did not appear to be enough resource available (based on our sample of firms) to spend on the fundamentals of supervision.

19. This was demonstrated by significant supervisory tasks being cut back for our sample of high impact firms. For example, the programme of meetings which made up the regular quarterly or six-monthly Close and Continuous (C&C) contact with the firms was cut back for three of the sample firms. This was despite the consistent recognition by all interviewees that C&C formed an integral part of the FSA's supervision and on-going risk assessment of high impact firms.

20. A further example relates to supervisory periods (i.e. the time between ARROW assessments). As the end of supervisory periods approached, these were extended for two of those in our sample because of a shortage of resources.

21. And finally, there were other important indicators pointing, in some part at least, to a resource capacity issue. These included IRM not being kept up-to-date and notes of key meetings not being written up or being written up some months after the relevant event.

*Effect of priority themes*

22. Perhaps, as a consequence of capacity issues, the priority themes (Basel, TCF) became, in some cases, the main substantive contact with the firms within our sample. This created gaps in the coverage that supervisors achieved. This 'siloed' approach appears to have created an environment whereby supervisors appeared overly focused on the priority in hand, and less likely to stand back and assess what the various issues from each strand added up to in terms of a bigger picture about the firm.

*Desired outcome*

In order to deliver prudential supervision (see Chapter D1: Risk framework), there should be an adequate amount of resource allocated to each high impact firm. Other agreed priorities may continue to be delivered by way of partnership between the supervisors and a specialist team.

*Recommended action*

See Section 6.5: Resource Planning – **Recommended Action 6.1**

## 6.4 Recent structural changes

23. One responsibility of directors and HoDs is to ensure that the structure of their divisions and departments supports effective supervision. Another responsibility is to consider the adequacy of staffing within this structure.

24. In 2007, MRGD and WIBD, the two principal areas with high impact firms, re-organised to introduce a new manager role (Reg E). The introduction of the Reg E role was a major initiative by the FSA to enhance the quality of staff at manager level as part of its move towards a More Principles Based approach. This would entail fewer managers, each with a bigger span of control – both in terms of the number of firms in their portfolio and the number of staff to manage. It was recognised that this would, in turn, result in the lead associate having an expanded role. Appendix 3 illustrates the structure before and after the Reg E process.

*Post-implementation review*

25. Associates and managers from across our sample (including, but not limited to, those in direct supervision roles) have expressed concerns to us about the introduction of Reg E managers' portfolios. Three key points have consistently arisen. First, that the size of the firm portfolios simply will not enable the manager to spend enough time understanding/engaging with each firm. Second, that, in the absence of the manager having enough time for each firm, the lead contact role for the firm will fall to the associate. Third, that the manager will not have sufficient time to focus on coaching and developing his/her staff.

26. It will be important to clarify what the Reg E managers and lead associates are expected to deliver in the new framework. As part of this there should be an assessment of whether the points relayed to the audit team are posing a risk to the success of the delivery of supervisory objectives.

*Operational risk*

27. Any structural change presents heightened operational risk, which should be assessed and, where appropriate, mitigated. In the case of the introduction of Reg E managers, we are aware that an assessment of the operational risk associated with the change

programme occurred within MRGD. When four out of nine[2] Reg E manager positions remained unfilled a contingency plan was put into effect to cover the six-month period until new managers were in place. One of the elements of this plan was that associates covered for Reg E roles and also, for some of the period, on a weekly rota, for the HoD roles. We believe that this created a situation of inadequate coverage for the high impact firms in this division – both in terms of the number of staff supervising the firms, and the seniority of these staff.

*Desired outcome*

The introduction of an enhanced manager role (Reg E) delivers on the benefits as specified (more effective supervision for high impact firms and better coaching and development of staff).

*Recommended actions*

The role of the 'Reg E' manager and consequential impact on the role of the lead associate should be clarified. As part of this, some assessment should be carried out on whether the responsibilities and workloads are manageable both for the Reg E managers and lead associates reporting to them. **Recommended Action 6.2**

The lessons that can be learned from the Reg E change initiative should be applied in future restructuring programmes. **Recommended Action 7.4**

## 6.5 Resource planning

28. Fundamental to achieving organisational objectives is having sufficient resources available to deliver the agreed business strategy. Therefore, it is vital for Directors and HoDs to ensure that resource planning processes are effective, in order to help them evaluate whether the level of resource is adequate. Good MI is then essential to enable management to make appropriate, well-informed decisions and monitor outcomes.

*Budgeting/planning*

29. The FSA's budgeting/planning process showed that MRGD intended to spend 63% of staff time on firm-facing supervision in both 2006/07 and 2007/08. However, we could not easily identify within that 63% the amount of time MRGD expected to spend on key individual activities (for example, reactive supervision, risk assessments, C&C, Basel, TCF). In other words, we did not have a basis on which to judge whether MRGD had considered a planned distribution of staff time. We did not find any other MI to help with this.

30. Within MRGD, there did not appear to have been a full review of how much resource was likely to be needed for the supervision of each high impact firm (such as a 'zero-based budget'). There was a review of manager resource requirements as part of the

[2] One out of four positions remained unfilled for WIBD.

'Reg E' process, but this did not consider the full resource required on a firm-by-firm basis. This was in contrast to WIBD which periodically used a zero-based budget to assess the amount of resource needed for each firm, based on key activities.

31. WIBD's budget has been used as a decision-making tool to determine what to de-prioritise at the departmental level as and when new priorities have arisen. This has created transparent and consistent decision-making and appears to contrast with MRGD where we saw evidence of decisions being made in a case-by-case manner. An example here would be the review of supervisory periods across the board in WIBD (and with clear understanding of how much supervisory resource this would free up) compared to firm-by-firm decisions by the director and/or HoDs and managers in MRGD.

*Contingency planning*

32. We also observed that resource planning or contingency scenario ('stress-testing') exercises were not regularly undertaken by divisions with high impact firms, as part of the FSA's budgeting/planning process. This would assess the implications for the division's workload of a changing economic environment or other one-off event or new issue. We believe that this is why, in the absence of planning around how one might deal with stressed scenarios (such as the recent market turbulence), resource is drawn together at high-speed on a 'who's available/who can be released/best endeavours' basis. If it were better prepared for plausible changes in circumstances, the FSA would be able to respond better and more quickly when situations change.

33. The lack of contingency planning was particularly evident when resource was diverted away from key roles in order to respond to the recent market crisis events. For example, to assist with the increased workload, we are aware that the MRGD Local Sector Lead (LSL) and the Deputy LSL for banking both spent a much reduced amount of time on their roles, even though the local sector role remained important. Robust planning would ensure that the decisions made are optimised, and that consequences are fully appreciated.

*Desired outcome*

Senior management of divisions with high impact firms are able to assess quickly and easily the resource planned for, and spent on, key supervisory priorities, thus enabling them to make transparent and consistent decisions on allocating resource to priorities. Further, they are equipped to respond quickly to, and in advance of, changes in circumstances.

*Recommended actions*

HIGH PRIORITY: A bottom-up approach was used for the FSA's annual plan for 2008/09. This should be developed for future years and a 'zero-based budget' constructed for areas dealing with high impact firms. This should allow senior management to monitor the balance of resource planned against key supervisory activities/priorities for each firm, with subsequent regular MI to check the position. **Recommended Action 6.1**

The FSA should make greater use of tools, such as contingency planning and stress testing, for internal planning. This is to help it understand and deal with scenarios in a considered manner. **Recommended Action 7.5**

To develop FSA thinking on whether and how contingency planning/stress-testing might be helpful, an assessment of the lessons learned from how the FSA has dealt with the current market crisis scenario should be performed. **Recommended Action 7.6**

# D7 FSA senior management

*Conclusions*

- The role of supervisory director is of strategic importance. It is vital that, in the director's input, the correct balance is struck between understanding of and engagement with firms, and time spent on the leadership of the division, including engaging with Heads of Department (HoDs) to agree the supervisory strategies for firms, and monitoring progress.

- The HoDs were not always proactive in ensuring there was a robust process for them to build up a complete picture of issues for each firm in their portfolios. This was the result of competing priorities on other firms and on internal issues, and insufficient engagement with firms assessed as lower probability.

## 7.1 Introduction

1. In this chapter, we focus primarily on directors' and HoDs' involvement with firm supervision (rather than on other aspects of their roles). Section 7.2 focuses on the directors' role, and Section 7.3 on the HoDs'.

## 7.2 Directors' involvement in supervision

2. Directors are responsible for ensuring proper oversight of the supervision of the firms in their area, and for influencing supervisory outcomes including, on significant issues, by direct personal intervention. Fundamental to directors' success in these areas of responsibility is that they lead their senior management teams in ensuring that the structures for the management of supervision are effective, that clear priorities and objectives are set, and that effective mechanisms allow the management team to keep abreast of progress against these objectives.

*Direct involvement with firms*

3. In order for directors to have an overview of the firms in their divisions, a certain amount of their time must be spent on direct firm-facing work. In the case of the Major Retail Groups Division (MRGD), we found that the director on average saw a firm each week, during a sample period reviewed[1]. During the review period as a whole (over the course of which there were two directors of MRGD), records indicate that the MRGD director met Northern Rock once.

4. To enable supervisory directors of high impact firms to give their input to the oversight of their divisions' supervision, in our view it is important for them to see all their firms periodically. They should meet each firm's senior management team, at least once a year, to discuss the firm's key strategic issues.

[1] January 2006 – July 2007.

*Internal management role*

5. In order to fulfil the supervisory oversight role effectively, directors need to ensure they are reliably informed about how well supervision is being delivered 'on the ground'. This requires a timely flow of reliable information from their HoDs and through management information (MI), as well as feedback from contacts with firms. However, the evidence we reviewed suggested that the MI and other information received by directors might not always have kept them sufficiently aware when key processes or common practices were not being implemented effectively. This was the case, in particular, with information from Interim Risk Manager (IRM) (see Chapter D1: Risk framework), and, at a divisional level, with the MI relating to budgeting and planning of resources and its allocation to individual teams (see Chapter D6: Supervisory resources).

6. As far as records management is concerned, in information gathering for our review, we experienced a number of difficulties in finding material on the firms in our sample within records management systems. As mentioned in Part B, a number of Northern Rock meetings were not written up. We also saw other instances, across our sample of firms, of poor filing and inconsistencies between the use of the electronic and paper-based systems. We note that, in the fulfilment of their managerial responsibilities, finding this material would be equally difficult for divisional management. Effective records management is a key element for effective information flow and audit trails within a division.

7. Key to ensuring that divisional objectives are achieved is that the division has effective structures, relevant processes and adequate resources. We have seen some developments in the structures, for example, through the 'Reg E' reorganisation (and comment on these and on resources in Chapter D6: Supervisory resources).

8. Beyond these developments, in the lessons learned from Northern Rock (summarised in Part C of this report), we comment on the desirability of firms being supervised alongside their peers, as far as possible. And in Chapter D5: Intelligence and information flows, we highlight, as one of the benefits of the recommended action to develop a sub-sector resource, that it could be used to support a 'more horizontal' emphasis in supervision.

*Desired outcome*

Supervisory directors, drawing on their knowledge of the firms in their portfolio, shape the strategic direction of their divisions in line with agreed desired outcomes, and ensure reporting and other structures and performance management measures are in place to show how far business objectives are being achieved and supervision is being performed effectively.

*Recommended actions*

Directors responsible for supervising high impact firms should meet the Chief Executive and members of the executive team of each firm at least once a year, to discuss its key strategic issues. The session could be combined with the seeking of feedback from firms on the FSA's supervision (as set out in the relationship management 'Statement of Mutual Expectations' sent to firms in April 2006). **Recommended Action 1.1**

Directors responsible for supervising high impact firms should have mechanisms in place, including MI, to enable them to monitor that the agreed supervisory strategy for each firm is being followed through into effective supervisory actions. **Recommended Action 7.2**

The MRGD director should consider whether there is a case for a divisional reorganisation to facilitate more effective peer comparison in firm supervision. **Recommended Action 5.3**

Directors should have a process and forward plan to ensure that ARROW Panels have the appropriate breadth and balance of skills and experience. **Recommended Action 7.3**

Directors should ensure that their divisions have agreed documented records management standards and that these are complied with. **Recommended Action 7.7**

Supervisors' objectives should be revised and their performance assessed to take account of the findings of this review and the implementation of its recommendations. **Recommended Action 7.8**

### 7.3 Head of Department involvement in supervision

9. The HoD has the prime responsibility for the oversight of supervision, being able to provide a more independent engagement than the team manager, but closer to the detail than the director. The HoD's role is pivotal in ensuring that information flows both upwards, to the director, and downwards, to the supervision teams. In the case of Northern Rock, we saw that the challenge provided by the HoDs in the line management chain was not sufficiently proactive.

*Direct involvement with firms*

10. Although the supervisory manager should provide the first level of challenge to the team, the manager is expected to have a hands-on involvement for high impact firms given the size of his or her portfolio. As a consequence, the HoD's second line of challenge is key. This can be effective only if the HoD concerned has a good understanding of the firms in the department. The HoD is also well placed to add value to the supervision of each individual firm through applying their knowledge of the peer group. However, our fieldwork showed that the HoDs were not always proactive in ensuring there was a robust process for them to build up a complete picture of issues for each firm in their portfolios.

11. An important element for HoDs' understanding of their firms is some direct engagement with the firms. Our testing showed that, on average, MRGD HoDs saw a firm each week, but that they did not see each firm at least once each year. We have proposed an annual meeting to review each firm's business/strategic plans, chaired at HoD level or above (see Chapter D2: Stress testing, Recommended Action 1.2).

*Internal management oversight role*

12. We explored the processes in MRGD for HoDs to review the supervision of firms in their portfolios.

13. Some interviewees suggested to us that firm reviews were conducted by way of MRGD's 'quarterly planning process' (held by the director with each HoD and the departmental managers). We reviewed the material put forward for a selection of these meetings. The quality of firm information presented was variable. We understand that these meetings did not always take place and MRGD senior management described them in any event as a forum for determining whether the department was on track to meet its objectives, rather than for discussing firms' profiles.

14. There were a number of regular meetings at which particular issues in relation to firms were discussed. Within that, the regular sequence of bilateral meetings between HoDs and managers could have been used to ensure that, over time, there was discussion of each firm; that the overall view of a firm was discussed; and that the HoD built up a complete picture of issues on a firm. We did not see evidence, however, that those meetings were always used to achieve those outcomes. The turnover of HoDs exacerbated this problem (along with the gaps in HoD coverage) although, from data provided to us by the Retail MSU, summarised in Appendix 4, it appears that only one other high impact firm supervised by MRGD and Wholesale Investment Banks Department was overseen by three HoDs in the period. In our view, particularly with the incomplete logging of issues on IRM, there was a risk that the HoD did not build up a complete picture of issues, given that their information depended mainly on the issues that the supervisory manager or team escalated.

15. We concluded that there was insufficient formality in MRGD HoDs' oversight of supervision, in particular because they were not proactive about putting in place a robust process to ensure they maintained a complete picture of the issues and held a regular review of supervision, for each firm. . That did not mean that the HoDs did not provided oversight and challenge, but, in particular where there was HoD turnover, a more formal process would have been a useful safeguard.

*Desired outcome*

Effective challenge provided by the HoD fosters the making of robust and consistent supervisory judgements.

*Recommended action*

HIGH PRIORITY: HoDs responsible for supervising high impact firms should formally review the supervision of each firm every six months.

- This review should act as a 'checkpoint' about the FSA's view of the firm, and take stock of the changes since the last formal risk assessment and last HoD review.
- It should cover both progress against the C&C schedule and MI relating to RMP actions.
- If the firm does not have an RMP, this review should assess whether that remains appropriate.
- It should be used as an opportunity to review the quality of MI received from the firm and to assess its continuing appropriateness, in particular as a complement to the standard regulatory returns.
- The review should also be used as a means of assessing manager performance and engagement.

As a result, formal ARROW risk assessments should become more of a stocktake, given more frequent challenge and escalation of issues as part of on-going supervision.

**Recommended Action 7.1**

APPENDIX 1

# E1 Terms of Reference of the review

1. The Chief Executive of the FSA, Hector Sants, has requested a 'lessons learned' review of the supervision of Northern Rock plc. A review team, led by the FSA's Director of Internal Audit, Rosemary Hilary, has been commissioned to deliver a report to the Executive by 31 January 2008 and to the FSA's Board at its meeting dated 28 February 2008.
2. The review will examine the lessons which the FSA should draw from the Northern Rock events and changes these suggest for the FSA's risk-assessment and risk mitigation practices in general. Where aspects of relevant regulatory practice or policy are currently already being reviewed or revised, the internal audit team will take account of that work in reaching its own conclusions.
3. Internal Audit will review the supervisory approach for Northern Rock plc during the period 1 January 2005 to 9 August 2007. In particular it will review whether the FSA's prevailing framework for assessing risk was appropriately applied such that the supervisory strategy, including the Supervisory Period and level of resourcing, was in line with Northern Rock's risk profile. A review of a small sample of other high-impact firms will be included over the same timeframe in order to provide a basis for comparison.
4. Internal Audit will then assess:
   (i) whether in future the FSA's framework for assessing risk should place more importance on liquidity, stress-testing, competence of firms' management and effectiveness of governing arrangements. In assessing this element Internal Audit will take into account the emphasis in the More Principles Based Regulatory approach on outcomes-based regulation;
   (ii) whether the processes or mechanisms for identifying, sharing and responding to internal and external intelligence/emerging risks (that may have firm-specific or sectoral impacts) can be improved; and
   (iii) whether improvements can be made in the adequacy of supervisory resource, both in terms of capacity and skills, devoted to high-impact deposit-takers.
5. The review team will exclude other areas of supervisory focus unless deemed appropriate by work emerging from the review. In framing recommendations for the FSA's Board on 28 February 2008, this internal audit review will not accompany these with a formal cost-benefit analysis.
6. The conclusions of the review will be made public and any changes to the FSA's approach will be communicated and/or be subject to consultation as appropriate.
7. In undertaking this review, the FSA is seeking to achieve the following outcomes:
   (i) to understand whether the application of the supervisory approach for high-impact deposit-taking firms was robust;
   (ii) in light of 7(i), to identify what lessons there are to be learned and to make recommendations that will enhance the supervisory approach going forward;
   (iii) in completing 7(i) and 7(ii), and in committing to publish its conclusions, to demonstrate to FSA's stakeholders (including regulated firms, consumers and staff) an on-going commitment, as an organisation, to continuous improvement.

APPENDIX 2

# E2 Recommendations and actions

The review, in looking at the supervision of Northern Rock and the sample firms, found variations in supervisory practice, including examples of good practice. Overall the supervision of Northern Rock was at the extreme end of the spectrum of supervisory practices observed. The recommendations and actions go further than addressing the principal weaknesses found in the supervision of Northern Rock. They are designed to enhance the FSA's supervision of high impact firms generally.

Although, unless otherwise specified, the recommended actions are designed to apply to the supervision of all high impact firms, it is recognised that many are more generally applicable.

We make seven high level recommendations, and set out under each of these our recommended actions. No dates have been set for these. They will be implemented as part of a programme for which an overall end date and interim deliverable dates will be determined. The actions that we regard as high priority are shown in bold.

The seven high level recommendations are:

- FSA senior management to have increased engagement with high impact firms;
- FSA to increase the rigour of its day to day supervision;
- FSA to increase its focus on prudential supervision, including liquidity and stress testing;
- FSA to improve its use of information and intelligence in its supervision;
- FSA to improve the quality and resourcing of its financial and sectoral analysis;
- FSA to strengthen supervisory resources; and
- FSA senior management to increase the level of oversight of firms' supervision.

## 1. FSA senior management to have increased engagement with high impact firms

1.1 Directors responsible for supervising high impact firms should meet the Chief Executive and members of the executive team of each firm at least once a year, to discuss its key strategic issues. The session could be combined with the seeking of feedback from firms on the FSA's supervision (as set out in the relationship management 'Statement of Mutual Expectations' sent to firms in April 2006).

1.2 **Supervisors should perform an annual review of the business/strategic plans for each high impact firm. This should take into account the stress testing carried out by the firm, the assumed management actions, and the firm's view of the likeliest scenarios that could threaten its viability. Supervisors should assess the robustness of the firm's plans to maintain adequate financial (capital and liquidity) and other resources. This review should encompass a discussion with the firm, chaired at HoD level or above. Issues arising should feed into the supervisory programme.**

APPENDIX 2

## 2. FSA to increase the rigour of its day to day supervision

2.1 A single Close and Continuous (C&C) approach should be defined and applied to all high impact firms. This should also be consistent across Business Units. It should include the annual review discussion of firms' business/strategic plans.

- The C&C approach should include regular meetings with key contacts at firms, although the frequency of meetings may vary between firms and some meetings/contacts may not be applicable for certain firms.
- It should set out the minimum level of engagement to occur; this should only be reduced with the formal agreement of the Head of Department.
- The purpose of C&C should be clearly defined and communicated to firms, together with a schedule setting out the programme.
- If a pattern emerges of the FSA being first to identify issues in a firm, or if a change in the assessment of the control environment occurs, the C&C relationship should be reappraised.

2.2 Across peer high impact firms, similar supervisory issues should be captured in Risk Mitigation Programmes (RMPs). This is to maintain a consistent approach to supervision.

2.3 Issues not included in the RMP should be monitored and incorporated into an overall view of the firm's risk profile. This requires emerging issues to be entered onto Interim Risk Manager on an on-going basis.

2.4 **Interim Risk Manager (IRM) should be updated to reflect issues as they emerge. Principles for updating IRM should be established that are consistent across all supervisory divisions – both in terms of the type of information included and the frequency of update.**

2.5 In addition to the automated production of Watchlist entries from IRM, the presumption should be that firms identified as having outlying business models, whether through the work of the sub-sector resource or that of supervisors, should be added to the Watchlist.

2.6 Given that ARROW Panels are executive decision makers (not advisory), Panel recommendations should only be varied with the formal agreement of a director.

2.7 ARROW Panels should implement Strategy & Risk Division guidance to have a maximum 24 month supervisory period for high impact firms. Subsequent to the Panel, the period should only be varied with the formal agreement of a director.

2.8 Where weaknesses, or potential weaknesses, are identified in the competence or behaviour of firms' management, these concerns should be discussed by supervisors with the firm (or escalated to the board as appropriate).

2.9 Any reluctance of firms to engage with particular FSA staff, or any lack of openness of the firm in the supervisory relationship, should be challenged.

2.10 Supervisors of high impact firms should meet the firms' external auditors at least once a year.

## 3. FSA to increase its focus on prudential supervision, including liquidity and stress testing

3.1 **For high impact firms, there should be an on-going supervisory assessment of all appropriate core ARROW risk areas, including capital. Capital and liquidity should have specific focus for high impact deposit-takers and investment firms and should not, in future, be de-prioritised below a certain level.**

**In practice, for capital and liquidity, this focus will include:**

- **applying the prevailing Handbook material;**
- **checking regulatory returns and analysing changes in data over time;**
- **considering the appropriateness of the data in the returns to the firm in question and, in light of this, considering what supplementary management information is needed from the firm on a regular basis;**
- **ensuring that meetings with firms' senior management responsible for capital and liquidity, take place; and**
- **ensuring that firms have appropriate risk management systems and controls in these areas.**

3.2 At the earliest opportunity, the FSA should confirm firms' effective compliance with existing Handbook liquidity risk material, qualitative and quantitative. In particular, the FSA should ensure that:

- in relation to the qualitative material, each firm is considering a range of scenarios of different severity, both firm-specific and market-wide, and has a plausible Contingency Funding Plan; and
- in relation to banks subject to the Sterling Stock Regime (SSR), there is proper assessment of foreign currency aspects of a firm's liquidity and consideration of the appropriateness of the SSR.

3.3 In relation to liquidity, more detail should be provided to firms:

- to explain the linkage between the level of stress to which the quantitative framework is designed to test a firm's resilience, and the FSA's risk appetite; and

- to explain the relationship between the proposed quantitative framework (in which firms would be required to hold liquidity sufficient to cover the test's implicit level of stress), and the qualitative material, particularly the requirement to have a contingency funding plan covering the preservation of a liquid position in extreme stresses.

3.4 The FSA should give more consideration to extreme but plausible scenarios on liquidity risk (and on other fundamental risks).

3.5 **The FSA should as a priority develop clear timetables for the implementation of changes to the qualitative and quantitative Handbook material on liquidity. Changes to the qualitative material are likely to build on existing material, and so should permit early implementation.**

3.6 The FSA should:

- re-confirm the approach to stress testing taken following its 2006 thematic review, including the decision not to add further Handbook rules or guidance; and

- consider the case for amendment of the Handbook to make it easier to understand the body of material on stress testing and how its parts fit together.

Thereafter, it should communicate the results of this to firms (probably in the form of a follow-up Dear CEO letter), setting out what further work the FSA proposes in the area. If appropriate, the communication should make clear the FSA's intention to add further rules and guidance at a later point, in the event that firms' progress in reaching good practice levels is judged insufficient.

3.7 In the development of Handbook material generally:

- when changes (particularly deletions) are proposed, policy divisions should operate appropriate controls to ensure there is adequate investigation of the reasons why the existing material was previously included; and

- the development cycle should include a timely post-implementation review of significant new material to test whether firms have put effective arrangements in place and to check the effectiveness of FSA arrangements to monitor firms' progress.

## 4. FSA to improve its use of information and intelligence in its supervision

4.1 **A strategy should be developed to ensure the priority risks identified in the Financial Risk Outlook are effectively 'operationalised':**

- **through firm and thematic work that addresses the risks; and**

- **through strategic consideration of the balance and allocation of resources across the organisation when the FSA changes its view of which risks are highest priority.**

4.2 Management should clarify supervisors' responsibility in relation to the use of analysts' reports and market data in the supervision of their firms.

4.3 A clear, detailed division of roles should be agreed between those responsible for the collection of regulatory returns and those responsible for the supervision of firms. Processes followed between the two should be regularly tested to ensure that they operate as intended.

4.4 MI from IRM should be developed to identify exceptions where sub-sector issues are not imported for a firm, so that the Sector teams (or the proposed sub-sector resource) can challenge omissions. The MI development should have regard for ease of use.

4.5 There should be more appropriate challenge processes for macro-economic environmental scorings, through:

- cross Business Unit challenge sessions; and

- exception reports generated when supervisors alter these scorings.

4.6 A comparative exercise should be carried out to identify good practice from the Retail and Wholesale Management Services Unit Risk teams so that past good practice can be taken into account going forward.

4.7 As an important element in developing the FSA's desired culture, alertness to the potential benefits of passing on and receiving intelligence should be reinforced as a principle for all staff behaviour.

## 5. <u>FSA to improve the quality and resourcing of its financial and sectoral analysis</u>

**5.1 For high impact firms, ARROW Panels must consider all relevant core risk areas. For high impact deposit-takers and investment firms, the Panel should particularly probe on capital and liquidity. Panel packs for high impact firms should include more substantive, in-depth comparative financial analysis, the parameters of which would change with market conditions. This analysis should always cover the business model of the firm in question and its peers.**

**5.2 There should be a clear assignment of the responsibility for peer analysis of firms and for identifying those that are outliers in an aspect of their business or business model. We recommend recruiting additional staff for the development of sub-sector resource, who would be located in the most relevant supervisory department. This resource should have responsibility for identifying outlier firms in its sub-sector. Adoption of the sub-sector resource model could also be used to address a number of other intelligence issues identified in this review.**

5.3 The Major Retail Groups Division director should consider whether there is a case for a divisional reorganisation to facilitate more effective peer comparison in firm supervision.

## 6. FSA to strengthen supervisory resources

6.1 **A bottom-up approach was used for the FSA's annual plan for 2008/09. This should be developed for future years and a 'zero-based budget' constructed for areas dealing with high impact firms. This should allow senior management to monitor the balance of resource planned against key supervisory activities/priorities for each firm, with subsequent regular MI to check the position.**

6.2 The role of the 'Reg E' manager and consequential impact on the role of the lead associate should be clarified. As part of this, some assessment should be carried out on whether the responsibilities and workloads are manageable both for the Reg E managers and lead associates reporting to them.

6.3 The presumption of tenure for a supervisory lead associate or manager, for a high impact firm, should be a minimum of two years and a maximum of four years.

6.4 Training for supervisors on the FSA's approach to firms' stress testing should be made available as soon as possible and undertaken by staff as a matter of priority. This should enable supervisors to engage effectively with firms to provide challenge on the robustness of their stress testing practices.

6.5 The FSA should ensure that any necessary training for supervisors in the area of liquidity risk has been made available as soon as possible and undertaken by staff as a matter of priority.

6.6 **The current training arrangements should be significantly enhanced to ensure that staff receive training appropriate for their roles, and that the roles they are assigned match their skills and experience and the training they have received and assimilated. Resource planning in divisions should take account of this.**

6.7 Corporate Learning should review the training offering that underpins the Regulatory Curriculum. We believe that, as a matter of priority:

- the training offered in three key areas (namely relevant Handbook rules and guidance, financial analysis and impact and influence) should be improved (in number as well as range of courses); and
- all training listed should be available (or a delivery date for courses under construction specified).

## 7. FSA senior management to increase the level of oversight of firms' supervision

**7.1 HoDs responsible for supervising high impact firms should formally review the supervision of each firm every six months.**

- **This review should act as a 'checkpoint' about the FSA's view of the firm, and take stock of the changes since the last formal ARROW risk assessment and last HoD review.**
- **It should cover both progress against the C&C schedule and MI relating to RMP actions.**
- **If the firm does not have an RMP, this review should assess whether that remains appropriate.**
- **It should be used as an opportunity to review the quality of MI received from the firm and to assess its continuing appropriateness, in particular as a complement to the standard regulatory returns.**
- **The review should also be used as a means of assessing manager performance and engagement.**

**As a result, formal ARROW risk assessments should become more of a stocktake, given more frequent challenge and escalation of issues as part of on-going supervision.**

7.2 Directors responsible for supervising high impact firms should have mechanisms in place, including MI, to enable them to monitor that the agreed supervisory strategy for each firm is being followed through into effective supervisory actions.

7.3 Directors should have a process and forward plan to ensure that ARROW Panels have the appropriate breadth and balance of skills and experience.

7.4 The lessons that can be learned from the Reg E change initiative should be applied in future restructuring programmes.

7.5 The FSA should make greater use of tools, such as contingency planning and stress testing, for internal planning. This is to help it understand and deal with scenarios in a considered manner.

7.6 To develop FSA thinking on whether and how contingency planning/stress-testing might be helpful, an assessment of the lessons learned from how the FSA has dealt with the current market crisis scenario should be performed.

7.7 Directors should ensure that their divisions have agreed documented records management standards and that these are complied with.

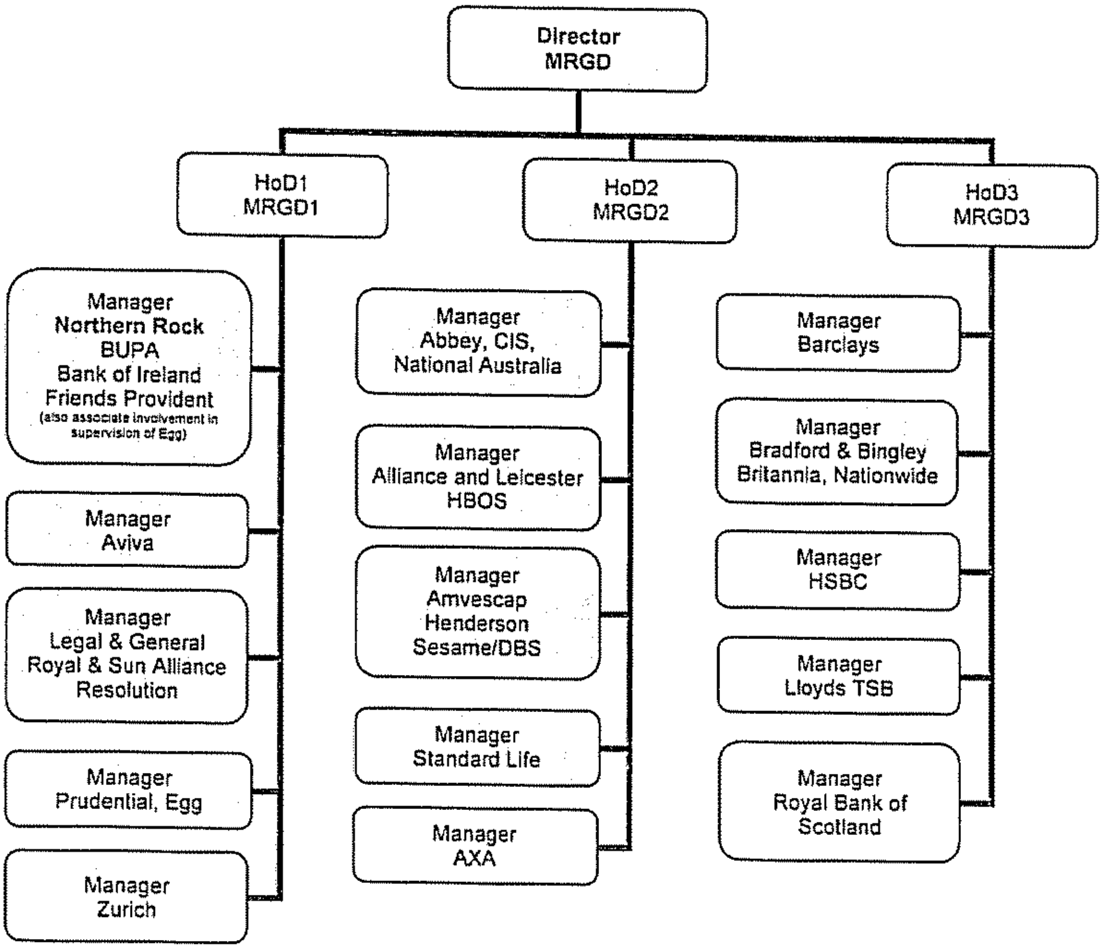
**APPENDIX 2**

7.8 Supervisors' objectives should be revised and their performance assessed to take account of the findings of this review and the implementation of its recommendations.

APPENDIX 3

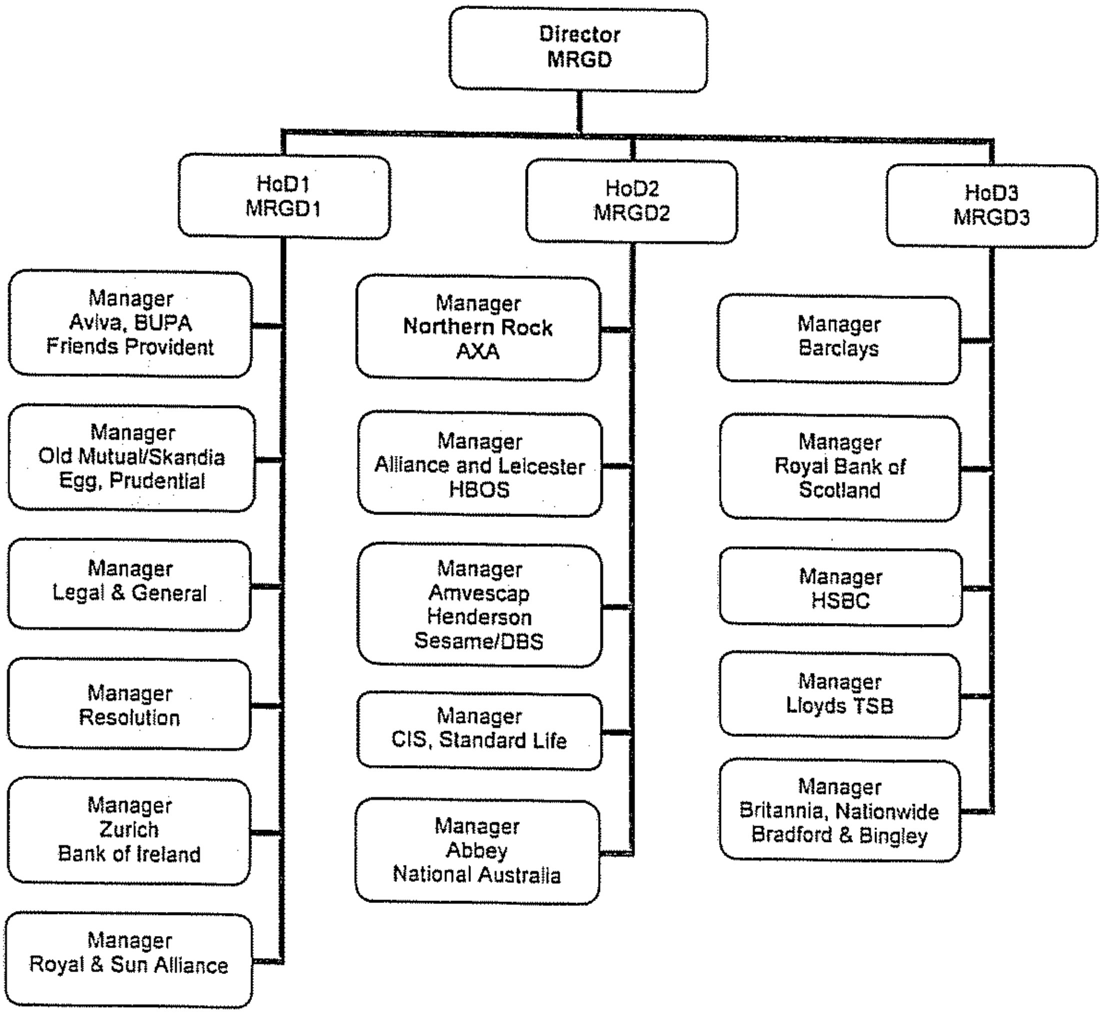
# E3 MRGD & WIBD organograms

## MRGD structure January 2005



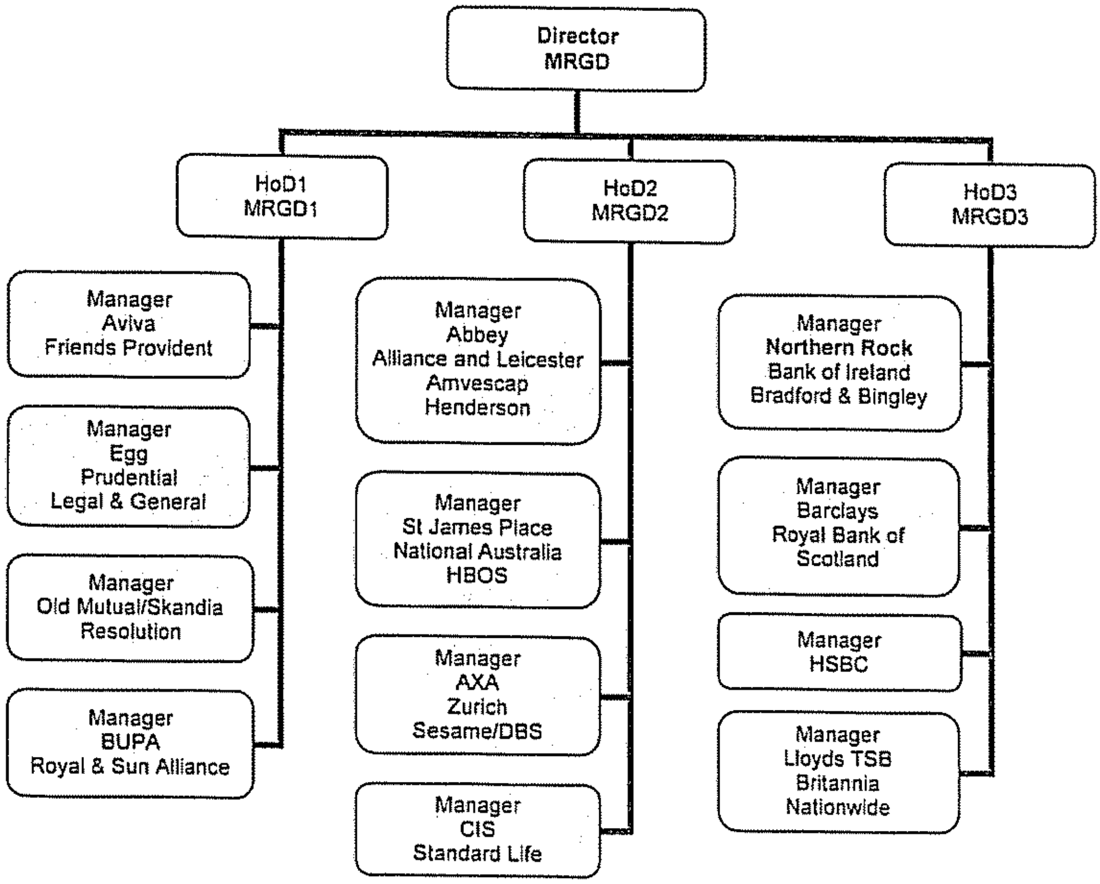
APPENDIX 3

# MRGD structure July 2006



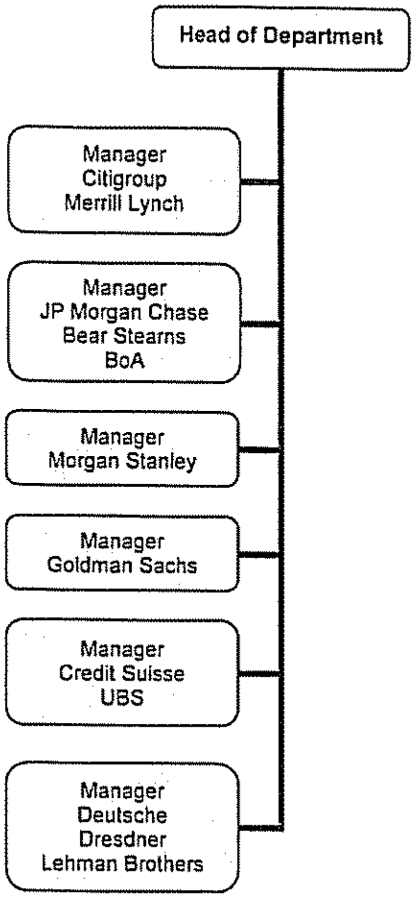
APPENDIX 3

# MRGD structure May 2007

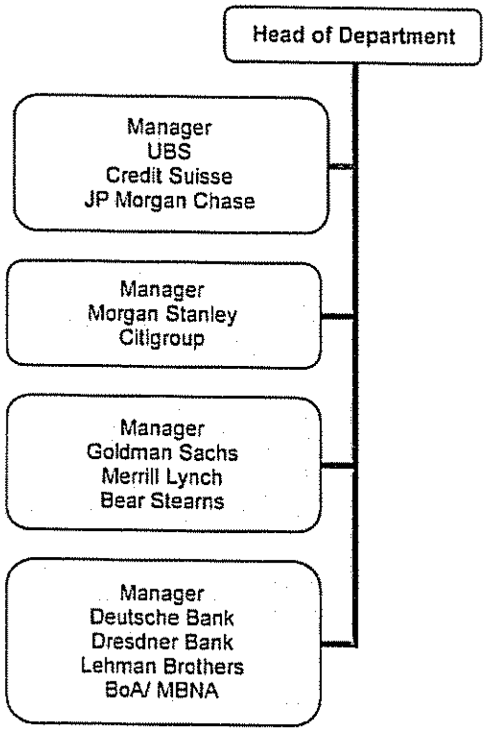


APPENDIX 3

# WIBD structure May 2006



# WIBD August 2007



# E4 Northern Rock quantitative comparisons

*Data provided by the Retail Management Services Unit, covering the high impact firms in Major Retail Groups Division and in Wholesale Investment Banks Department. Northern Rock is in the highlighted box in each population.*

**Supervisory Period** - data taken from IRM

| Firms with regulatory periods of: | | |
|---|---|---|
| 18-24 months | 24 | 63% |
| 25-30 months | 10 | 26% |
| 36 months | 4 | 11% |

(As at 1 August 2007, high impact firms only: MRGD-26 and WIBD-12)

**Turnover of HoDs experienced by MRGD firms**

| Number of HoDs (1 Jan 05 – 9 Aug 07) | 1 HoD | 2 HoDs | 3 HoDs |
|---|---|---|---|
| Number of high impact firms | 18 | 6 | 2 |
| | 69% | 23% | 8% |

**C&C meetings** - estimates made by staff based on various sources for high impact firms

| | 1 Jan - 9 Aug 2007 | 2006 | 2005 | Period Total |
|---|---|---|---|---|
| Average for WIBD firms | 13 | 24 | 18 | 55 |
| Average for MRGD firms | 22 | 29 | 23 | 74 |
| Average for MRGD excl 5 largest banks | 17 | 22 | 19 | 58 |
| Average for 5 largest retail banks | 43 | 59 | 41 | 143 |
| Northern Rock | 7* | 1 | 0 | 8 |

* Out of which five meetings were held on one day in April 2007 and two were by telephone in January and February 2007.

**Risk mitigation programmes (RMP)** - data taken from IRM

| | |
|---|---|
| Number of firms with RMP | 37 |
| Number of firms without RMP | 1 |