FINANCIAL STABILITY BOARD

Peer Review of the United Kingdom

Review Report

10 September 2013

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Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards*[1], to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund-World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, the United Kingdom (UK) volunteered to undertake a peer review in 2013.

This report describes the findings and conclusions of the UK peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 15 July 2013. It is the ninth country peer review conducted by the FSB and the third using the revised objectives and guidelines for the conduct of peer reviews set forth in the December 2011 *Handbook for FSB Peer Reviews.*[2]

The analysis and conclusions of this peer review are based on the UK financial authorities' responses to a questionnaire and reflect information on the progress of relevant reforms as of July 2013. The review has also benefited from dialogue with the UK authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Luiz Pereira da Silva (Central Bank of Brazil) and comprising Karen Badgerow (Office of the Superintendent of Financial Institutions, Canada), Luci Ellis (Reserve Bank of Australia), Balu Kenchappa (Reserve Bank of India), Christian Schindler (BaFin, Germany), Johanna Schwab (Federal Reserve Bank of New York, United States) and Wang Yu (People's Bank of China). Jason George, Simonetta Iannotti, Grace Sone, Costas Stephanou and Uzma Wahhab (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

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[1] See http://www.financialstabilityboard.org/publications/r_100109a.pdf.

[2] See http://www.financialstabilityboard.org/publications/r_120201.pdf.

Abbreviations

BCPs	Core Principles for Effective Banking Supervision
BMA	Business model analysis
BoE	Bank of England
CCP	Central Counterparty
CEO	Chief Executive Officer
CPSS	Committee on Payment and Settlement Systems
EC	European Commission
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
ESCB	European System of Central Banks
ESMA	European Securities Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FMI	Financial Market Infrastructure
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act
FSR	Financial Stability Report
GBP	Great Britain Pound
GDP	Gross Domestic Product
ICB	Independent Commission on Banking
IOSCO	International Organization of Securities Commissions
LBS	Lloyds Banking Group
MoU	Memorandum of Understanding
MPC	Monetary Policy Committee
OTC	Over-the-Counter
PCBS	Parliamentary Commission on Banking Standards
PIF	Proactive Intervention Framework
PFMIs	Principles for Financial Market Infrastructures
RBS	Royal Bank of Scotland
RCH	Recognised Clearing House
RDG	Regulatory Data Group
ROCH	Recognised Overseas Clearing House
ROSC	Reports on the Observance of Standards and Codes
SCSI	Standing Committee on Standards Implementation
SRU	Special Resolution Unit (Bank of England)
UK	United Kingdom
USD	United States Dollar

Executive summary

Background and objectives

The main purpose of this peer review is to examine three topics that are relevant for financial stability and important for the United Kingdom (UK): macro-prudential policy framework; micro-prudential supervisory approach; and supervision and oversight of central counterparties (CCPs). All three topics were included in the key Financial Sector Assessment Program (FSAP) recommendations and are topical for the broader FSB membership. The peer review focuses on the steps taken to date by the UK authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations.

Main findings

A new regulatory framework came into force in the UK on 1 April 2013, which resulted in the Bank of England (BoE) being entrusted with significant new responsibilities. The legislation established a macro-prudential authority, the Financial Policy Committee (FPC) within the BoE to monitor and respond to systemic risks; transferred responsibility for significant micro-prudential regulation to a focused new regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the BoE; and created a new conduct of business regulator, the Financial Conduct Authority (FCA). The UK authorities should be commended for their ability to successfully steer the transition to a new regulatory structure at the same time as undertaking major changes in the supervisory approach, adopting new international regulatory reforms, and responding to broader post-crisis market developments.

Good progress has been made in addressing the FSAP recommendations across all three topics, although many of these reforms are still ongoing. The challenge for the authorities will be to continue their work to roll out and integrate the reforms, address execution risks, and take the necessary steps to ensure the effectiveness of those reforms over the long term. Promoting strong relationships between staff at all levels in the newly-created authorities and within the BoE is an important prerequisite for the success of the reforms.

Macro-prudential policy framework

The establishment of the FPC largely addresses the FSAP recommendation to "revise the legal framework to clarify mandates and include a specific financial stability mandate for the prudential authorities". The interim FPC helped develop the framework for macroprudential policy in the UK and made a series of recommendations focused on creating a better (and more transparently) capitalised banking system. The FPC is now operational and playing a useful role in identifying systemic risks and facilitating coordinated policy action; it is underpinned by a substantial analytical framework and explicit transparency arrangements; and there is evidence of increased staff-level interactions among its member agencies.

These changes are very recent, so it is too early to evaluate the FPC's overall effectiveness. With a reform of this scope, there are execution risks that need to be managed and some fine-tuning of the framework will likely be necessary as more experience is gained. Some issues that may warrant further consideration to enhance the FPC's effectiveness and operations are:

- *Mandate and governance:* The specific governance model chosen in the UK is unique and reflects experience with the BoE's Monetary Policy Committee, on which the FPC's structure appears closely modelled. Centralising the supervisory and systemic roles within the BoE may improve information flow, coordination, and a shared sense of purpose. On the other hand, such an arrangement increases the potential of creating a 'group-think' mentality, particularly since a large scope of responsibility is vested in a small number of senior executives. In addition, this institutional model may expose supervision to lower prioritisation in terms of status, shared resourcing, and policy-making priorities. The UK authorities are alert to these risks and they have made commendable efforts to address them, including via the appointment of independent external members to the FPC and PRA Board as well as the involvement of senior BoE management in supervisory decisions at the PRA. It will be important to ensure that the close and equal partnership between the PRA and the rest of the BoE endures.
- *Analysis and tools*: To its credit, the FPC has realised that no single set of indicators can ever provide a perfect guide to risk management or appropriate policy, and it therefore monitors a wide and time-varying set of metrics, as well as qualitative information from market intelligence and other sources. However, in order to design an appropriate policy response, decision makers will also need to have a thorough understanding of the prudential framework. Given the composition of the new FPC, a particular challenge will be to leverage front-line supervisory actions (in addition to regulatory measures) as a policy tool to promote financial stability. It will also be important, in that context, to maintain the 'will to act'. While the crisis experience has clearly tilted the culture of UK policy-making in favour of a stronger emphasis on financial stability, maintaining that culture will require ongoing effort. Finally, the FPC will need to better develop understanding and acceptability of the new framework and policy among market participants and the public. This is a more challenging task than for monetary policy decisions given the broad remit of possible policies that can be employed (or recommended) by the FPC and their more complex transmission mechanism. The FPC statements and the FSR address part of this challenge, but the authorities may want to add other communication channels (targeted public speeches, meetings with industry representatives and the public, website development) to reach out to the general public and particular stakeholder groups.
- *Inter-agency (and intra-agency) relationships and subject matter expertise:* In the new UK arrangements, coordination and flow of information are largely facilitated through overlapping committee and other memberships. There are early indications of central bank staff actively engaging with supervisors at the PRA, but it is not a given that such collaboration will always work better within the same organisation. To embed that relationship-building into the organisational culture, it will be important to instil a corporate value of respecting different kinds of expertise and technical background. The authorities will need to continue to enhance formal and informal relationship building, cooperation and coordination via regular fora, briefings, secondment and staff exchange arrangements. In that context, the relationship between the PRA and the FPC has advanced further than that between the FCA and the FPC. It is important that the FPC attain a similar level of engagement with the FCA as it has done with the PRA. To make best use of that opportunity, the FCA will need to enhance its capacity for

systemic risk surveillance and analysis so as to protect and enhance the integrity of the financial system. This includes, for example, identifying when a pattern of individual firms' conduct issues or certain market activities and participants could give rise to systemic problems.

- *FPC involvement in the prudential framework:* The Financial Services Act requires that the FPC use its direction tools to focus on system-wide, rather than firm-specific, issues. The Act makes clear that, where relevant to sustaining systemic stability, the FPC should use its 'comply-or-explain' recommendation powers to steer the general policies of the PRA/FCA towards particular types of firms or risks. What is less clear in this context is whether this steer should be expressed in general terms by leaving the details of the response to the agencies, or whether the recommendations can set out specific regulatory details that should be changed (e.g. risk weight parameters, exposure limits etc.). Depending on how specific those recommendations to the PRA and FCA will be regarding implementation details (i.e. which prudential parameter to alter and by how much), the FPC may end up having substantial influence over the details of the prudential framework – an outcome that may create tensions between the relevant agencies and confusion in the marketplace. That risk is tempered by cross-membership between the FPC and the boards of the PRA/FCA and by the FPC's explanation of its recommendations in the record of its meetings and in the FSR, but it may be useful to publicly clarify the FPC's approach on this matter.

Micro-prudential supervisory approach

The need for more intrusive supervision was one of the main financial crisis-related lessons identified by the UK authorities. Significant progress has been made in introducing reforms to the micro-prudential supervisory approach in response to these lessons and the corresponding FSAP recommendations. In particular, the UK authorities have amended the legislation to allow regulatory power over holding companies; enhanced risk assessments and are in the process of adopting new supervisory tools; developed a proactive intervention framework (PIF) that involves making a judgment on each supervised firm's proximity to failure; are extending the intrusive risk-based approach to a wider range of insurers; and are undergoing a significant business transformation process.

Notwithstanding these efforts, it is fair to say that many of the initiatives are in their early stages of implementation and are yet to be completely integrated with other supervisory processes. Rolling out these initiatives at the same time as adopting important regulatory reforms may be difficult to manage in the timeframes contemplated. Significant interdependence and extensive consultation is required for many of these initiatives. It will be critical for the UK authorities to ensure retention of key senior staff to lead the change over the coming years and to have well-established coordination mechanisms across the different agencies involved in the oversight of the financial sector. There are also some issues that merit further consideration as these reforms are implemented:

- *Cooperation between the FCA and the PRA***:** Approximately 2,000 firms will be subject to dual regulation by both the FCA and the PRA. The PRA is expected to lead the assessment for most of the groups comprising these firms, assisted by the FCA. Dual regulated firms could also be subject to the issuance of a power of direction over a qualifying parent undertaking by both the PRA and the FCA. Legislation and the

Memorandum of Understanding (MoU) between the FCA and the BoE require prior consultation between the PRA and the FCA when issuing a power of direction to ensure that both authorities have a clear understanding of its impact both on the firm and on overall financial stability. Such consultation is also envisaged in the MoU between the PRA and the FCA concerning the use of the PRA powers to issue a direction requiring the FCA not to act in a specified manner, so as to ensure adequate information flow and exchange of views within the parameters set by the agencies' statutory duties. The authorities will need to continue to promote strong relationships between staff at all levels in the PRA and FCA in order to ensure effective cooperation and coordination.

- *Supervisory effectiveness:* Although there have been some enhancements to the PRA's powers, the more significant change has been the adoption of an approach to supervision that is more intrusive and forward-looking. The authorities should monitor not only the effectiveness of supervisory actions but also the willingness of supervisors at all levels to make this cultural change. Furthermore, senior management should ensure a culture that encourages the flow of information through the organisation, particularly upwards. In that context, it is important to do a periodic "use test" to measure how risk assessment tools are being integrated into supervisory judgements and actions. The PRA may also wish to consider engaging with external stakeholders (e.g. through surveys or special reviews) to enhance transparency and accountability regarding the effectiveness of the changes.

  The new supervisory approach requires front-line supervisors to leverage off of the work of the risk specialists to make informed judgements about current and future firm risks in order to take appropriate supervisory/intervention actions. The UK authorities may wish to further formalise the type of interaction and responsibilities between the risk specialists and front line supervisors. One way would be to ensure a more formalised sign-off by risk specialists on key supervisory ratings (as they pertain to their risk area) and on the overall supervisory strategy as part of the annual stock taking exercise. There should also be a process to encourage the flow of information between risk specialists and front-line supervisors across the PRA's bank and insurance departments. Finally, given that UK-domiciled banks have over half of their assets abroad and foreign banks constitute around half of UK banking assets, the PRA may wish to consider designating country risk specialists for material jurisdictions.

  It is unclear whether the number of front-line supervisors overseeing smaller firms (which collectively can pose risks to financial stability) will be sufficient to satisfy the mandate of the PRA and ensure their effective oversight. While various tools and techniques are being deployed to ensure that trends and outliers are identified, the regime for many smaller firms is largely reactive. The PRA will have to ensure that its resourcing model is flexible enough to reallocate staff to small firm supervision should the need arise. Moreover, while the PRA is not expecting to expand the number of resources dedicated to supervision, there may be a need to re-assess whether an adequate number of resources exist to meet several new initiatives (e.g. sector-wide regular stress testing). Given the longevity of the business transition process (3-4 years) for restructuring the regulatory system and the potential for distraction due to conflicting priorities from other initiatives, it may also be necessary to keep certain transition groups in place to provide continuous reassessment of human resource needs.

- *Disclosure of PIF ratings:* Given the disclosure obligations for listed firms in European Union (EU) legislation, the PRA has decided not to disclose the PIF rating to the firm concerned in order to avoid a situation in which the firm would then have to publicly disclose the rating. Awareness of the PIF rating, particularly by a firm's Board of Directors and senior management, could positively influence behaviours and compel desired outcomes as firms would better understand the potential consequences. Until these constraints are addressed, the PRA should continue to explore alternative means to make firms aware of heightened concerns and accompanying intervention activities.
- *Data collection and analysis*: There are many data initiatives underway, including wide-ranging changes under EU legislation, which necessitates adequate (enhanced prudential reporting) and accurate disclosures (data quality) on a firm-by-firm basis. There are also numerous projects under the business transformation initiative with long timelines. Finally, there is a significant degree of co-dependency across projects that has the potential to extend timelines beyond the current plan. The UK authorities are encouraged to continue with their coordination efforts amongst the various regulatory agencies to avoid duplication and potential overlap among data initiatives.
- *Insurance supervision:* Although the PRA is committed to extending its new judgement-led risk-based supervision approach to a wider range of insurers, this process is still evolving. The PRA recognises that there is a wide variety of business models across insurance firms and has committed not to have a one-size-fits-all approach. Going forward, it will be important for the authorities to follow through with their plans to implement the new supervisory approach for insurance companies, and to ensure an appropriate allocation of risk specialists to insurance firms.

Supervision and oversight of CCPs

Given the global importance of certain UK-based CCPs, the FSAP made a number of recommendations to maintain robust prudential and risk management standards. The follow up by the UK authorities on these recommendations has to be seen in the context of ongoing international policy developments and UK/EU regulatory reforms involving CCPs, particularly the implementation of the CPSS-IOSCO *Principles for Financial Market Infrastructures* (PFMIs) and in the EU's European Market Infrastructure Regulation (EMIR).

As regards the FSAP recommendation on sufficient and reliable funding options for CCPs, it is the BoE's assessment that both of the large global CCPs are able to meet their stressed liquidity needs with the highest quality collateral (cash or high quality government bonds). Secured cash collateral held for the benefit of CCPs at commercial banks is seen by the BoE as an acceptable, and even preferable, alternative to committed credit lines. As such, not all UK CCPs have committed liquidity arrangements/lines in place nor does the BoE require that they do so. While the BoE's policy is not to produce detailed criteria and guidance on what CCPs are required to do to meet particular elements of the PFMIs or EMIR, the BoE does expect CCPs to comply with the relevant requirements of EMIR and/or the PFMIs by regularly reviewing their assumptions about the liquidity of the assets, establishing relationships with repo counterparties and regularly testing these. These are important steps to support the FSAP recommendation for sufficient and reliable funding options, but it is not clear how the BoE satisfies itself that such repo arrangements are highly reliable, even in extreme but plausible market conditions. Under EMIR, UK CCPs will have to invest at least

95% of their cash investments on a secured basis, and the UK authorities report that major UK CCPs already meet this standard. While a CCP's cash is the first line of defence, a CCP may also have alternative committed funding arrangements in place to meet its obligations, as recommended by the FSAP.

The BoE is also addressing the "no technical obstacles" safeguard – one of the four safeguards identified by the FSB to help national authorities make informed decisions on the appropriate form of CCPs to meet their G20 commitments on over-the-counter (OTC) derivatives market reforms – for the provision of central bank liquidity to global CCPs, and is actively involved in relevant international fora.

In accordance with the FSAP recommendation concerning settlement in central bank money for systemically important CCPs, the PFMIs, and the requirements set out in EMIR to settle transactions in central bank money where this is "practical and available", the BoE offers settlement facilities to CCPs in Sterling and Euro. The two large global CCPs have access to BoE Sterling concentration bank services, while one of them currently has access to Euro services. Other UK CCPs are engaged in discussions with the BoE for it to become the concentration bank for Sterling settlement. It is important for these efforts to continue in order for the CCPs to reduce credit risk exposures to their financial resource providers.

The BoE has also undertaken significant steps to follow up on the FSAP recommendation that contingency plans be developed to deal with a potential failure of a CCP. With respect to resolution of CCPs, the UK relies broadly on resolution tools similar to those available for banks. With respect to recovery, the BoE has been working with CCPs to ensure they have loss allocation rules in place for the purpose of covering losses beyond the CCP's financial resources. The authorities are further developing these tools on the basis of recent legislation that makes recovery plans and loss-allocation arrangements mandatory for CCPs.

As regards UK CCPs, cross-border coordination takes place through supervisory colleges at the EU level (EMIR colleges), multilateral cooperative oversight arrangements (for relevant supervisory authorities of UK CCPs offering clearing services in non-EU jurisdictions) as well as respective bilateral cooperation with relevant jurisdictions. A particular concern with these mechanisms is their complex and partly overlapping structure. The same CCP may end up being subject to various cooperative frameworks with authorities from different jurisdictions vested with heterogeneous mandates (e.g. central banks, prudential supervisors, market conduct authorities) and covering a broad range of issues (e.g. compliance, risk assessments, exchange of information, cooperation in normal and stressed situations etc.). A high-level of cross-border coordination will be important to ensuring the effectiveness of respective arrangements for the supervision of CCPs, without compromising efficiency by creating duplicative or conflicting efforts. As more experience is gained with the functioning of these mechanisms, the UK authorities may want to share any lessons of experience and bring practical problems to the attention of international bodies so that they can be addressed.

The BoE's approach to the supervision of FMIs, i.e. the development of risk assessment frameworks to guide regulatory activities, appears similar to that of the PRA with respect to banks. Going forward, the BoE will need to pay particular attention to how measures implementing EMIR are applied and how CCP supervision is exercised in practice, given the complexities and sequencing challenges facing market participants and FMIs, and the continued changes in the CCP landscape through mergers and the migration of certain clearing activities across different infrastructures. It also remains to be seen how the various UK authorities will operationalise coordination and information sharing set out in the relevant MoUs in both normal and stressed conditions given that (for example) different aspects of OTC derivatives markets reforms fall within the remit of different authorities.

Integrating the micro- and macro-prudential perspectives on CCPs is a difficult but critical task. Relevant policy tools, such as margin and collateral requirements, haircuts or countercyclical capital buffers, can be applied by different agencies in the UK regulatory structure. These can impact the activities of individual CCPs and their clearing members but they also have systemic effects. Against this background, the BoE should promote the flow of information across relevant authorities (both domestically and internationally) to develop an integrated view on CCPs combining the micro- and macro-prudential perspectives.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations for consideration by the UK authorities:

Macro-prudential policy framework

- The FPC should build upon the technical expertise of the PRA and FCA on the prudential framework and supervisory practices in identifying and implementing policies to promote financial stability.
- The FPC should further develop its relationship with the FCA by deepening the latter's involvement in FPC meeting preparations and by jointly undertaking systemic risk analysis work. The FCA should enhance its capacity to undertake such work so as to be able to actively contribute to the FPC deliberations.
- The authorities should clarify the appropriate level of detail in the FPC's comply-or-explain recommendations, and thus the influence that the FPC is expected to have on the broader prudential framework.

Micro-prudential supervisory approach

- In order to enhance the effectiveness of the supervisory regime, the PRA should: a) continually assess the adequacy of front-line supervisors in terms of numbers and skillset as well as the application of supervisory tools and their contribution to supervisory outputs and judgement (e.g. using external surveys or special reviews); b) formalise the sign-off of individual firms' risk assessments and supervisory strategies by risk specialists; c) ensure an appropriate level of coverage of smaller firms via flexible resourcing models; and d) consider designating country risk specialists to build specialised knowledge for material jurisdictions.
- The PRA should ensure that supervised firms are aware of any heightened concerns and accompanying intervention activities, and should explore options to disclose the PIF rating to such firms without triggering public disclosure.

Supervision and oversight of CCPs

- The BoE should actively promote the alignment of micro- and macro-prudential objectives for CCP supervision and oversight by systematically elevating relevant issues on the agenda of the FPC and to the attention of the PRA and the FCA.

1. Introduction

The UK underwent an FSAP update in 2011[3] that included assessments[4] of the *Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision* (BCPs), IAIS *Core Principles*, IOSCO *Principles and Objectives of Securities Regulation*, CPSS *Core Principles for Systemically Important Payments Systems*, and the CPSS-IOSCO *Recommendations for Central Counterparties* and *Recommendations for Securities Settlement Systems*.

The FSAP concluded that decisive policy responses during the financial crisis had stabilised the financial system, but that vulnerabilities remained and that the recovery process was not yet complete. It noted the important size and role of the UK financial system in global financial intermediation and stressed the need for effective implementation of reforms to embed and further enhance the supervisory approach for banks and insurers. It also expressed concern that the transition to the new "triple peak" model of regulation (separate authorities for micro-prudential supervision, financial conduct, and macro-prudential policy) may divert resources and attention from efforts to enhance supervision of the financial sector, which is still in recovery mode. Finally, it called on the UK authorities to continue to push for the development of a stronger international framework for the oversight of cross-border financial institutions and market infrastructures.

Following the FSAP, a new regulatory framework came into force under the Financial Services Act 2012.[5] The legislation established a macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England (BoE), to monitor and respond to systemic risks; transferred responsibility for significant prudential regulation to a focused new regulator, the Prudential Regulation Authority[6] (PRA), established as a subsidiary of the BoE; and created a new conduct of business regulator – the Financial Conduct Authority[7] (FCA) – which will supervise all firms to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.[8]

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[3] See "United Kingdom: Financial System Stability Assessment" (IMF Country Report No. 11/222, July 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11222.pdf).

[4] See "United Kingdom: Report on Observance and Codes" (IMF Country Report No. 11/223, July 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11223.pdf). All ROSC assessments and technical notes have been published and are available on the IMF website (http://www.imf.org/external/np/fsap/fsap.aspx).

[5] The Act is available at www.legislation.gov.uk/ukpga/2012/21/contents/enacted.

[6] The PRA's general objective is to promote the safety and soundness of PRA-authorised firms primarily though seeking to: a) ensure that the business of such firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and b) minimise the adverse effect that the failure of a firm could be expected to have on the stability of the UK financial system.

[7] The FCA's general objective is to ensure that relevant markets function well by advancing the protection of consumers and the integrity of the UK financial system as well as by promoting effective competition.

[8] See http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm. See also "A new approach to financial regulation: securing stability, protecting consumers" by the UK HM Treasury (Cm 8268, January 2012, available at http://www.hm-treasury.gov.uk/d/fin_fs_bill_policy_document_jan2012.pdf).

The main purpose of the peer review report is to examine three topics that are relevant for financial stability and important for the UK: macro-prudential policy framework; micro-prudential supervisory approach; and supervision and oversight of central counterparties (CCPs). All three topics were included in the key FSAP recommendations and are topical for the broader FSB membership. The peer review focuses on the steps taken to date by the UK authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations. In particular, the review evaluates progress with the reforms in order to draw conclusions and policy implications as well as identify remaining impediments and lessons of experience that could be of benefit to the UK and its FSB peers.

The report has three main sections, corresponding to the three topics being reviewed. Section 2 focuses on the proposed objectives, scope, powers, tools and governance arrangements underpinning the FPC's macro-prudential policy framework. Section 3 analyses the policies undertaken by the PRA for more intensive micro-prudential supervision in light of available international guidance in this area. Section 4 describes the proposed supervisory approach toward CCPs by the BoE, including as it relates to the arrangements to cooperate and exchange information with overseas authorities (cooperative oversight arrangements).

In addition to these sections, Annex 1 provides background information on the structure of the UK financial system and on recent regulatory developments, while Annex 2 presents the follow-up actions reported by the UK authorities to other key FSAP recommendations; these actions have not been analysed as part of the FSB peer review and are presented solely for purposes of transparency and completeness.[9]

2. Macro-prudential policy framework

Background

Failings in pre-crisis institutional arrangements prompted the UK government to make wholesale changes to the regulatory landscape with the aim of fundamentally strengthening the system. The motivation for the creation of the FPC was that the "tripartite" regulatory system (BoE, Financial Services Authority or FSA, HM Treasury) that existed prior to the financial crisis contained a number of inherent weaknesses. In particular, according to the authorities, no single institution had the authority to monitor the overall financial system, identify potentially destabilising trends, and respond to them promptly with concerted actions. In this regard, while the BoE had responsibility for financial stability, it felt that it did not have the tools or formal mandate to carry out its role effectively.

The FSAP noted these weaknesses, as well as the sizeable aggregate balance sheet of the banking sector (about five times Gross Domestic Product, or GDP) and the systemic risks arising from the UK's role as an international financial centre. Against this backdrop, it

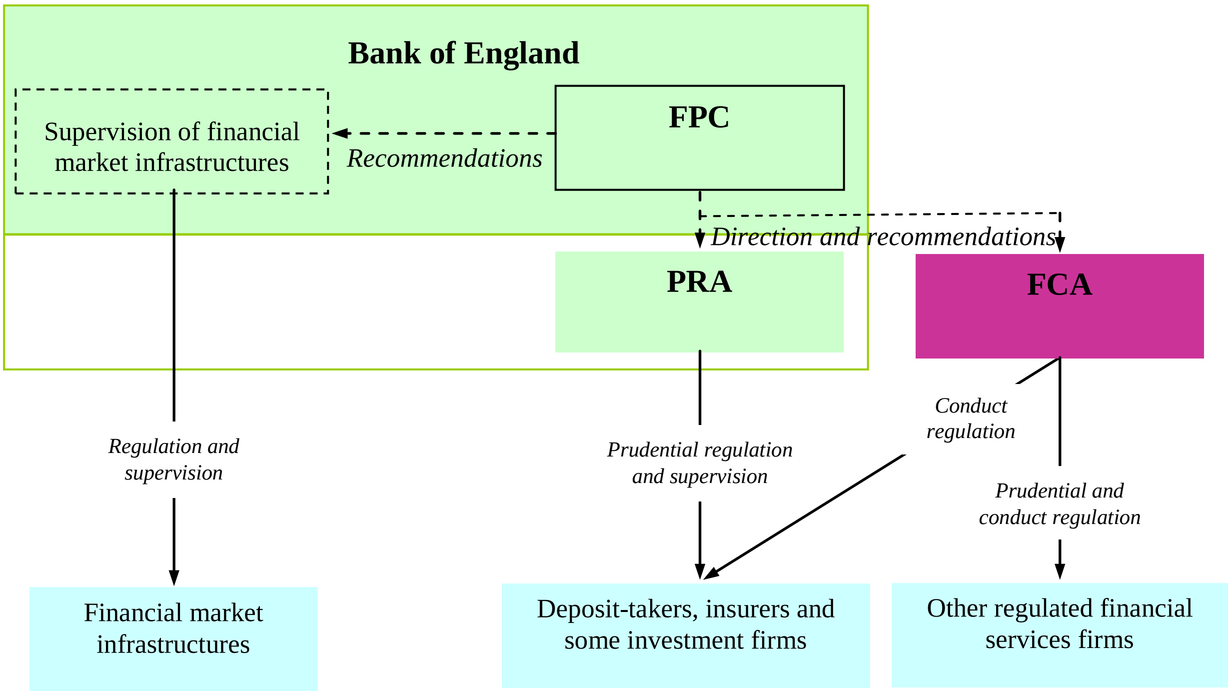
[9] The IMF has also provided an update on the status of the main FSAP recommendations in its latest Article IV report. See "United Kingdom: 2013 Article IV Consultation" (July 2013, IMF Country Report No. 13/210, http://www.imf.org/external/pubs/ft/scr/2013/cr13210.pdf).

recommended that the UK authorities revise the legal framework to clarify mandates and include a specific financial stability mandate for the prudential authorities.

Steps taken and actions planned

The new regulatory framework that came into force on 1 April 2013 resulted in the BoE being entrusted with significant new responsibilities, including macro-prudential regulation of the financial system through the creation of the FPC; micro-prudential regulation of insurers, deposit-takers and major investment firms through the creation of the PRA; and supervision of some critical post-trade financial market infrastructure (FMI) providers (see Figure 1). In addition, the Banking Act 2009 introduced a special resolution regime for dealing with failing credit institutions in which the FSA (and now the PRA), in consultation with the BoE and HM Treasury, decides whether to place a bank into the resolution regime.[10] By locating these distinct but complementary functions within the BoE, the government intends that systemic and firm-specific regulation be better coordinated, and that the market knowledge and economic expertise of the central bank will be brought to bear on financial stability issues. The FPC and the PRA Board, like the BoE's Monetary Policy Committee (MPC), are statutory decision making bodies.

Figure 1: Stylised diagram of the new regulatory framework



[10] While the PRA decides whether to place a bank (or building society) into the resolution regime, the authority charged with implementing the resolution is the BoE, except where the failing entity constitutes a serious threat to the stability of the UK financial system, in which case it may be placed into temporary public ownership by the Treasury. The BoE must consult the PRA, FCA and the Treasury when deciding which tool(s) to use; the Treasury must consult the PRA, FCA and BoE when temporary public ownership is the resolution tool. The Financial Services Act 2012 extended the resolution regime to investment firms, CCPs and related financial group companies (including those of banks).

The primary statutory objective of the FPC is to identify, monitor and take actions to reduce or remove systemic risks so as to protect and enhance the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the government, including its objectives for growth and employment. Unlike in the previous system, the government has provided the FPC with specific powers and macro-prudential tools to address risks to financial stability. In particular, the FPC has the power to: (1) make 'comply or explain' recommendations to the PRA and FCA; and (2) mandate that the PRA/FCA adopt certain macro-prudential tools that HM Treasury has set out in secondary legislation (see below). The FPC can also make general recommendations, without a 'comply or explain' compulsion, to any entity.

The FPC has ten voting members: the Governor (who chairs the FPC); the Deputy Governors of the BoE for financial stability, monetary policy and prudential regulation (the latter is also the Chief Executive Officer, or CEO, of the PRA); the BoE's Executive Director responsible for Financial Stability; the CEO of the FCA; and four external members appointed by the Chancellor of the Exchequer.[11] In addition, a representative of HM Treasury is a non-voting member of the FPC and the BoE's Executive Director responsible for Markets routinely attends FPC meetings. If a consensus cannot be reached, then a decision will be taken by a vote of those voting members present at the meeting. In the event of a tie, the Chair of the FPC has a second, or tie-breaking, vote. The nature of the vote on any decision, whether unanimous or otherwise, is reflected in a formal record of the meeting.

The analytical support for the FPC's activities is provided predominantly by the BoE's Financial Stability Directorate, with the Markets Directorate, PRA and FCA staff also participating in the briefings. Logistical and secretariat support are provided by a dedicated Secretariat, also housed within the Financial Stability Directorate.

The FPC is required by statute to meet at least four times a year. Meetings are held according to a pre-announced quarterly schedule, with a record of the FPC's deliberations published at present within two weeks of a meeting. The FPC is also required to publish a twice-yearly Financial Stability Report (FSR) presenting its assessment of financial sector stability and resilience. The FSR also reviews progress against previous recommendations and directions, as well as reporting any new policy actions that the FPC has taken to mitigate risks to financial stability.[12] The FPC's public policy decisions are announced via the FSR or in an official statement to the market shortly after a meeting.

Prior to the statutory FPC, the Court – the Board of the BoE – created an interim FPC in February 2011 to undertake (as far as possible) the future statutory FPC's macro-prudential role. Under the previous institutional arrangements, the interim FPC lacked the formal powers of the statutory FPC. It nonetheless contributed to maintaining financial stability by identifying, monitoring and disclosing risks to the stability of the financial system and

[11] See http://www.bankofengland.co.uk/financialstability/Pages/fpc/members/default.aspx. The rationale for appointing external members is to access additional financial sector expertise and provide external challenge. In appointing external members, the Chancellor must consider any conflicts of interests that they may have.

[12] See the June 2013 FSR (http://www.bankofengland.co.uk/publications/Documents/fsr/2013/fsrfull1306.pdf).

recommending actions to mitigate them. The interim FPC held its first policy meeting in June 2011 and has met on a quarterly basis since then.[13] It issued 24 recommendations, including a series of recommendations focused on creating a better (and more transparently) capitalised banking system, against a backdrop of large and persistent risks from the Euro area and weak credit growth in the UK.

In addition, the interim FPC led the development of the macro-prudential policy framework that would be in the remit of the statutory FPC. In particular, in December 2011 it published a discussion paper on macro-prudential tools and in March 2012 made recommendations to HM Treasury on the set of statutory macro-prudential instruments that the permanent FPC should have at its disposal.[14] The FPC subsequently published a draft Policy Statement in January 2013 explaining how it would use its proposed new macro-prudential powers to set counter-cyclical capital buffers and sectoral capital requirements.[15] The Policy Statement describes these tools, the likely impact of using them on financial stability and growth, and the circumstances in which the FPC might expect to use each tool. It also describes the core indicators the FPC will routinely review to help inform its judgment. The UK government subsequently proposed that the FPC be made responsible for policy decisions on the counter-cyclical capital buffer (in line with the European implementation of Basel III as expressed in CRD IV) and has given it powers of direction over capital requirements for exposures to specific economic sectors. The UK government also stated its intention to provide the FPC with direction powers over a time-varying leverage ratio tool no earlier than 2018 and, subject to a government review in 2017, to assess progress on international standards.

The interim FPC has also illustrated the importance for coordinated policy action across a number of committees. For instance, in the summer of 2012 a package of policies was unveiled by the BoE, FPC and FSA including: actions on the UK banks' capital, developed by the FPC; the Funding for Lending Scheme; activation of the Extended Collateral Term Repo Facility; and amendments to the UK banks' liquidity regulation designed to support lending to the real economy and improve the resilience of the UK financial system.

In November 2012, the interim FPC identified three factors that supervisors needed to take into account when assessing the capital adequacy of the banking system: (1) expected losses on vulnerable credit portfolios; (2) expected costs from misconduct; and (3) imprudently low risk-weights. Having reviewed supervisory estimates of these three pressures on capital positions, the FPC decided that the appropriate way to assess capital adequacy was on a fully phased-in Basel III basis after adjusting for these factors. The FPC decided that UK banks and building societies needed to raise capital, or restructure their balance sheets in a way that did not hinder lending to the real economy, to meet a fully phased-in Basel III ratio, after the three adjustments, of 7% by end-2013. This has since been mapped into capital plans

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[13] Details of FPC meetings are available at http://www.bankofengland.co.uk/financialstability/Pages/fpc/meetings/default.aspx.

[14] See the interim FPC's recommendations for macro-prudential direction powers (March 2012, available at http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement120323.pdf). See also the discussion paper on "Instruments of macroprudential policy" by the BoE (December 2011, available at http://www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf).

[15] See http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement130114.pdf.

developed by the PRA for each individual institution. In its March 2013 meeting, the FPC also recommended that the BoE (including the PRA) develop a framework for regular stress testing from both macro-prudential and micro-prudential perspectives. BoE and PRA staff are currently working on such a framework (see section 3). The permanent FPC started its activities on 1 April 2013, and met for the first time on 18 June.

Lessons learned and issues going forward

The experience of the financial crisis has prompted a rethink in many jurisdictions of both institutional arrangements and the analytical processes supporting financial stability policy. Mandates have been clarified, resources increased, policy tools identified and – in some cases – responsibilities altered. The changes in the UK have perhaps been the most comprehensive, encompassing new institutional arrangements, powers and internal processes. This major rethink of the institutional architecture supporting financial stability policy is understandable given the UK's experience during the crisis, and the reforms largely address the FSAP recommendation in this area. In particular, the FPC is now operational and playing a useful role in identifying systemic risks and facilitating coordinated policy action; it is underpinned by a substantial analytical framework and explicit transparency arrangements; and there is evidence of increased staff-level interactions among its member agencies (see below). The interim FPC has provided leadership in developing the framework for macroprudential policy in the UK by carrying out preparatory work to support the creation of the statutory FPC.

The establishment of the FPC is very recent, so it is too early to evaluate its overall effectiveness. With a reform of this scope, there are execution risks that need to be managed and some fine-tuning of the framework will likely be necessary as more experience is gained. Some issues that may warrant further consideration to enhance the effectiveness of the FPC and its operations are: mandate and governance; analysis and tools; inter-agency relationships and subject matter expertise; and FPC's involvement in the prudential framework.

Mandate and governance*:* Several distinct institutional models for financial stability policy are taking shape internationally.[16] The specific governance model chosen in the UK is unique and reflects the UK's experience with the MPC, on which the FPC's structure appears closely modelled. The similarity in structures and accountability arrangements may have given some comfort to the authorities when designing the institutional architecture, but it has also produced quite formal and resource-intensive briefings and meeting preparation processes that might constrain nimble policy responses.

The new regulatory structure makes the prudential supervisor a subsidiary of the central bank, with the PRA and its head being structurally subordinate to (and thus not fully independent of) the BoE and its Governor.[17] Centralising the supervisory and systemic roles within the

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[16] See, for example, "Macroprudential Policy Tools and Frameworks – Progress Report to the G20" by the FSB, IMF and BIS (October 2011, http://www.financialstabilityboard.org/publications/r_111027b.pdf) and "Macroprudential Policy: An Organizing Framework" by the IMF (March 2011, http://www.imf.org/external/np/pp/eng/2011/031411.pdf).

[17] The UK authorities are of the view that the PRA's operational independence is unaffected by its status as an entity within the BoE group. Operational independence in relation to statutory functions is secured by the fact that the PRA must act with reference to its statutory duties and objectives (and is unable to delegate these functions), and is supported by governance arrangements that include a majority of independent non-executives on the PRA Board.

BoE may improve information flow, coordination, and a shared sense of purpose. On the other hand, such an arrangement increases the potential of creating a 'group-think' mentality, particularly since a large scope of responsibility is vested in a small number of senior executives (primarily the BoE Governor and the Deputy Governor for Financial Stability, who serve on all of the MPC, FPC and PRA Boards). The role played by the independent external members to the FPC and PRA Board is particularly important in that regard.

In addition, this institutional model may expose supervision to lower prioritisation in terms of status, shared resourcing, and policy-making priorities. The UK authorities are alert to this risk and they have made commendable efforts to address it – for example, by ensuring that the PRA Board is responsible for the prioritisation of policy and use of resources across its own responsibilities, by building relationships between PRA and non-PRA staff, and by including PRA staff in key FPC-related meetings. Senior management at the BoE have already been closely involved in supervisory decisions at the PRA through the Governor's role as chair of the PRA Board and two of the BoE's Deputy Governors serving as members of the Board. The PRA Board has met at least fortnightly, ensuring that the Bank's senior management has been continuously engaged in supervisory issues. It will be important to ensure that the close and equal partnership between the PRA and the rest of the BoE endures and that staff-level coordination and cooperation is continually reinforced (see below). Possible measures to promote this could include internal policies to promote staff rotation at all levels between the PRA and the rest of the BoE as well as adequate resource sharing.

Analysis and tools: With the institutional framework already established, the next challenge is to choose suitable policy responses and apply them appropriately to mitigate risks to financial stability and growth. The first step in the process is to identify the risks. To do so, responsible authorities need to have sufficient information to detect growing risks or vulnerabilities, and the analytical capacity to identify them as such.

To its credit, the FPC has realised that no single set of indicators can ever provide a perfect guide to risk management or appropriate policy, and it therefore monitors a wide and time-varying set of metrics, as well as qualitative information from market intelligence and other sources.[18] The legislative powers to collect information appear sufficient: the PRA has the power to collect data and the FPC can recommend that it be collected. The BoE's market intelligence function has been useful in helping identify emerging issues and sectors where official data collection is not yet available (e.g. shadow banking and emerging market practices such as collateral swaps). Similarly, the FCA's market surveillance can also be useful in the FPC's risk assessment process (see below). The BoE has, quite properly, not designed an overarching macro-prudential data collection, preferring to be eclectic in its sources. Going forward, it will be important to balance the government's expectations that the FPC will develop a set of published indicators that it will use to monitor and assess risks to financial stability, with the need to have nimble information gathering processes that detect and monitor emerging and previously unanticipated risks.

The next step in the policy-making process is determining the appropriate action. In order to design an appropriate policy response, decision makers will need to have a thorough

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[18] See http://www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx.

understanding of the prudential framework. Given its complexity, this is not a straightforward task for anyone without a background in prudential matters. Given the composition of the new FPC, a particular challenge will be to leverage front-line supervisory actions (in addition to regulatory measures) as a policy tool to promote financial stability. The recommendation on banks' Pillar 3 disclosures in the interim FPC's June 2012 meeting was a promising first step in this regard.[19] The PRA and FCA should continue to develop formal induction and training in support of the FPC and relevant non-PRA BoE staff, so that they have a good appreciation of how the prudential framework and supervisory practice may serve as tools to promote financial stability.

- ***Recommendation 1*: *The FPC should build upon the technical expertise of the PRA and FCA on the prudential framework and supervisory practices when identifying and implementing policies to promote financial stability.***

It will also be important to avoid relying solely on the designated tools over which the FPC has directions power as the primary focus of macro-prudential policy, since other policies (whether micro-prudential or even non-financial) might better deal with certain types of risks. In this regard, the record of the interim FPC is encouraging: it has maintained a broad scope of interest and has generated policy recommendations beyond the tools over which the permanent FPC has directions powers.

Having identified the policy action, the final challenge is maintaining the 'will to act'. While the crisis experience has clearly tilted the culture of UK policy-making in favour of a stronger emphasis on financial stability, maintaining that culture will require ongoing effort. The actions of the interim FPC show that even if the authorities do not have explicit, pre-assigned policy tools for responding to financial stability risks, a sufficiently resolute agency can act appropriately if it feels morally empowered and politically able to do so. However, the challenge of maintaining a robust stance on financial regulation in one of the world's largest financial centres, given its importance to the UK economy, should not be underestimated.

When selecting and deploying policies to support financial stability, the authorities need to understand how they interact with or affect other policy goals. As noted in the recommendations sent to the FPC by HM Treasury in April 2013,[20] the objectives of financial stability and price stability will be complementary with both the MPC's and FPC's primary and secondary objectives respectively. The interaction between macroprudential and monetary policies is the subject of considerable theoretical and empirical work globally, and it is possible for conflicts to arise between these sets of policies. It is therefore appropriate for the two Committees to have overlapping memberships, to share certain policy briefings, and to reflect in their deliberations and public communication how they have regard to the policy actions of each other. In addition, the FPC will need to meet its primary statutory objective of ensuring resilience without adversely affecting growth over the medium and long term, an issue that is already generating difficult policy trade-offs.

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[19] See http://www.bankofengland.co.uk/publications/Pages/Records/fpc/2012/record1207.aspx.

[20] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207473/remit_fpc_290413.pdf for details. The FPC responded to these recommendations in June 2013 (http://www.bankofengland.co.uk/financialstability/Documents/fpc/letters/chancellorletter130626.pdf).

Finally, as in many areas of economic policy, financial stability policy is most effective when it shapes the expectations and behaviour of actors in the system. The most applicable policy response will therefore generally be the one with the most transparent intended outcome. The UK government has already undertaken extensive public consultation throughout the development of new legislation. The challenge will be to better develop understanding and acceptability of the new framework and policy, including the pre-specified tools, the indicator evaluation process, and the rationale for the deployment of the pre-specified tools or other policies, starting from a low base of awareness among market participants and the public. This is a more challenging task than for monetary policy decisions given the broad remit of possible policies that can be employed (or recommended) by the FPC and their more complex transmission mechanism; communicating about tail risks, contingent scenarios and the results of stress tests can also be more complex than communicating about central forecasts. The FPC statements and the FSR address part of this challenge, but the authorities may want to add other communication channels to engage with the public and particular stakeholder groups. These could include targeted public speeches, meetings with industry representatives and other interested members of the public, and plain English 'fact sheets' on the BoE website. In this way, market participants and the public can have a better understanding of macro-prudential policy and gradually adapt to the new framework in their daily operations.

***Inter-agency (and intra-agency) relationships and subject matter expertise**:* The new macro-prudential policy framework is unlikely to function effectively if the different parts of the BoE operate in a silo manner. In the new UK arrangements, coordination and flow of information are largely facilitated through overlapping committee and other memberships. There are early indications of central bank staff actively engaging with supervisors at the PRA, but it is not a given that such collaboration will always work better within the same organisation. To embed that relationship-building into the organisational culture, it will be important to instil a corporate value of respecting different kinds of expertise and technical background. The financial, actuarial, legal and accounting expertise commonly found in prudential supervisors and conduct regulators can provide useful perspectives that can differ from those of central bank economists, who tend to dominate the financial stability discussions. The authorities will need to continue to enhance formal and informal relationship-building, cooperation and coordination via regular fora, briefings, secondment and staff exchange arrangements etc. Setting out guidelines between the FPC, the PRA and FCA that describe the mechanisms for effective communication and close coordination is encouraged. Success in this area over time could be reasonably defined as having supervisors and other experts from the PRA being appointed to senior positions related to financial stability in the rest of the BoE (and vice versa).

In that context, because they are part of the same organisation and because the FPC was initially more focused on major UK bank capital positions, the relationship between the PRA and the FPC has advanced further than that between the FCA and the FPC. The PRA currently plays a greater role in briefing the FPC, and more joint analytical projects have been undertaken between other parts of the BoE and the PRA than with the FCA. However, a conduct regulator has expertise and access to information that central banks cannot easily replicate, such as that obtained through its surveillance function on markets and sectors that are not prudentially regulated. Conduct regulators also have insights into the poor ethics and behaviours that are symptomatic of risk-taking that could pose a threat to financial stability.

Moreover, the best response to a particular risk might be a change to conduct regulation (e.g. on lending standards) rather than a prudential response. For these reasons, it is important that the FPC attain a similar level of engagement with the FCA as it has done with the PRA.

The presentation by FCA staff at FPC briefing meetings is an opportunity for the FCA to actively engage with the FPC on matters within its broad regulatory remit that are relevant for financial stability. To make best use of that opportunity, the FCA will need to enhance its capacity for systemic risk surveillance and analysis so as to protect and enhance the integrity of the financial system. This includes, for example, identifying when a pattern of individual firms' conduct issues or certain market activities and participants (e.g. relating to shadow banking) could give rise to systemic problems.

- ***Recommendation 2*: The FPC should further develop its relationship with the FCA by deepening the latter's involvement in FPC meeting preparations and by jointly undertaking systemic risk analysis work. The FCA should enhance its capacity to undertake such work so as to be able to actively contribute to the FPC deliberations.**

***FPC involvement in the prudential framework*:** The FPC's macro-prudential objectives are distinct from micro-prudential ones: the overriding goal is the stability of the system and steady provision of financial intermediation services to the economy, rather than the health of individual firms. Indeed, the Financial Services Act requires that the FPC use its direction tools to focus on system-wide, rather than firm-specific, issues. The FPC's recommendations and directions cannot be applied solely to individual institutions; nor can its directions specify precisely when the micro-prudential framework should be adjusted. However, the UK financial system is quite concentrated, and the large systemically important financial institutions have distinct business models. Actions to manage a specific risk will inevitably disproportionately affect those few firms that are most involved in the relevant market segment (and may have been responsible for generating that risk). In this sense, the boundary between micro- and macro-prudential supervisory approaches is quite blurred in practice. This blurring is made even more apparent by the fact that certain macro-level factors, such as economic growth and asset price movements, are clearly relevant for individual firms.

It is also worth noting that the explicit separation of specific macro-prudential tools from the overall prudential framework is a relatively new and untested practice globally. The FPC will need to ensure that when applying its designated macro-prudential tools, it is not at cross-purposes with the broader prudential work of the PRA. The overlapping membership of the PRA Board and the FPC is intended to protect against this risk, and there are no indications at this early stage that such a problem has arisen.

If the FPC determines that the appropriate response to a systemic risk is prudential in nature, it will need to decide whether that response should be an adjustment to a designated macro-prudential tool under its control; a 'comply-or-explain' recommendation to the PRA and FCA to adjust the broader prudential framework; or a more general recommendation calling on the relevant UK authorities (and/or market participants) to address the identified risk without prescribing the specifics of the prudential policy response by those authorities.

The Act makes clear that, where relevant to sustaining systemic stability, the FPC should use its 'comply-or-explain' recommendation powers to steer the general policies of the PRA/FCA towards particular types of firms or risks. What is less clear in this context is whether this steer should be expressed in general terms by leaving the details of the response to the agencies, or whether the recommendations can set out specific regulatory details that should be changed (e.g. risk weight parameters, exposure limits etc.). Depending on how specific those recommendations to the PRA and FCA will be regarding implementation details (i.e. which micro-prudential parameter to alter and by how much), the FPC may end up having substantial influence over the details of the prudential framework – an outcome that may create tensions between the relevant agencies and confusion in the marketplace. That risk is tempered by cross-membership between the FPC and the boards of the PRA/FCA and by the FPC's explanation of its recommendations in the record of its meetings and in the FSR, but it may be useful to publicly clarify the FPC's approach on this matter.

- ***Recommendation 3*: The authorities should clarify the appropriate level of detail in the FPC's comply-or-explain recommendations, and thus the influence that the FPC is expected to have on the broader prudential framework.**

3. Micro-prudential supervisory approach

Background

Oversight of the financial sector prior to the crisis relied heavily on market discipline and weaknesses in the supervisory framework enabled the large, complex and interconnected financial institutions to assume substantial risks. The crisis also revealed that there were significant shortcomings in risk measurement and in particular the supervisors' ability to identify and remedy these deficiencies. Recognising these deficiencies and the important international character of the UK financial system, the FSAP noted that the micro-prudential supervisory approach for banks and insurers in the UK needed to be strengthened. It recommended *inter alia* that the authorities:

- amend legislation to allow for regulatory power over holding companies of regulated entities;
- enhance resources for supervision of banks, insurers and securities firms based on the agreed-upon supervisory operating model and the new macro-prudential overlay;
- enhance supervision by conducting detailed reviews of credit and market risk assessment by banks, better integrating specialist work into the supervision program, and enhancing peer analysis;
- adopt a proactive intervention framework through triggers for contacts and coordination actions with other authorities and amend legislation as needed;
- develop a comprehensive plan to enhance prudential reporting and conduct a review to deliver a more systematic approach to data quality; and
- extend the new intrusive risk-based approach to supervision to a wider range of insurers.

This section reviews the progress made by the UK authorities in implementing the FSAP and ROSC recommendations as they pertain to the BCPs[21] and in light of available international guidance in this area.[22]

Steps taken and actions planned

The need for more intrusive supervision was one of the main financial crisis-related lessons identified by the UK authorities. In response to the FSAP and other reports[23] on the causes and impact of the financial crisis on the UK, the FSA tightened its supervisory approach in a number of key areas, including bank governance and Pillar 2 requirements. In October 2012, the PRA issued two documents (subsequently revised and re-issued in April 2013) – one in relation to deposit-taking institutions and investment firms, the other in relation to insurance firms – setting out its proposed supervisory approach. These documents describe the PRA's statutory objectives, set out the expectations that it will have of the firms it regulates, and explain how it intends to assess firms against them.[24]

Amend legislation to allow for regulatory power over holding companies of regulated entities: Under the prior regime, the FSA's power over holding companies was limited to imposing consolidated obligations through the UK regulated entity within a consolidated group, i.e. there was no ability to direct the action of a holding company. This proved to be ineffective in certain cases, for example when the UK regulated entity was small relative to the UK non-regulated entity within a group. As a result, in the Financial Services Act 2012, the UK Government introduced provisions to allow the PRA and the FCA to exercise a power of direction over qualifying parent undertakings in certain situations. The power has since come into force and both regulatory authorities have issued statements of policy on its use.[25] The use of this power will allow both the PRA and the FCA, under specified conditions, to take actions to protect authorised firms from the adverse effects of being part of a group (e.g. financial and reputational contagion, multiple gearing, capital, barriers to effective resolution, and the impact of intra-group relationships on authorised firms).

The power of direction provides the authorities with the ability to enforce prudential standards or systems of governance and controls on a consolidated basis. With this new power, the authorities will have the ability to conduct more effective consolidated supervision in conformance with relevant EU Directives and international standards, in that they will be

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21 The main BCP recommendations focused on CP-1 (Responsibilities and Objectives), CP-19 and CP-20 (Supervisory Approach and Supervisory Techniques), CP-21 (Supervisory Reporting), and CP-24 (Consolidated Supervision). The numbering of the Principles is based on the older (2006) version of the BCPs, upon which the assessment was made.

22 See, for example, the work undertaken by the FSB on supervisory intensity and effectiveness (http://www.financialstabilityboard.org/list/fsb_pa/tid_158/index.htm).

23 See, for example, "The Turner Review: A regulatory response to the global banking crisis" by the FSA (March 2009, available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf).

24 See http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf and http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf.

25 Three sets of powers can be applied directly to a qualifying parent undertaking: a power of direction; a rule-making power for information gathering; and a supporting enforcement power to fine or censure for breaches of a direction or information rule. The definition of a qualifying parent undertaking is outlined in the Financial Services Act 2012. For more details, see http://www.bankofengland.co.uk/publications/Documents/other/pra/powerdirection.pdf and http://www.fca.org.uk/static/documents/policy-statements/fsa-ps13-05.pdf#page=73.

able to take action, when appropriate, at the qualifying parent undertaking level. For dual regulated firms,[26] the FCA can exercise this power to fulfil its oversight responsibilities. In order to ensure consistency in the exercise of this power, the Financial Services Act 2012 requires cross consultation between the PRA and FCA prior to the issuance of a direction.

Enhance resources for the supervision of banks, insurers and securities firms based on the agreed-upon supervisory operating model and the new macro-prudential overlay: In total, the PRA supervises around 900 deposit-taking financial groups (both UK-domiciled and foreign firms) and about the same number of insurers.[27]

Between the advent of the financial crisis in 2007 and 31 March 2012, the number of supervisory staff at the FSA increased by 40% to 3,500 full-time equivalent employees. Of this amount, about 1,000 are operations and central services staff and around 400 are in the Enforcement and Financial Crime Division (the overwhelming majority of whom have remained with the FCA). The remaining 2,000 were roughly evenly split between the Conduct and Prudential Business Units, with the majority of the latter forming the core of the PRA. Of the around 1,000 staff transferred to the PRA, approximately 60% represent front-line supervisors, with a further 27% performing policy and risk specialist roles. The PRA has shifted its rank and mix of supervisors in order to ensure that the highest proportion of senior and experienced supervisors are responsible for supervising those firms that present the greatest risk or impact to the UK's financial system (see Table 1 for a breakdown of resource allocation by functional units).

Table 1: PRA resource allocation by functional units (budgeted for February 2014)

Division	Resources
CEO (CEO Office, FPC and HMT liaison, Supervisory Oversight, COO Office and Central Supervisory Support)	111
Insurance	272
Policy	144
Banking - Risk Specialists	142
Banking - International Banks	129
Banking - Domestic UK and International UK Banks	262
Total	**1,060**

The PRA's approach to banking supervision and insurance supervision allocates more senior supervisory resources to the 20 or so firms (i.e. 200 supervisors, representing an average supervisor to firm ratio of 10:1, supplemented by risk specialists) with the highest potential

[26] These are firms regulated by both the PRA and the FCA (for example, a firm prudentially regulated by the FCA that forms part of a PRA-consolidated group).

[27] Deposit-taking institutions comprise around 240 banks, 50 building societies, 600 credit unions and 12 designated investment firms (these are designated to be under PRA supervision as they have the potential to present significant risk to the stability of the financial system). Insurers include 636 general insurers (of which approximately 300 operate in the UK under a passport from other EEA countries), 123 life insurers (of which 70 will be EEA-authorised), 133 friendly societies and around 132 small insurers involved in the London market.

impact[28] on the UK financial system (Category 1 firms); a further 200 supervisors focus on the next 70-80 most significant firms (Category 2); while the remaining approximately 150 supervisors focus on the 1,300 lower impact firms (Category 3 and below).

The appropriateness of the current level of supervisory coverage (i.e. supervisor to firm ratio) is difficult to assess. The FSB's November 2011 Report on the *Intensity and Effectiveness of SIFI Supervision*[29] noted that across FSB member jurisdictions, supervisory resources per SIFI ranged from the equivalent of 50 to 155 full-time equivalents. While the numbers reflected in the PRA statistics may appear to be on the lower side relative to the ranges suggested above, the more important preconditions to successful supervisory outcomes are expertise and the "will to act". It is therefore essential that supervisory authorities have the ability to attract and retain experienced senior staff that can exercise appropriate judgement and have the necessary gravitas to challenge management. To that end, the PRA's resource allocation model has a high proportion of senior associates (43%) and senior specialists (17%) allocated to the highest impact firms.

Knowledge and supervisory skill development on an on-going basis is an important priority. Training programs include a seven week induction program for any external recruitment or staff transferring into PRA from other areas within the BoE. Additionally, graduates are expected to undertake a three year development programme to provide more in-depth knowledge and experience on key risk issues. Training initiatives are also contemplated by the operating units of the PRA to better reflect local practices and expectations which will be supported by tailored case studies. In addition, the PRA has begun developing a technical competency framework that will define the qualities and characteristics of an effective supervisor that in turn, is expected to influence the types of newly recruited staff. As more enhanced supervisory tools, such as stress testing, evolve further, additional resources with technical skills may be required. It is also expected that more resources may be required to support full implementation of the EU Directive on Solvency II for the insurance sector.

Enhance supervision by conducting detailed reviews of credit and market risk assessment by banks, and verification and selected model replication reviews on a proactive basis; better integrating specialist work into the supervision program; and enhancing peer analysis: To advance the goal of more intrusive, forward looking supervision, the PRA undertakes a set of core supervisory activities that vary in intensity and frequency in accordance with a firm's potential systemic impact. Core assessment work includes at a minimum, one asset quality review and one trading book review for material portfolios; this rigour would typically be applied to Category 1 and 2 firms. The overall supervisory strategy, including the need for detailed asset quality and trading book reviews, is considered in the annual stock-taking meeting. This meeting is an annual process attended by supervisory staff and senior management within the PRA including, for the highest impact firms, the CEO of the PRA. Periodic interim reviews may also be required depending on the perceived risk. Smaller firms would not be subject to a detailed review unless a specific issue requires such an assessment. The PRA's approach also focuses on the need for robust frameworks for risk

[28] The impact of a firm is determined by the extent to which its activities could impair the capacity of the UK financial system as a whole to carry out activities important to the functioning of the economy.

[29] See http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

management and financial and operational controls that are scaled according to the nature, size and complexity of the business.

The PRA has taken a more intrusive approach to understanding firm governance and has observed select board committee and management meetings across a number of major UK banks over the last two years as part of their enterprise wide risk management reviews.[30] A Business Model Analysis (BMA) tool has been rolled-out across the PRA with a more scalable version applied to insurance companies. This analytical tool was first developed by the FSA, but the Financial Services Act 2012 introduced new "business model" threshold conditions for all firms to become authorised, and is an on-going requirement. The FCA has also initiated a similar programme.

Peer review is an important part of the assessment and is used in both banking and insurance analysis. At a high level, horizontal peer reviews are performed on cross-firm risks and in undertaking BMA work on banks. Peer analysis is also employed through detailed risk review work conducted by risk specialists. In addition, the PRA's approach to stress-testing has continued to evolve and further work is underway to set out the strategic vision for future stress testing initiatives, particularly in light of the interim FPC recommendations of the March 2013 meeting.

Under the PRA's supervisory approach, smaller firms will be assessed on a portfolio basis since these firms have the lowest potential impact on the stability of the financial system. Firms in this category tend to be small overseas banks (branches or subsidiaries) and credit unions. Automated tools that trigger alerts and identify outliers are utilised by supervisors to analyse smaller firms' regulatory returns. The PRA has characterised its approach to smaller firms as being more reactive since these firms are generally only examined when their regulatory returns trigger an alert.[31] In order to better understand the risks posed by groups of low impact firms, the PRA will conduct peer group and trend analysis.

With respect to selected model replication reviews for larger firms, the PRA has indicated its intent to focus on the review of model documentation/validation processes (i.e. run sensitivity analysis on key variables and benchmarks through known variables and experience gained across industry sector data) rather than total model replication.[32] The PRA expects firms to maintain an inventory of models they use as well as to monitor and report on material model modifications. Collection of firm inventory information will be provided to the PRA over the coming year. The PRA cautions against heavy reliance on models, noting that management and boards should understand the extent of the firm's reliance on these models and the limitations associated with their use. Senior management is also expected to understand risks that are not captured by the models and ensure that there are alternative risk management processes in place.

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30 See http://www.fsa.gov.uk/doing/regulated/approved/persons.

31 The PRA's approach is not completely reactive: all category 5 firms are subject to an annual Periodic Summary Meeting and a six-month Head of Department review, but will be looked at as a sector rather than on an individual basis. These firms are also covered by the PRA's thematic reviews.

32 Model replication would entail running a parallel modeling exercise to replicate bank model results.

Adopt a proactive intervention framework through triggers for contacts and coordination actions with other authorities and amend legislation as needed: The PRA's Proactive Intervention Framework (PIF) is described in the PRA's April 2013 document entitled *The PRA's approach to banking supervision*. Judgements about a firm's proximity to failure are derived from those elements of the supervisory assessment framework that reflect the risks faced by a firm and its ability to manage those risks. The PRA's view about proximity to failure is expressed by a firm's position within the PIF, ranging from stage 1 (low risk to viability of firm) to stage 5 (firm in resolution or being actively wound up).

The PIF's aim is to ensure that PRA supervisors and senior management identify and respond to emerging risks at an early stage. Each stage rating has a menu of possible prudential actions including a series of triggers for contact and coordination with other authorities, such as the BoE's Special Resolution Unit (SRU) at stage 2 and the FCA (Client Assets and Listing Authority) at stage 3. The FCA is expected to be routinely informed of the PIF stage by the PRA for all dual regulated firms, while the same applies for other UK authorities (e.g. the Financial Claims Compensation Scheme) beginning with stage 3.

The PRA has been working with the SRU to coordinate activities as a firm's risk profile worsens and its PIF rating increases. In order to define accountabilities and responsibilities, the SRU is developing a document that will set out the principles for coordinating staging/intervention activities between the SRU, PRA and (as appropriate) other authorities. The PIF was tested during 2012 with the PRA recently allocating a stage to every Category 1-4 firm (for both insurance and banking), with Category 5 firms being allocated a stage only by exception. A firm's PIF stage rating will be reviewed at least annually and in response to relevant material developments. The PRA expects to publish aggregate statistics on the number of firms in each PIF stage in its Annual Report.

Develop a comprehensive plan to enhance prudential reporting and conduct a review to deliver a more systematic approach to data quality: The PRA has leveraged off of the tools and data analytics systems previously developed by the FSA, and has also developed and implemented new tools (i.e. stress testing and BMA) to identify risk. To oversee the PRA's collection and use of data, it has established a Data Board to act as the single decision-making forum on all PRA data matters, including collection, storage and dissemination. The objective of the Data Board's efforts is to ensure that prudential data collected from firms meets the PRA's supervisory needs.[33] The Data Board is chaired by the PRA's Director of the Risk Specialist Division and contains senior representatives from both banking and insurance supervision, prudential policy, as well as various parts of the BoE (financial stability, monetary analysis and statistics, information service and technology). The Data Board will oversee the execution of the PRA's data strategy, which covers the quantitative and qualitative prudential data collected from regulated firms. To do so, it will conduct a comprehensive review of regulatory data that includes other data-related projects underway as well as move towards compliance with new CRD-related reporting requirements.[34]

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[33] See the BoE's 2012Q4 Quarterly Bulletin for details (available at http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120405.pdf).

[34] The EU reporting framework will replace national rules governing periodic, standardised prudential reporting by banks, building societies and investment firms.

Several actions have been taken by the BoE and the PRA to ensure more consistent data quality across authorities. As part of the PRA's transition programme, a project was initiated that led to the formation of a Regulatory Data Group (RDG)[35] within the BoE's Statistics and Regulatory Data Division. The RDG is mandated to manage and assure the quality of regulatory data on behalf of the PRA. The RDG's systematic data quality assurance will initially focus on the quality of three key data items: the capital statement, balance sheet and enhanced asset-liability mismatch report. A comprehensive use test took place in June, and a launch for all firms took place in July.

As of the PRA's launch date in April 2013, a significant portion of the IT infrastructure was legacy FSA systems. A major focus of the data transformation program will be to move from a predominantly tactical IT system to a more strategic system with data and reporting focused on supporting the more intrusive, forward looking approach to supervision. The data transformation process will initially focus on the current suite of around 300 reporting forms to determine their on-going applicability, particularly in light of new EU requirements. The PRA is working with the FCA to consider which systems are required to receive prudential data from banks, building societies and investment firms. Additional data in support of its more focused mandate will also be identified. A new risk management system that will capture supervisors' risk assessment of firms is expected to be completed by end of 2013, although successful execution will depend upon the ability of supervisors to provide input into the development process. The roadmap that has been developed to guide these changes includes extensive consultation with key stakeholders including firms, the FCA, other areas of the BoE, and overseas regulators.

Extend the new intrusive risk-based approach to supervision to a wider range of insurers: The Core Prudential Programme for Insurers adopted by the PRA comprises three major work streams: BMA, financial risk reviews, and stress testing. While the FSA previously focused on major insurers, the PRA expects to extend its supervisory approach to all insurers.

The Insurance Specialists & Prudential Support is responsible for the recent rollout of the BMA process to a wider range of insurers (i.e. proportionate to the nature, scale and complexity of the supervised firms). Consistent with the PRA's continuous monitoring process, it forms an integral part of the core insurance supervisory practice involving all supervisory reviews. However, BMA is less advanced in the insurance sector and full implementation has been somewhat hampered by resource constraints. Much of the planned insurance supervision reform will be achieved through the forthcoming introduction of the Solvency II framework, complemented by the PRA's more intrusive and forward-looking supervisory approach.

Lessons learned and issues going forward

Significant progress has been made in introducing reforms to the micro-prudential supervisory approach to address the financial crisis-related lessons and the corresponding

[35] Starting in the second quarter of 2011, the BoE established a Data Management Day 1 Project with responsibility for the BoE's existing Statistics Function, which established the RDG. The RDG recruited 26 staff (covering both bank and insurance) by January 2013 and assumed operational data management responsibilities from the FSA in February 2013.

FSAP recommendations. In particular, the UK authorities have amended the legislation to allow regulatory power over holding companies; enhanced risk assessments and are in the process of adopting new supervisory tools; developed a proactive intervention framework; are extending the intrusive risk-based approach to a wider range of insurers; and are undergoing a significant business transformation process. Although the effective date for the separation of the prudential authority from the market conduct authority was in April 2013, a significant amount of preparatory work took place in the prior 18 months.

Notwithstanding these efforts, it is fair to say that many of the initiatives are in their early stages of implementation and are yet to be completely integrated with other supervisory processes. The challenge for the UK authorities will be to continue their work to integrate and roll out the various initiatives at the same time as they adopt important regulatory reforms in response to new international standards and policies. The UK authorities have indicated that the level of prescription required in some EU directives may somewhat constrain the more judgement-based approach currently being pursued as part of the domestic reform process. Additionally, there is the possibility that the magnitude of these changes may be difficult to manage in the timeframes contemplated. Significant interdependence and extensive consultation is required for many of these initiatives. It will be critical for the UK authorities to ensure retention of key senior staff to lead the change over the coming years and to have well-established coordination mechanisms across the different agencies involved in the oversight of the financial sector.

***Cooperation between the FCA and the PRA*:** Approximately 2,000 firms will be subject to dual regulation by both the FCA and the PRA. The PRA is expected to lead the assessment for most of the groups comprising these firms, assisted by the FCA. This approach is being taken to avoid duplication and ensure that supervisory work is conducted in a consistent fashion. Although not significant in terms of the number of groups, there may be cases where the FCA supervises the top-most shareholding entity within a group. Procedures have not been tested in these circumstances and will need to be reviewed on a case-by-case basis. The UK authorities indicate that there is a significant amount of cooperation between the PRA and FCA for these firms, partly stemming from the strong collaborative relationships that staff previously maintained in the FSA.

Dual regulated firms could be subject to the issuance of a power of direction over a qualifying parent undertaking by both the PRA and the FCA. Legislation and the MoU between the FCA and the BoE (including the PRA)[36] require prior consultation between the PRA and the FCA when issuing a power of direction to ensure that both authorities of a dual regulated firm have a clear understanding of how the issuance of a power of direction could impact not only the firm in question but also overall financial stability. In addition, Section 31 of the FSMA gives the PRA the power to issue a direction requiring the FCA not to act in a specified manner where, in the PRA’s view, this would threaten the stability of the UK financial system or result in the failure of a PRA firm in a way that would adversely affect the UK financial system. As already envisaged in the MoU between the PRA and the FCA,[37] the

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[36] See http://www.bankofengland.co.uk/about/Documents/mous/moumarket.pdf.

[37] See http://www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf.

use of these veto powers should include appropriate prior consultation between the PRA, the FCA and other relevant UK authorities to ensure adequate information flow and exchange of views within the parameters set by the agencies' statutory duties. It is expected that the cross-membership of the PRA and FCA Boards, wherein the CEO of each organisation sits on the board of the other, should help to enhance cooperation between these agencies. However, consistent with Principle 3 of the BCPs,[38] the authorities will need to continue to promote strong relationships between staff at all levels in the PRA and FCA in order to ensure effective cooperation and coordination.

Supervisory effectiveness: Various reports on the lessons learned from the financial crisis indicate that the supervisory process was not sufficiently rigorous and that the FSA did not apply appropriate scepticism when overseeing the financial sector. Although there have been some enhancements to the PRA's powers, the more significant change has been the adoption of an approach to supervision that is more intrusive and forward-looking. The authorities should monitor not only the effectiveness of supervisory actions but also the willingness of supervisors at all levels to make this cultural change towards more intrusive oversight. Furthermore, senior management should ensure a culture that encourages the flow of information through the organisation, particularly upwards. Supervisors must have confidence that they can feed bad news up in the organisation without repercussion. Moreover, it is important to do a periodic "use test" to understand if and how risk assessment tools are being integrated into supervisory judgements and actions. Given the newness of the regime and approaches, the authorities may want to consider assessing the usefulness of major supervisory tools on a periodic basis.

The measurement of supervisory effectiveness could take the form of both internal (e.g. survey of PRA managers) and external verification (e.g. industry survey), an approach that has been employed by other supervisory agencies (e.g. OSFI in Canada). The Supervisory Oversight Function can play a role in this area, since it: (1) has been established to provide assurance to PRA senior management as to the quality and effectiveness of supervision; (2) has an independent reporting line to the CEO of the PRA; and (3) regularly reports to senior management about thematic issues arising from effectiveness reviews. Related to this, the BoE's planned internal audit of the PRA is expected to include reviews of a number of areas including the effectiveness of front-line supervisors. The PRA may wish to consider engaging with external stakeholders (e.g. through surveys) and commissioning special reviews to enhance transparency and accountability regarding the effectiveness of the changes.

It is unclear whether the number of front-line supervisors overseeing smaller firms (which collectively can pose risks to financial stability) will be sufficient to satisfy the mandate of the PRA and ensure their effective oversight. Although various tools and techniques are being deployed to ensure that trends and outliers are identified, the regime for many smaller firms is largely reactive. Quantitative measures are often lagging indicators and, without the benefit of a direct view into the control environment as well as management and board oversight, risks may be missed. While the need to focus the rank/mix/number of supervisors for the Category 1 firms is understandable, emerging risks amongst smaller firms can also inform the

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[38] See http://www.bis.org/publ/bcbs230.pdf.

supervisory strategy for larger firms. Small firm failures also have the ability to shake public confidence in supervisory regimes. The PRA will have to ensure that its resourcing model is flexible enough to reallocate staff to small firm supervision should the need arise.

Supervisory resources*:* The new supervisory approach requires front-line supervisors to have the right skills and tools to make judgements about current and future risks to a firm's safety and soundness in order to take appropriate supervisory actions. Part of a supervisor's ability to make such judgements and take actions will depend on his/her ability and opportunity to leverage off of the work of the risk specialists and to make appropriate use of existing industry peer and stress testing analysis. Although the PRA has structurally situated the risk specialists within the bank and insurance supervision departments, the authority should also monitor the effectiveness of the flow of information and analysis between these areas. The UK authorities may wish to further formalise the type of interaction and responsibilities between the risk specialists and front line supervisors. One way would be to ensure a more formalised sign-off by risk specialists on key supervisory ratings (as it pertains to their risk area) and on the overall supervisory strategy as part of the annual stock taking exercise.[39] There should also be a process to encourage the flow of information between industry sectors. Risk specialists and front-line supervisors from both the insurance and bank departments should have the ability to share experiences and lessons since risks from one sector may spill over to the other.

Risk specialist resources will always be in high demand. Risk specialists will largely be dedicated to higher impact firms and be made available only on an as needed basis to other firms. The annual stock taking exercise should be used to assess whether the proportional allocation of risk resources remains appropriate given the results of peer and trend analysis for firms below Categories 1 and 2.

Given that UK-domiciled banks have over half of their assets abroad and foreign banks constitute around half of UK banking assets, the PRA may also wish to consider designating country risk specialists for material jurisdictions to ensure the monitoring of regulatory and market developments as well as the timely identification of emerging risks in that jurisdiction. This can facilitate the supervisory assessment of firms' policies and processes to address country and transfer risks, consistent with BCP 21. The fact that several foreign-owned firms operate in the UK may also necessitate enhanced cooperation and information sharing with home country supervisors, which country risk specialists can help provide.

Although the PRA is not expecting to expand the number of resources dedicated to supervision, there may be a need to re-assess whether an adequate number of resources exist to meet several new initiatives (e.g. sector-wide regular stress testing). Furthermore, given the longevity of the business transition process (3-4 years) for the restructuring of the regulatory system and the potential for distraction due to conflicting priorities from other domestic and international initiatives, implementation risk of the new supervisory approach could be high. There may therefore be a need to keep certain transition groups in place in order to provide

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[39] The Director of Risk Specialists Division is a member of the Supervision, Risk and Policy Committee chaired by the PRA's CEO, and is therefore closely involved in questions of supervisory risk strategy.

for continuous reassessment of human resource needs, including the allocation of resources between the banking and insurance teams.

Increased coordination of front-line supervisors with the risk specialists (i.e. more transaction-based credit and market risk reviews) together with enhanced peer assessments and stress testing should significantly inform the supervisory strategy. An important challenge will be to keep new techniques and tools at the focal point of the supervisory approach and to appropriately embed the results/findings into supervisory strategy and firms' risk ratings. Another challenge will be to determine "how much assessment is enough". For example, model replication may not necessarily be a value added use of resources. The UK authorities have acknowledged that this can be resource-intensive work. It may be more appropriate to focus resources on ensuring that banks have processes with robust vetting and validating models and employ common-portfolio review to periodically assess model outputs. Furthermore, with various competing international developments (e.g. Solvency II for insurance companies), the UK authorities are encouraged to continue to build in-house tools while awaiting finalisation of such rules. The authorities have indicated their desire to move forward to a more rigorous US-type stress testing regime that would allow for the simultaneous assessment of numerous firms. In all likelihood, this more rigorous approach would require more dedicated resources to conduct this annual exercise (or potentially bi-annual exercise) and ensure appropriate coordination between macro-economic inputs and micro-prudential outcomes.

- ***Recommendation 4*: In order to enhance the effectiveness of the supervisory regime, the PRA should: a) continually assess the adequacy of front-line supervisors in terms of numbers and skillset as well as the application of supervisory tools and their contribution to supervisory outputs and judgement (e.g. using external surveys or special reviews); b) formalise the sign-off of individual firms' risk assessments and supervisory strategies by risk specialists; c) ensure an appropriate level of coverage of smaller firms via flexible resourcing models; and d) consider designating country risk specialists to build specialised knowledge for material jurisdictions.**

Disclosure of PIF ratings: As in other jurisdictions, the PRA considers it important for markets and counterparties to make their own judgements on the viability of a firm; therefore, the PRA will not be disclosing to the market the PIF rating of individual firms. However, given the current disclosure obligations for listed firms in EU legislation,[40] the PRA has decided not to disclose the PIF rating to the firm concerned in order to avoid a situation in which the firm would have the legal obligation to publicly disclose the rating. Awareness of the PIF rating, particularly by a firm's Board of Directors and senior management, could positively influence behaviours and compel desired outcomes regarding particular resolvability/recovery actions as firms would better understand the potential consequences. Until these constraints are addressed, the PRA should continue to explore other means to ensure that firms are aware of heightened concerns and accompanying intervention activities.

[40] Firms must comply at all times with their disclosure and transparency obligations in respect of information that would (under the Market Abuse Directive) be likely to have a significant effect on price or (under the Prospectus Directive) be necessary to make an informed assessment of the issuer's financial position and prospects. A firm may therefore conclude that it must disclose a notification of a change in PIF status because, whilst the PIF does not require a particular supervisory intervention as a result of the change of status, it creates an expectation that such action will result.

The PIF does outline in theory the requirements to communicate and coordinate the PIF rating to other appropriate UK authorities. Since the framework was only recently adopted, its effectiveness in the context of communicating ratings amongst agencies is untested. Dual regulated firms will pose unique regulatory/supervisory challenges in terms of the coordination of legal actions and directions.

- ***Recommendation 5: The PRA should ensure that supervised firms are aware of any heightened concerns and accompanying intervention activities, and should explore options to disclose the PIF rating to such firms without triggering public disclosure.***

***Data collection and analysis*:** There are currently many data initiatives underway, including wide-ranging changes required under European legislation, which necessitates adequate (enhanced prudential reporting) and accurate disclosures (data quality) on a firm-by-firm basis. There are also numerous projects under the business transformation initiative with long timelines. Finally, there is a significant degree of co-dependency across projects that has the potential to extend timelines beyond the current plan should any part of the plan be delayed. The UK authorities are encouraged to continue with their coordination efforts amongst the various regulatory agencies to avoid duplication and potential overlap among data initiatives.

In the interim, it will be important for senior management of the PRA and other UK authorities to make use of both firm-specific data and any *ad hoc* data that is being collected and used as part of stress testing exercises. Data is a key input in the development of an appropriate supervisory strategy, including intervention strategies for problem financial institutions. Further, continuous "use test" of models will influence data quality. There is a risk that the collection of data will not be streamlined and that the data requests will not be conducted or coordinated amongst all regulatory authorities (i.e. PRA and FCA), therefore, duplication across regulatory agencies needs to be managed appropriately.

Insurance supervision: Although the PRA is committed to extending its new judgement-led risk-based supervision approach to a wider range of insurers, this process is still evolving. The PRA recognises that there is a wide variety of business models across insurance firms and has committed not to have a one-size-fits-all approach. Going forward, it will be important for the authorities to follow through with their plans to implement the new supervisory approach for insurance companies, and to ensure an appropriate allocation of risk specialists to insurance firms.

4. Supervision and oversight of CCPs

Background

The FSAP noted that the stability of the UK financial sector critically depends on a stronger international framework for oversight of cross-border financial institutions and FMIs. In its assessment, the FSAP noted that FMIs, including CCPs, need to maintain robust prudential and risk management standards. Given the global importance of certain UK-based CCPs, the FSAP recommended that: (i) sufficient and reliable funding options be in place for CCPs, including committed credit lines subject only to presentment (i.e. the credit lines should not contain material adverse change clauses); (ii) contingency plans be developed to deal with a potential failure of a CCP; and (iii) settlement in central bank money be provided to CCPs classified as systemic institutions.[41]

This section reviews the progress made by the UK authorities in implementing the above FSAP recommendations in the context of ongoing international policy developments and domestic (UK) / European Union (EU) regulatory reforms described below. It also briefly discusses the BoE's approach to the supervision of FMIs, including as it relates to the establishment of cooperative oversight arrangements involving the regulators and central banks in the country in which the CCP operates and the countries for which the CCP may be systemically important.[42]

New UK financial services regime: At the time of the FSAP, the main legislative framework for UK financial services regulation, including the supervision of CCPs, was the FSMA, particularly Part 18 (*Recognition Requirements for Investment Exchanges and Clearing Houses)*. The Financial Services Act 2012 amended and made extensive changes to the FSMA and other relevant legislation. More specifically, it assigned the FSA's responsibilities for FMIs (including CCPs) to the BoE as the sole regulator for CCPs, effective 1 April 2013. Concurrently, the BoE published a report (following public consultation) to inform the public, Parliament, the operators of and participants in FMIs, and the wider financial system of its supervisory approach with respect to FMIs.[43] The BoE also published rules for Recognised Clearing Houses (RCHs) covering the appointment and resignation of key individuals, duty and notice requirements for proposals to make regulatory provisions, and fees in respect of expert reports; these rules came into force on 1 April 2013.[44] The responsibility for CCP supervision sits alongside the BoE's responsibilities for the oversight of payment systems and securities settlement systems in the Financial Stability Directorate.

Interaction of the new UK regime with EU financial services regulation: The BoE's supervision of CCPs sits within directly applicable EU regulations and binding technical standards. As mentioned above, CCPs continue to be regulated under Part 18 of FSMA, and are subject to recognition requirements as RCHs.[45] The legal obligations that CCPs have to satisfy are defined in large part under European law. In particular, *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties (CCPs) and trade repositories (TRs)*[46] – known as the European

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[41] These recommendations were principally based on the FSAP's assessment against the CPSS-IOSCO *Recommendations on Securities Settlement Systems* (2001) and the *Recommendations for Central Counterparties* (2004).

[42] Cooperative oversight arrangements is one of the four safeguards identified by the FSB to help national authorities make informed decisions on the appropriate form of CCPs to meet their G20 commitments on over-the-counter (OTC) derivatives market reforms. For more details, see the discussion in the FSB's June 2012 progress report on the implementation of OTC derivatives market reforms (http://www.financialstabilityboard.org/publications/r_120615.pdf) and Responsibility E of the April 2012 CPSS-IOSCO *Principles for Financial Market Infrastructures* or PFMIs (http://www.bis.org/publ/cpss101.htm).

[43] See http://www.bankofengland.co.uk/financialstability/Documents/fmi/fmisupervision.pdf and the BoE's 2013Q2 Quarterly Bulletin article on CCPs (http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb1302ccpsbs.pdf).

[44] See http://www.bankofengland.co.uk/financialstability/Documents/fmi/rulesforrchs.pdf.

[45] UK recognition requirements will be updated and largely superseded by EMIR once a CCP is authorised under EMIR and FSMA RCH provisions will be amended to be in line with EMIR.

[46] See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

Market Infrastructure Regulation (EMIR) – came into force in August 2012, with supporting technical standards entering into force on 15 March 2013. As a directly applicable regulation in the EU Member States, the EU regime establishes key parts of the content of the UK regime, supported where necessary or appropriate by changes to UK implementing legislation. The international standards for payment, clearing and settlement systems including CCPs and TRs, i.e. the CPSS-IOSCO PFMIs, form the foundation both for EMIR and for the UK's supervisory regime for CCPs.

EU CCPs, including UK-incorporated CCPs, will be subject to a re-authorisation process according to EMIR, including a pre-determined timeline for granting or refusing re-authorisation. CCPs have until 15 September 2013 to apply for re-authorisation and therefore need to satisfy the provisions of the regulation, together with any additional domestic requirements (to the extent they are not covered by the scope of EMIR) in order to achieve and maintain authorisation.[47] Non-EU ("third country") CCPs providing clearing services in the EU are subject to a recognition regime under the aegis of the EC and the European Securities and Markets Authority (ESMA).[48]

Whether and to what extent UK CCPs comply with EMIR requirements is subject to the assessment and recommendation of the BoE as the home competent authority for supervising UK CCPs (see Table 2 and Annex 1 for the supervised CCPs), as well as to the respective supervisory colleges established for each CCP comprised of other EU authorities.[49] These colleges may include the PRA/FCA as the supervisor of the clearing members with the largest contributions to the respective CCP's default fund and/or the FCA as *inter alia* the supervisory authority for trading venues being served by the CCP. While UK CCPs are awaiting EMIR authorisation, they continue to be supervised under the existing national regime (FSMA).[50] At the time of this review, no UK CCP has been authorised by the BoE on the basis of EMIR, nor has ESMA recognised or admitted any non-EU CCPs to provide clearing services in the EU.[51]

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[47] See http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR.

[48] See http://www.esma.europa.eu/system/files/tc-ccp_applications_updated_20130618.pdf.

[49] EMIR establishes supervisory colleges comprised of: (a) ESMA representatives; (b) the CCP's competent authority; (c) the competent authorities responsible for the supervision of the clearing members of the CCP that are established in the three EU Member States with the largest contributions to the default fund of the CCP referred to in Article 42 of EMIR on an aggregate basis over a one-year period; (d) the competent authorities responsible for the supervision of trading venues served by the CCP; (e) the competent authorities supervising CCPs with which interoperability arrangements have been established; (f) the competent authorities supervising central securities depositories to which the CCP is linked; (g) the relevant members of the European System of Central Banks (ESCB) responsible for the oversight of the CCP and the relevant members of the ESCB responsible for the oversight of the CCPs with which interoperability arrangements have been established; and (h) the central banks of issue of the most relevant EU currencies of the financial instruments cleared. The relevant supervisory college is involved in the EMIR authorisation process for each CCP. See http://register.consilium.europa.eu/pdf/en/13/st10/st10611.en13.pdf.

[50] See http://www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx.

[51] Non-EU CCPs offering clearing services in the EU prior to 15 March 2013 continue to do so under the grandfathering provisions in EMIR.

Table 2: UK CCPs supervised by the BoE (as of July 2013)

Clearing house	Main products cleared	Number of members
European Central Counterparty (EuroCCP) Ltd	European equities	24
CME Clearing Europe Ltd	OTC commodity derivatives and interest rate swaps	18
ICE Clear Europe Ltd	Energy and commodity contracts and European credit default swap transactions, interest rate, fixed income and equity derivatives (post-LIFFE Administration and Management's (LIFFE A&M) clearing migration)[52]	80
LCH.Clearnet Ltd	Clears a range of asset classes including interest rate swaps, repos, equities and commodities	170

Source: BoE Quarterly Bulletin 2013 Q2: *Central counterparties: what are they, why do they matter and how does the Bank supervise them?* By Amandeep Rehlon and Dan Nixon.

(a) The London Metal Exchange Ltd has also made public its intention to establish a UK CCP, aiming to commence clearing in September 2014. Trades in its exchange are currently cleared through LCH.Clearnet Ltd.

(b) EuroClear UK & Ireland Ltd is an RCH under the Act but does not offer central counterparty clearing services.

(c) A list of RCHs can be found at www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx#13.

UK CCPs that will be authorised under EMIR are subject to additional UK requirements with respect to recovery and resolution planning (see below). The EC also publicly consulted in late 2012 on a recovery and resolution framework for financial institutions other than banks (including CCPs)[53] that would complement OTC derivatives regulation under EMIR.

***Global reform initiatives**:* The UK and EU regulations and standards intend to support the implementation of: (i) the 2009 G20 Leaders commitments to reform the OTC derivatives markets;[54] and (ii) the PFMIs. The UK regulatory framework is intended to be consistent with the minimum standards in the PFMIs, but will go beyond those standards if the BoE deems it necessary in order to address systemic risk. For example, in the context of ongoing international work on the design of loss allocation rules for CCPs, the BoE has published high-level principles that could guide the development of such rules.[55]

The PFMIs address contingency planning by requiring CCPs to comprehensively manage risks through recovery and orderly wind-down plans (Principle 3) as well as, among other things, through business continuity planning (Principle 17). Work is also underway by the FSB and standard setting bodies on recovery and resolution regimes for FMIs, including CCPs. As previously mentioned, the FSB identified four safeguards for clearing OTC derivatives through a global framework of CCPs. One of these safeguards is to establish effective resolution regimes. In October 2011, the FSB issued the *Key Attributes of Effective*

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[52] On 1 July 2013, ICE Clear Europe Ltd and LIFFE A&M, the derivatives division of NYSE Euronext, completed the clearing transition for the London-based derivatives market of LIFFE A&M to ICE Clear Europe Ltd. for interest rate products, equities, index and commodities derivatives.

[53] See http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf.

[54] See the Pittsburgh G20 Leaders Statement (http://www.g20.org/documents/#p4) and the FSB's latest progress report on OTC derivatives market reforms (April 2013, http://www.financialstabilityboard.org/publications/r_130415.pdf).

[55] The BoE has publicly stated that it will have regard to such principles in assessing the suitability of a CCP's loss allocation rules. See http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper20.pdf.

Resolution Regimes for Financial Institutions (*Key Attributes*),[56] which also apply to FMIs. In_August 2013, the FSB published proposed guidance on FMI resolution that, together with the consultative report on FMI recovery by CPSS-IOSCO, provides a comprehensive set of guidance on recovery and resolution for different kinds of systemically important FMI.[57]

Steps taken and actions planned

UK supervisory approach for CCPs*:* The BoE notes that its supervisory approach builds upon the PFMIs and the above-mentioned European legal framework with respect to CCPs. Certain areas identified by the BoE as focal points for supervision are: governance of CCPs; loss absorbency; recovery and resolvability; and transparency and disclosure. The BoE periodically issues rules, policy statements and papers further specifying its supervisory framework, e.g. on financial penalties,[58] appointment and resignation of key individuals,[59] or with respect to qualifying parent undertakings of UK RCHs.[60]

The BoE describes its supervisory focus as having a forward-looking view on whether an FMI's governance, operational design, policies or actions pose unacceptable risks to financial stability. This approach shares aspects with the new micro-prudential supervisory approach for financial institutions (see section 3) but also reflects FMI-specific issues and lessons from the BoE's existing supervisory responsibilities. According to the BoE, an important aspect in this context is that its risk assessment starts from an analysis of the main risks to the stability of the UK financial system by the FMI's design or by any interruption to the services it provides. The BoE has stated that it expects the boards and managers of recognised FMIs to have regard to the stability of the financial system as a whole and to take full responsibility for managing their systems in a manner that protects the resilience of the FMI. Consistent with that, the BoE will expect each recognised system to undertake a self-assessment against the PFMIs. FMIs will be expected to review their self-assessment at least annually, and alert the BoE to any material changes.[61] With respect to UK CCPs, self-assessment exercises will be undertaken in the context of their applications for authorisation under EMIR.

Rather than limiting its supervisory actions to assessing compliance with rules, the BoE's approach emphasises the development of frameworks specifically in areas where international standards are due to be developed; for example, in the area of recovery of FMIs. In order to further inform various aspects of CCP supervision, the BoE publishes research papers to provoke industry feedback. The BoE also reports that, where practical, it consults

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56 See http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

57 See http://www.financialstabilityboard.org/press/pr_130812.pdf and http://www.bis.org/publ/cpss109.pdf.

58 See http://www.bankofengland.co.uk/financialstability/Documents/fmi/Penalties.pdf.

59 See http://www.bankofengland.co.uk/financialstability/Documents/fmi/rulesforrchs.pdf.

60 See http://www.bankofengland.co.uk/financialstability/Documents/role/risk_reduction/payment_systems_oversight/pdf/finalcpsupervisionoffmis.pdf.

61 An FMI's self-assessment against the PFMIs and subsequent annual review, together with notification of material changes, are cited as inputs to the BoE's own risk assessment. See http://www.bankofengland.co.uk/publications/Documents/psor/psor2012.pdf.

with CCPs, their participants and other relevant experts (unless such consultation may be prejudicial to financial stability) when developing supervisory policy for CCPs.

Domestic consultation and coordination of the BoE with HM Treasury, FCA and PRA are set out in MoUs that have been adopted by the respective UK authorities. The BoE's supervisory staff cooperates at a working level with staff from the PRA and the FCA (the latter agency represents the UK in ESMA) on entities of the same corporate group or regarding linkages with respect to FMIs as well as on policy issues for CCPs and OTC derivatives market regulation. While the supervisory approach and objectives for CCPs and financial institutions will have elements in common, such as sound governance and resolvability, the BoE recognises that respective entities also have unique characteristics that may require a diverse set of objectives and a more tailored approach. As such, the BoE aims to develop an integrated view on CCPs that considers their financial stability role but is also informed by the perspective of the PRA as the prudential supervisor of CCP clearing members.

The BoE intends to work closely with the PRA and the FCA owing to the interconnections among CCPs, their clearing members and market participants accessing clearing indirectly. The BoE's MoU with the FCA and PRA covers, among other things, cooperation in relation to recognised investment exchanges and RCHs. Where the PRA is responsible for the prudential supervision of participants of FMIs supervised by the BoE, it will share relevant information with the BoE as appropriate and vice versa. The BoE intends to work closely with the FCA where responsibilities overlap – for example, on the supervision of groups that include trading venues as well as CCPs. In addition, the FPC may make recommendations to the BoE in relation to the supervision of FMIs as part of its statutory mandate, and CCP-related issues have already been on the agenda of the interim FPC.

***Reliable funding options**:* The FSAP recommended that the UK authorities work with CCPs to ensure that sufficient and reliable funding options are in place, including committed credit lines subject only to presentment. Since the FSAP, the FSA in cooperation with the BoE has reviewed the liquidity of the two large global CCPs to understand in detail how they manage their liquidity risk under stressed scenarios and to identify any gaps. The BoE has identified certain areas of improvement and has worked with the CCPs to address them over the last 12 months, and it expects all such actions to be completed by September 2013. The BoE is currently conducting liquidity reviews at the two smaller CCPs and will also be reviewing all CCPs' liquidity management practices as part of their EMIR re-authorisation applications.

Presently, one of the two large CCPs does not have committed arrangements/lines in place nor does the BoE require that CCPs do so. It is the BoE's assessment that both of the large global CCPs are able to meet their stressed liquidity needs with the highest quality collateral (cash or high quality government bonds).[62] The BoE receives weekly liquidity stress test reports that it relies upon to ensure that CCPs adequately manage their liquidity risks on an ongoing basis. According to the BoE, all UK CCPs will only accept cash and highly liquid collateral as margin and default fund contributions as required by EMIR. Secured cash collateral held for the benefit of CCPs at commercial banks is seen by the BoE as an acceptable, and even preferable, alternative to committed credit lines due to the ready

[62] USD, GBP and EUR account for approximately 97% of both CCPs' total cash flows.

liquidity and availability of cash. In the BoE's experience, committed credit lines typically include contingencies (such as material adverse change clauses) and, as such, may not be reliable in a stressed situation; therefore, the BoE focuses its supervision on CCPs' management of liquid resources at hand.

The BoE reports that UK CCPs have a mix of committed and uncommitted repo arrangements in place to meet liquidity needs that exceed cash collateral. Certain UK CCPs are in the process of reviewing other funding options. The BoE has also undertaken work to ensure that there are no technical obstacles to provision of liquidity to a CCP against appropriate collateral.[63]

In its liquidity review of the two large global CCPs, the BoE focused on treasury investment and collateral policies, which have been updated to be EMIR-compliant, in addition to liquidity stress testing and monitoring. The reviews revealed that both CCPs run forward-looking liquidity risk stress testing incorporating both operational and default (of the two members posing the largest liquidity drain) stress tests in their material currencies (i.e. USD, GBP and EUR). For currencies accounting for less than 1% of investment management flows, the CCPs monitor their cash inflows/outflows and foreign exchange risk, although they do not conduct detailed liquidity risk stress testing as above. The BoE reports that the CCPs have also put in place a process to review the potential impact on liquidity risk management of any new risk methodology or clearing service, and the BoE requires completion of this process for its own review of significant changes to CCPs' offerings. The liquidity review also revealed further improvements that the CCPs are expected to make to ensure they have in place sufficient and reliable funding options. Although the two CCPs are said to monitor their intra-day liquidity flows and use of daylight lines from their payment banks, the BoE would also like them to introduce intra-day liquidity risk stress testing. Both CCPs will be expected to have introduced this in the course of 2013 as this is also an EMIR requirement. For the other UK CCPs, the BoE has recently started liquidity risk reviews and expects them to meet the same standards as the two large global CCPs by end-2013.

The BoE states that, given competitive pressures to lower a CCP's risk management standards (for example, by accepting lower quality collateral),[64] it will carefully supervise where and how discretion is used in the modelling and assessment of risks, and in the CCP's choices on how to mitigate that risk. This will include the use of specialist resources, potentially commissioning external reviews of CCPs' modelling methodologies, and reacting on a case-by-case basis to proposed changes to risk management processes.

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[63] Appropriate liquidity arrangements is one of the four safeguards identified by the FSB to help national authorities to make informed decisions on the appropriate form of CCPs to meet their G20 commitments on OTC derivatives market reforms. This safeguard is addressed within the PFMIs and also through conclusions by the Economic Consultative Committee (ECC) of the Bank for International Settlements that are included as Appendix II of the FSB's June 2012 progress report on OTC derivatives market reforms (http://www.financialstabilityboard.org/publications/r_120615.pdf). The ECC statement notes that central banks are currently working on how to ensure that there are "no technical obstacles" impeding them from providing liquidity assistance at very short notice to a fundamentally sound, but illiquid, systemically important CCP.

[64] The PFMIs and EMIR grant a certain degree of discretion to the CCP on the specificities of its risk models. Differences in, for example, the relation between the margin model and how tail risks are calculated may result in different degrees of mutualisation of potential losses.

At the European level, the requirement for CCPs to have sufficient and reliable funding options is covered in EMIR, which reflects the PFMI's enhanced standards for CCP credit liquidity management.[65] The BoE has stated that its own supervisory approach for CCPs is intended to be consistent with the PFMIs and that CCPs will be assessed against the PFMIs.[66]

Central bank settlement for CCPs classified as systemic institutions:[67] As above, the relevant requirements are set forth in EMIR, with which UK CCPs must comply and which will be assessed in the re-authorisation process. At present, UK CCPs use payment infrastructure provided by both commercial and central banks to effect movements of funds between themselves and their clearing members. Prior to the FSAP, the BoE was already acting as concentration bank for one large global CCP in Sterling and Euro. In line with the requirements set out in EMIR to settle transactions in central bank money where this is "practical and available" and to reduce the credit risk exposures that CCPs face, other UK CCPs are in the process of moving to settlement in central bank money. In particular, the BoE has become the concentration bank for Sterling settlement for one large global UK CCP. The same CCP is scheduled to complete an analysis on the scope for the BoE to become its concentration bank for Euro settlement by the third quarter of 2013. The BoE is also in discussions with other CCPs about providing Sterling concentration bank services. All UK CCPs have access to securities settlement systems for the lodgement and holding of non-cash collateral and also, in specific cases, for the settlement of cleared contracts.

Contingency plans to deal with a potential failure of a CCP: The FSAP recommendation to develop contingency plans to deal with a potential failure of a CCP is being addressed by the PFMIs, the aforementioned international reforms with respect to the recovery and resolution of FMIs, as well as through relevant UK legislation (including updated recognition requirements) and the BoE's own supervisory focus on ensuring CCPs have loss allocation rules in place (see below).

The UK authorities have also been developing a recovery and resolution framework for CCPs. Legislation was passed in December 2012 that, among other things, provides the BoE with resolution authority and powers over UK CCPs.[68] The key features of the statutory regime are transfer powers (similar to the stabilisation power in the UK's banking resolution regime) with regard to the business of a CCP in resolution; an enhanced power of direction enabling the BoE to direct UK CCPs to take actions on financial stability grounds; and a power of direction by the BoE over an administrator of an insolvent UK CCP. The existing resolution regime for CCPs, which will take effect once secondary legislation has been

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65 These options include cash at the central bank of issue and at creditworthy commercial banks, committed lines of credit, committed foreign exchange swaps, and committed repos, as well as highly marketable collateral held in custody and investments that are readily available and convertible into cash with prearranged and highly reliable funding arrangements, even in extreme but plausible market conditions.

66 CPSS-IOSCO have started the process of monitoring implementation of the PFMIs, and issued the results of the first level 1 assessment of jurisdictions' progress in August 2013; see http://www.bis.org/publ/cpss111.pdf.

67 The UK and EU regimes do not provide for a CCP designation of "systemic importance".

68 See http://www.publications.parliament.uk/pa/bills/cbill/2012-2013/0101/130101.pdf and the FSB peer review on resolution regimes (April 2013, available at http://www.financialstabilityboard.org/publications/r_130411a.pdf).

finalised,[69] does not include a specific restructuring mechanism to recapitalise a CCP (e.g. a bail-in tool), although it may be possible to allocate losses utilising one or more resolution tools (e.g. partial transfer of a CCP's business to another institution or to a BoE-owned bridge institution). The regime is also constrained from having a power to stay the close-out of contracts in resolution by the EU's Financial Collateral Arrangements Directive.[70]

Because CCPs provide critical services to market participants, the continuous functioning of such services is a high priority for regulators. To this end, supplemental work is underway in the UK to set out how CCPs can and should recover from losses that might otherwise threaten their viability, for example through the CCP's introduction of loss allocation rules to address the situation in which they face a loss greater than the size of their available financial resources in the event of a clearing member default, with the aim of continuing to provide clearing services.[71] The BoE has been working with UK CCPs to ensure they have loss allocation rules in place, and CCPs that have not already put rules in place are in the process of implementing corresponding changes to their rulebooks.[72] In some cases, the BoE is requiring CCPs to improve their existing loss allocation rules and put rules in place for remaining services (e.g. for certain product classes). All CCPs re-authorised (or in the process of being re-authorised) under EMIR are now required to have loss allocation rules in place. HM Treasury has recently published legislation that updates the recognition requirements by mandating UK CCPs to introduce such rules into their respective rulebooks. CCPs have six months to put in place arrangements for dealing with losses that arise as a result of member default and nine months to put in place arrangements that arise as a result of losses which arise for some other reason that is not a member default.[73]

As previously mentioned, the BoE has analysed the case for loss allocation rules and has published high-level principles that it will have regard to in assessing the suitability of a CCP's loss allocation rules. These go beyond EMIR requirements and describe how the CCP may further assess members' financial resources e.g. by introducing variation margin haircutting, rights of assessment, initial margin haircutting, and tear-ups. In support of orderly resolution, UK CCPs have also implemented segregated default funds. According to EMIR's capital requirements for CCPs, CCPs are expected to submit wind-down plans to their regulators by the first half of 2014.

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69 HM Treasury's secondary legislation requiring CCPs to have loss allocation rules in place for clearing member defaults was laid in Parliament in July 2013.

70 The April 2013 FSB peer review on resolution regimes recommended that FSB member jurisdictions should undertake certain actions to introduce, or revise their existing, resolution regimes for financial institutions in order to fully implement the *Key Attributes*, including introducing powers to impose a temporary stay on the exercise of contractual acceleration or early termination rights in financial contracts. For more details, see http://www.financialstabilityboard.org/publications/r_130411a.pdf.

71 In the event of such a default, CCPs apply funds in the following order to cover losses: (1) defaulting member's initial margin; (2) defaulting member's default fund contribution; (3) contribution by the CCP (surviving members' default fund contributions). For more details, see Annex 1 of the BoE's April 2013 Financial Stability Paper No. 20 ("Central counterparty loss-allocation rules"). Existing contractual loss allocation rules of CCPs offering clearing services in the UK are based on a CCP's rulebook and contain, for example, rights of assessment/cash calls (uncapped in some instances and only if the participant remains a clearing member of the CCP), variation margin haircutting and tear-ups.

72 All UK CCPs currently have loss allocation rules except for two CCPs on a subset of services.

73 See http://www.legislation.gov.uk/uksi/2013/1908/contents/made. CCPs have until 5 February 2014 to have loss allocation rules for defaults in place, and until 5 May 2014 to have them in place for non-default losses.

Cooperative oversight arrangements*:* One of the four safeguards identified by the FSB is the establishment of cooperative oversight arrangements involving the regulators and central banks in the country in which the CCP operates and the countries for which the CCP may be systemically important; Responsibility E of the PFMIs also requires cooperation among authorities with respect to CCPs. To this end, cooperation with respect to the oversight of UK CCPs is based on different arrangements for the respective entities. UK CCPs will have arrangements in place in the form of supervisory colleges established by EMIR. Where UK CCPs have licenses or operate in non-EU jurisdictions, the UK authorities also have certain arrangements in place with respective jurisdictions that govern the UK's cooperative oversight. Furthermore, the BoE participates in a college arrangement for EU authorities to oversee groups comprising European and non-European CCPs. At present, the BoE is a member of the only such arrangement that has been established (LCH.Clearnet Group). Finally, the BoE has established global, multilateral cooperative oversight arrangements for two UK CCPs clearing OTC derivatives (LCH.Clearnet Ltd.'s Swapclear and ICE Clear Europe's CDS Clear). The respective arrangements may also serve as additional fora for the exchange of information on supervisory issues as well as in contingency situations. Attention is given by the BoE to coordinating supervision within different cooperative structures and between structures, namely those established on the basis of EMIR.

Lessons learned and issues going forward

The BoE is taking important steps to follow up on the FSAP recommendations with respect to sufficient and reliable funding options and central bank settlement for CCPs as well as developing contingency plans to deal with a possible failure of a CCP. Progress on these recommendations has to be seen in the context of ongoing international policy developments and UK/EU regulatory reforms involving CCPs, particularly the implementation of the PFMIs by the UK authorities and in EMIR. Compliance with EMIR requirements, in the context of the re-authorisation process for all EU CCPs, will be assessed by both the national competent authority (in the UK's case, the BoE) and the EMIR supervisory colleges.

As regards the FSAP recommendation on sufficient and reliable funding options for CCPs, it is the BoE's assessment (based on in-depth liquidity reviews) that both of the large global CCPs are able to meet their stressed liquidity needs with the highest quality collateral (cash or high quality government bonds), although certain areas of improvement have been identified and are being addressed. Secured cash collateral held for the benefit of CCPs at commercial banks is seen by the BoE as an acceptable, and even preferable, alternative to committed credit lines; therefore the BoE focuses its supervision on CCPs' management of liquidity resources at hand. As such, not all UK CCPs have committed liquidity arrangements/lines in place nor does the BoE require that they do so. While the BoE's policy is not to produce detailed criteria and guidance on what CCPs are required to do to meet particular elements of the PFMIs or EMIR, the BoE does expect CCPs to comply with the relevant requirements of EMIR and/or the PFMIs by regularly reviewing their assumptions about the liquidity of the assets, establishing relationships with repo counterparties and regularly testing these. These are important steps to support the FSAP recommendation for sufficient and reliable funding options, but it is not clear how the BoE satisfies itself that such repo arrangements are highly reliable, even in extreme but plausible market conditions. Under EMIR, UK CCPs will have to invest at least 95% of their cash investments on a secured basis, and the UK authorities report that major UK CCPs already meet this standard. While a CCP's cash is the first line of defence, a CCP may also have alternative committed funding arrangements in place to meet its obligations, as recommended by the FSAP.

The BoE is also addressing the "no technical obstacles" safeguard for the provision of central bank liquidity to global CCPs (provided that appropriate collateral is available), and is actively involved in relevant international fora.

In accordance with the FSAP recommendation concerning settlement in central bank money for systemically important CCPs, the PFMIs, and the requirements set out in EMIR to settle transactions in central bank money where this is "practical and available", the BoE offers settlement facilities to CCPs in Sterling and Euro. The two large global CCPs have access to BoE Sterling concentration bank services; one of them currently has access to Euro services, while the other is conducting an analysis. Other UK CCPs are engaged in discussions with the BoE for it to become the concentration bank for Sterling settlement. It is important for these efforts to continue in order for the CCPs to reduce credit risk exposures to their financial resource providers.[74]

The BoE has also undertaken significant steps to follow up on the FSAP recommendation that contingency plans be developed to deal with a potential failure of a CCP. Against the backdrop of ongoing international and EU policy work in this area, the UK authorities have launched a number of national initiatives. With respect to resolution of CCPs, the UK relies broadly on resolution tools similar to those available for banks. With respect to recovery, the BoE has been working with UK CCPs to ensure they have loss allocation rules in place for the purpose of covering losses beyond the CCP's financial resources. The UK authorities have recently brought forward legislation that amends the recognition requirements for CCPs to have recovery plans and loss-allocation arrangements in place by 2014.

Cross-border regulatory coordination with respect to CCPs is critical in promoting the safety and efficiency of CCPs. As regards UK CCPs, coordination takes place through supervisory colleges, multilateral cooperative oversight arrangements as well as respective bilateral cooperation with relevant jurisdictions. To this end, some non-EU authorities rely on BoE assessments with respect to UK CCPs offering services in those jurisdictions; some others also conduct their own assessments. Furthermore, coordination and information sharing mechanisms have been, or are due to be, established at both the EU level (EMIR colleges) and at the international level (cooperative oversight arrangements for relevant supervisory authorities of UK CCPs offering clearing services in non-EU jurisdictions). A particular concern with these mechanisms is their complex and partly overlapping structure. The same CCP may end up being subject to various cooperative frameworks (including EMIR colleges) with authorities from different jurisdictions vested with heterogeneous mandates (e.g. central banks, prudential supervisors, market conduct authorities) and covering a broad range of issues (e.g. compliance with regulations, risk assessments, exchange of information, cooperation in business-as-usual and stressed situations etc.). A high-level of cross-border coordination will be important to ensuring the effectiveness of respective arrangements for

[74] The first sentence of Principle 9 of the PFMIs states: "An FMI should conduct its money settlements in central bank money where practical and available."

the supervision of CCPs, without compromising efficiency by creating duplicative or conflicting efforts. As more experience is gained with the functioning of these mechanisms, the UK authorities may want to share any lessons of experience and bring practical problems to the attention of international bodies so that they can be addressed.

The BoE's approach to the supervision of FMIs, i.e. the development of risk assessment frameworks to guide regulatory activities, appears similar to that of the PRA with respect to banks. The BoE analyses connecting points in the underlying framework for CCP supervision in order to develop appropriate supervisory measures to mitigate systemic risk. Going forward, the BoE will need to pay particular attention to how measures implementing EMIR are applied and how CCP supervision is exercised in practice, given the complexities and sequencing challenges facing market participants and FMIs, and the continued changes in the CCP landscape through mergers and the migration of certain clearing activities across different infrastructures.

One important aspect of CCP supervision will be the consultation and coordination of the BoE with other relevant domestic agencies. In particular, it is not yet clear whether and to what extent the interrelated supervisory objectives of the BoE (for CCPs), the PRA (for firms providing financial resources to CCPs and relying on CCP services) and the FCA (for market conduct regulation of such firms; prudential and conduct regulation of trading platforms and large non-bank firms) will be channelled and aligned in practice. It also remains to be seen how these authorities will operationalise coordination and information sharing set out in the relevant MOUs in both normal and stressed conditions given that (for example) different aspects of OTC derivatives markets reforms – such as access to CCPs, client protection, and contingency planning – fall within the remit of different authorities. Information flow is promoted via the membership of the PRA's CEO on the BoE's FMI Board but, as noted in section 3, it will be important to ensure that coordination and information sharing also exists among the staff of the respective agencies and with the FCA.

By performing centralising activities, CCPs create interdependencies and concentrate risks between themselves and among participating firms. To this end, integrating the micro- and macro-prudential perspectives for this market is a difficult but critical task. Relevant policy tools, such as margin and collateral requirements, haircuts or countercyclical capital buffers, can be applied by different agencies in the UK regulatory structure (FPC, BoE, PRA). These can impact the activities of individual CCPs and their clearing members but they also have systemic effects. In this sense, micro-prudential and macro-prudential considerations and objectives will have to be aligned; for example, between the interests of the CCP and its members, in the governance and conduct of a CCP, or in recovery and resolution scenarios. Against this background, the BoE should promote the flow of information across relevant authorities (both domestically and internationally) to develop an integrated view on CCPs combining micro- and macro-prudential perspectives.

- ***Recommendation 6*: The BoE should actively promote the alignment of micro- and macro-prudential objectives for CCP supervision and oversight by systematically elevating relevant issues on the agenda of the FPC and to the attention of the PRA and the FCA**.

Annex 1: Structure of the financial system and regulatory developments

Financial system structure

Financial services are a growing and increasingly important part of the UK economy. The sector contributed 9.6% of the UK's GDP in 2011, versus 5.2% in 2000. Over 1 million people work in financial services with many more employed in related professional services such as law, accountancy and actuarial services. Employment in the sector is not just concentrated in London; more than two-thirds of employment in financial services is located outside London.

Financial sector contribution to UK households and businesses

There are 64 million personal current accounts in the UK, with the vast majority of households having a current account and 90% of adult consumers having at least one current account, giving the UK one of the highest levels of banking penetration among advanced economies. In recent years, the Government has sought to increase penetration of banking services through initiatives such as the basic bank account initiative. There were 9.1 million basic bank accounts in the UK in 2011 – a rise from 2.7 million from 2005. UK fund managers – representing saving through pensions, life assurance policies and other investments – helped protect and grow over GBP 3.2 trillion in financial assets, a significant proportion of which is on behalf of UK households and families.

UK companies raised a total of GBP 286 billion in issuance of shares between 2006 and 2011 – GBP 236 billion of this was in the issuance of shares on the London Stock Exchange markets, with GBP 50 billion raised in private equity. Banks in the UK had outstanding loans of GBP 450 billion in loans to businesses in mid-2012. Of this, approximately GBP 160 billion or 38%, of the loans were extended to small- and medium-sized enterprises. This is a vital source of finance for these enterprises, accounting for 80% of their finance.

The UK financial sector also helped households and business protect against risks and provides stability through the provision of insurance. In 2011, the insurance sector paid out an average of GBP 1,260 per person in the UK in pension benefits, claims related to life insurance, accident and disability policies and general insurance claims.

Financial sector contribution to current and capital accounts

The UK has a comparative advantage in financial services and is a net exporter of financial services, generating a trade surplus of GBP 47.2 billion in 2011. This was roughly the same as the combined surplus of all net exporting industries in the UK and amounted to nearly 4% of GDP on its own. The top destinations for the UK's financial services exports were the Netherlands, France, Germany, Luxembourg and Ireland. UK financial exports also went to emerging markets such as Russia, Saudi Arabia, South Africa and Turkey and international centres such as Hong Kong and Singapore.

The UK as an international financial centre

The UK is an international financial sector with 251 branches and subsidiaries of foreign banks across the UK in March 2011 – more than in any other country worldwide. Foreign banks manage nearly half of UK banking sector assets (equivalent to GBP 8.1 trillion at end of 2011). Around half of European investment banking activity is conducted in London. Of financial groups operating in the UK and valued in excess of GBP 100 million, over 46% are overseas-owned. The UK alongside the US is one of the largest markets in the world for fund management with a record GBP 5.1 trillion assets under fund management. The UK's financial sector is also a world leader in cross-border bank lending (19% of global share), foreign exchange turnover (37%), interest rate OTC derivatives turnover, (46%) and marine insurance and net premium income (19%). The UK also has the second largest share (after the US) of hedge fund assets and private equity.

It is no surprise that location data from the Bank of International Settlements on cross-border holdings shows the UK is "central" to the global financial network in the sense of having many large connections to other centres, including other well-connected financial centres. But the UK is also central in the sense of lying on the path between other nodes, reflecting its role as a financial centre where a bank from a second country raises money in a third country to lend to a fourth. On this measure of centrality, the UK exceeds all other financial centres, including the United States.

Deposit-taking institutions

UK banking sector assets are the fourth largest in the world and include large domestic and foreign-owned financial institutions. The latter – consisting of both foreign branches and subsidiaries – account for one half of banking assets in the UK, while UK-owned banks have over half of their assets outside the country. Overall, these institutions hold over GBP 12 trillion of assets in the UK and globally, equal to just over eight times GDP, of which banks resident in the UK account for assets equivalent to five times GDP. Foreign branches alone account for one-third of UK resident banks' assets.

UK: Global market share in financial services (April 2013)

Products	**UK market share (in per cent unless stated otherwise)**	**Global rank**
International banking		
Lending	19	1
Borrowing	21	1
European activities	50	1
Insurance market		
Global insurance premia	$320 billion	3 (Global) and 1 (Europe)
Pension fund assets	10	1 (Europe)
Equities		
Global foreign equity trading	19	2
Number of International Public Offerings (IPOs)	6 IPOs with 12 per cent market share	17 IPOs in Hong Kong; 12 in the United States

Turnover on the London Stock Exchange (LSE)	5 of global turnover / 7 of global equity market capitalization	
Bonds		
Euro-bonds secondary market	70 per cent of trading by bookrunners in London	
Securitization issuance	6	2 (behind the United States, 75)
Fund management		
Fund management (source of funds)	8	2 (behind the United States, 50)
Hedge fund assets	18	2 (behind the United States, 68)
Private equity investment value	12	2 (behind the United States, 45)
Derivatives		
OTC interest rate derivatives	46 (turnover)	1
Exchange-traded derivatives	Three derivative exchanges: New York Stock Exchange Liffe is #2 for interest rate derivatives in Europe (by volume). London Metals Exchange is #1 for non-ferrous metals. ICE Futures Europe is #1 in Europe and #2 worldwide for energy products.	
Foreign exchange		
Turnover	38	1
Commodities		
Commodity derivatives trading	London and New York are main international players (Chicago is the biggest domestic player).	
Bullion markets (gold/silver)	The London Bullion Market Association (LBMA) is the largest OTC market ahead of New York and Zurich and clears most of the wholesale OTC trades.	
Islamic finance		
Largest number of 'sharia complaint' banks (22), exchange-traded funds (7), law firms (25) among Western countries; issued 37 sukuk on LSE.		
Sources: TheCityUK, Bank of England		

As can be seen from the table above, UK financial institutions and market infrastructure are both widely exposed to stresses originating from elsewhere in the world and potentially can cause spillovers onto the global financial system and economy.

UK: Composition of the banking system
(in GBP millions)

Date	Firm	Total assets		Total sterling assets		Sterling loans and advances	
		Amount		Amount		Amount	
Dec-10	UK owned MFIs	5,968,217	49.2%	2,602,367	71.0%	1,987,967	70.9%
	Non-UK owned MFIs	6,169,746	50.8%	1,062,145	29.0%	815,570	29.1%
		12,137,963	**100.0%**	**3,664,512**	**100.0%**	**2,803,537**	**100.0%**
Dec-11	UK owned MFIs	6,384,494	47.2%	2,637,824	72.0%	2,175,867	73.4%
	Non-UK owned MFIs	7,156,072	52.8%	1,027,610	28.0%	786,531	26.6%
		13,540,566	**100.0%**	**3,665,434**	**100.0%**	**2,962,398**	**100.0%**
Dec-12	UK owned MFIs	5,953,424	47.8%	2,684,131	72.6%	2,289,625	75.9%
	Non-UK owned MFIs	6,498,745	52.2%	1,010,551	27.4%	728,063	24.1%
		12,452,168	**100.0%**	**3,694,682**	**100.0%**	**3,017,688**	**100.0%**

Source: Bank of England, 2012

Recapitalisation of the Royal Bank of Scotland and Lloyds Banking Group

In the immediate aftermath of the financial crisis in 2008-09, the UK Government undertook a number of interventions to prevent a catastrophic collapse of the financial sector, to protect depositors and ensure vital functions such as the payment system continuing to operate. This included a capital injection of GBP 66 billion into both The Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG), for which the Government became an 80% and 40% shareholder, respectively. The Government also nationalised Northern Rock and Bradford and Bingley. The retail deposits and branch network of the latter were transferred to Abbey National plc. Northern Rock, on the other hand, was split into Northern Rock plc and Northern Rock Asset Management and the former sold to Virgin Money. The remaining assets of both Northern Rock Asset Management and Bradford and Bingley are now managed by UK Asset Resolution, which is fully owned by the Government. These shareholdings are managed on a commercial and arm's length basis by UK Financial Investments Ltd (UKFI). As an engaged shareholder, UKFI works closely with the banks' management to assure itself of the banks' approach to strategy and to hold management rigorously to account for performance. However, UKFI's role is to manage the investment, not to manage the banks; the banks retain their own independent board and management teams for strategic and operational decision-making.

Both RBS and LBG are to make a retail divestment of branches as a result of European Commission approval of the aid that they received from the UK government during the financial crisis. This aid was subject to approval by the European Commission under the European Union's State aid rules, which regulate the provision of aid to private companies. RBS is to divest 320 branches (with the package known as 'Rainbow') and LBG is to divest 630 branches (with the package known as 'Verde').

Insurance companies

The UK insurance market is the largest in Europe and the third largest in the world, accounting for 7% of total worldwide premium income1 (2011 figures). It employs 290,000 people and contributes GBP 10.4 billion in taxes.

The general insurance market has grown in 2010 and 2011 with non-life firms accepting GBP 68.3 billion in premiums in 2011. In the life insurance market, there continue to be net outflows as the population ages and customers are increasingly moving from the accumulation (e.g. pensions) to the decummulation (e.g. annuities) phase of savings products.

A major threat to life and general insurers continues to be the prolonged macroeconomic downturn. A persistent low interest rate environment threatens to undermine the value proposition of life insurance companies and puts pressure on general insurance writers to underwrite profitably.

The unresolved timetable for Solvency II implementation presents significant uncertainty for the UK insurance industry. Whilst European negotiations continue to be delayed, preparation for implementation of Solvency II continues to consume resources for all major insurers.

Financial markets

The UK is recognised as a major international centre for financial services and is the largest global exporter of financial services. Given this context, the UK has a particularly deep wholesale financial market in relation to its retail market participation. Since the FSAP, the UK has benefited from the on-going development of an EU single market for financial services, and supports well-regulated and open markets. Given the size and importance of the UK's market, the new regulatory framework places a very strong emphasis on market conduct and investor protection.

The size and depth of the UK's market is evidenced across all major asset classes (following statistics taken from CityUK, April 2013, unless otherwise stated). In derivatives, the UK enjoys a significant proportion of global over-the-counter trading, with a notable 46% market share in OTC interest rate derivatives (source: BIS 2010). The UK also enjoys a prominent role in the exchange-traded derivatives market, with over 1.5 billion contracts traded on UK derivatives exchanges in 2011. Worldwide, the largest exchange derivatives groups are the US-based CME Group, the UK-based NYSE LIFFE and German-based Eurex (based on notional value of trading). Commodity derivatives trading is also a significant component of the UK market, as evidenced by the presence of the London Metal Exchange, ICE Futures Europe (the largest EU energy futures exchange) and NYSE LIFFE.

The UK's global share of foreign exchange trading is estimated at 37% - the highest proportion worldwide. The UK also has substantial domestic and international bond markets (led by the Eurobond market) - in both issuance and secondary trading - with the outstanding value of UK international bonds estimated at GBP 3.5 trillion by end-2012, and with an estimated 70% of secondary market trading activity in international bonds. Due in part to deleveraging in the financial sector, private sector bond issuance in the UK has recently fallen. However, the LSE launched a platform for the trading of bonds to retail investors in February 2010 – where the UK has historically had a limited market– which has expanded rapidly since its creation.

Underpinning the UK's market structure is a strong emphasis on competition – as evidenced by the successful London Stock Exchange, but also the presence of alternative multilateral trading facilities. UK-based equity trading venues dominate secondary market trading in Europe. Three UK platforms account for one third of total turnover in European equities: The London Stock Exchange Group, and the two multilateral trading facilities, BATS/Chi-X and Turquoise. In the 'lit' order book equity trading sector, these venues account for nearly half of all European equity turnover. Dark order-book trading is also conducted over UK platforms, although is far less common in Europe compared to the USA, accounting for no more than 7% of total secondary trading. In UK equities specifically, the UK's primary exchange (LSE) still dominates the trading landscape, with 37% of trade turnover, set against BATS/Chi-X and Turquoise accounting jointly for around 20% of UK equities. Trading volumes on all venues fell between 15% and 20% in 2012; however, the first quarter of 2013 recorded a notable improvement in activity.

Figures from the London Stock Exchange Group indicate that around a fifth of companies listed on the London Stock Exchange's main market or junior market are international, with UK equity markets providing an important source of finance to domestic and international businesses alike. The UK listings themselves make up 7% of global equity market capitalization and account for 5% of global equity turnover. The UK has the highest equity market capitalization in relation to GDP of the developed economies, with 165% at the end of 2012. Against challenging market conditions following the financial crisis, the capacity to raise further finance has been important and remained robust, with the IPO market also now strengthening. The UK's equity markets also play a key role in financing small and medium sized businesses, due to the presence of a junior growth market, AIM, which has raised almost GBP 81 billion since its launch in 1995. ISDX is another UK-based small-company growth market, with 144 companies listed, making London a leader in small cap markets in Europe. The UK takes a strong interest in the SME sector: its role in the wider economy; its ability to access finance; and capacity to raise a diversified source of financing, in addition to traditional bank finance.

Fund management

The UK asset management industry is a world-leading industry in the management of third-party assets. These assets are managed on behalf of a wide range of clients, of whom the major ones are estimated to be: pension funds (approx. GBP 2 trillion), insurance funds (approx. GBP 1.8 trillion) and mutual funds (GBP 525 billion mutual funds). The UK is estimated to be the second largest manager of assets globally (with around 8% market share), albeit significantly behind the US (approximately 50% market share). The UK is Europe's leading fund manager, managing c.33% of all assets under management in Europe and is estimated to have the highest ratio of assets managed to GDP of any country globally (272%).

The industry has continued to grow significantly, and UK assets under management are estimated to be around GBP 5.1 trillion at end 2011.

The UK is also a major centre for alternative asset management, with approximately 18% of global hedge fund assets managed in the UK (which is around 80% of the assets managed in Europe). UK Private Equity firms accounted for 12% of global investments in 2011 (USD30 billion), second to US firms (45% / USD112 billion).

Payments

Inter-bank payment systems handled 7 billion transactions with a value of GBP 69.2 trillion in 2011, of which GBP 68.5 trillion were electronic and GBP 705 billion were paper transactions (mainly cheques). The card and ATM networks handled 9.4 billion purchases in the UK with a total value of GBP 474 billion, and facilitated cash acquisition of GBP 199 billion.

The BoE is responsible for oversight of systemically important inter-bank payment systems. Some risk-reducing changes have been implemented over the past year. These include:

- Reduced tiering: Banks with a significant amount of sterling payments should participate in the CHAPS system directly rather than indirectly.
- Improved default arrangements for Deferred Net Settlement (DNS) payment systems, limiting the maximum debit position of each member during the settlement cycle, and arrangements to increase these caps by lodging additional collateral if necessary.
- Work is underway to develop a long-term model for eliminating settlement risk in the DNS systems.
- Work is also underway to introduce a Special Administration Regime for Payment and Settlement Systems to minimise the potential disruption of an insolvent Payment or Settlement System. HM Treasury has consulted industry on the design of the regime. The consultation closed on 19th June 2013, and the UK government is currently considering the responses from industry.

Regulatory structure and developments

The UK Government has taken a large number of important steps to reform the regulatory and legislative framework, to address the lessons already learned from the financial crisis. These steps are intended to (1) reform the corporate governance of banking institutions, (2) change the amount of capital firms will need, (3) reduce their leverage; lead to more intensive regulation of such firms, and (4) give the authorities new powers to deal with failing banks.

Banking Reform Bill

The Financial Services (Banking Reform) Bill was introduced to Parliament on 4 February 2013 with the aim of establishing a more resilient, stable, and competitive banking sector, to reduce the severity of a future financial crisis, and to protect taxpayers in the event of such a crisis. The Bill implements many of the recommendations of the Independent Commission on Banking (ICB), chaired by Sir John Vickers. Pre-legislative scrutiny of the Bill was carried out by the Parliamentary Commission on Banking Standards (PCBS), in response to which the Government made a number of amendments based on their recommendations.

The Bill will:

- Introduce a ring-fence around deposits to separate important everyday banking activities from investment banking activities for the largest deposit-takers.
- Give deposits protected under the Financial Services Compensation Scheme preference if a bank enters insolvency.
- Give the Government power to regulate the way in which debt requirements are imposed on banks, to ensure banks are more able to absorb losses during a crisis.

Ring-fencing: Ring-fencing will improve the resolvability of banks and create a more sustainable banking industry. It will insulate core banking services whose temporary disruption would have a significant direct impact on the domestic economy – in particular the taking of deposits and the provision of overdraft facilities and payments services. Ring-fencing will also support continuity of provision of these vital core services, even where financial institutions are in trouble, reducing the perceived implicit guarantee that the Government will be compelled to step in to support failing banks that are perceived to be "too big to fail".

"Electrification": The UK Government has agreed with the PCBS that a reserve power to require banks to divest certain operations may be a powerful additional tool to guarantee the independence of ring-fenced banks within their corporate group. This so-called "electrification" of the ring-fence will enable the regulator to split individual banks if this is necessary to achieve the purposes of ring-fencing.

Depositor Preference: Depositor preference gives depositors, protected under the UK Financial Services Compensation Scheme, preference if a bank enters insolvency.

The Government will implement the ICB recommendation for deposits which are eligible for compensation under the FSCS ('insured deposits') to be made preferred debts. Uninsured deposits would continue to rank alongside senior unsecured creditors in the insolvency creditor hierarchy. This form of depositor preference would improve financial stability, by reducing the risk of contagion to other financial services firms, and the contingent liability for the taxpayer, should a bank fail.

Primary loss-absorbing capacity (PLAC): The Bill enables the Government to require the setting of robust debt requirements on banks. This will ensure that banks are able to absorb more losses during a crisis.

All banks should be subject to normal competitive market forces. They must be able to fail safely without relying on a perceived implicit government guarantee and without putting the provision of core banking services at risk.

Meeting the costs of international bodies: Meeting the costs of international bodies will ensure that the industry, not the taxpayer, meets the Treasury's costs of participating in international bodies concerned with financial services or financial stability, such as the FSB.

The Bill amends the FSMA 2000 to enable HM Treasury to recover costs and expenses it incurs arising from its participation in international organisations whose functions relate to financial stability and financial services.

The Parliamentary Commission on Banking Standards (PCBS)

The PCBS is a joint committee appointed by both Houses and chaired by Andrew Tyrie MP. The Committee has a remit to consider and report on:

- Professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process
- Lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action.

The PCBS published their report on 19 June and the Government responded in July.

LIBOR and Benchmark Reform

Through the Financial Services Act, the UK Government has made two new regulated activities related to benchmarks. In particular, the activities of submission to, and administering of, LIBOR (the London Inter-Bank Offered Rate) are now regulated activities. The FCA has subsequently made rules detailing the obligations on firms when carrying out these activities. The rules outline high level requirements on the systems and control frameworks, as well as the requirement to have a thorough submission methodology, that LIBOR submitting banks must have. The rules also outline the required governance frameworks for the LIBOR administrator and the obligation to monitor and survey submissions in order to identify potential manipulation. Submitting-banks' systems in relation to LIBOR will be comprehensively reviewed in late 2013 and will be regularly monitored through supervision.

Opening up UK payments

The Government is proposing to bring inter-bank payment systems under economic regulation by creating a new competition-focused, utility-style regulator for payment systems. A consultation setting out the Government's proposals is accessible at www.hm-treasury.gov.uk/consult_opening_up_uk_payments.htm.

Non-bank resolution

The UK has already extended resolution powers for banks to certain non-bank financial institutions: investment firms, parent undertakings and central counterparties (through the Financial Services Act 2012). The Government has already consulted on proposals for the resolution of payment and settlement systems, and the responses indicated that a Special Administration Regime (SAR) was a more appropriate way of dealing with the failure of such systems. As such, HM Treasury consulted on the design of a SAR; the consultation closed on 19th June and the government is currently reviewing the responses.

Financial Services Trade and Investment Board (FSTIB)

The UK Government recently announced the creation of the Financial Services Trade and Investment Board (FSTIB), which will be chaired by a senior Treasury official and will comprise senior representatives from UK Trade and Investment (UKTI), other parts of the UK Government and TheCityUK which will represent the UK financial services industry. The Board will have the authority and expertise to identify trade and investment priorities, and to ensure that Government and the industry acts together to pursue these opportunities vigorously.

EU and international regulation

The UK Government has been at the forefront of much of the broader international debate on reforming financial regulation. The results have included international agreement on reforming bank capital and liquidity, through the Basel III accord, framework for ending “too big to fail” through strengthened resolution regimes and resolution planning for global systemically important banks (G-SIBs) as well as reforms to OTC derivatives. The UK is also working hard to make sure that what has been agreed at a G20 level is adopted in the EU. As such, the UK’s European financial services priorities for 2013 are:

Banking union: The UK has consistently argued that euro area Member States will need to integrate further to provide stability to the single currency. The Commission’s proposal to give responsibility for the supervision of euro area banks to the European Central Bank is an important first step in this regard. It is important that any proposals for a euro area banking union reflect the needs of all Member States and respects the unity and integrity of the Single Market.

Markets in Financial Instruments Directive: MiFID 2 introduces a variety of new rules for financial markets, building on the original MiFID which came into force in 2007. The key areas for the UK are on market structure and open access. On market structure, the MiFID proposal brings more trading venues into scope (Organised Trading Facility) and increases transparency. The UK supports both measures, but want to ensure that end users do not end up paying more. OTFs help clients find liquidity and get a good price in less liquid instruments. Sometimes the best price is available in unlit markets or on venues which use own capital to facilitate trades.

Recovery and resolution: The bank recovery and resolution directive (RRD), once adopted, will require EU Member States to adopt a common set of minimum recovery and resolution tools for resolving failing banks and investment firms in an orderly manner, increasing the likelihood that creditors of the failed bank bear the losses, and not the taxpayer. The European Commission’s forthcoming proposal on the recovery and resolution of non-bank financial institutions is likely to require a minimum toolkit for certain of these institutions, particularly CCPs.

Insurance: UK Government and industry are supportive of Solvency II, which, by creating a single rule-book and single market for insurance, will put European insurers on a sounder prudential footing and will open up opportunities for UK industry across the EU. There is, however, currently some uncertainty over the timetable for implementation of Solvency II.

Occupational pensions: The Commission is reviewing the Institutions for Occupational Retirement Provision (IORP) Directive. No proposals have been formally tabled however the direction of this review is to impose Solvency II inspired capital requirements on defined benefit occupational pensions. This is very strongly opposed by the UK as it would reduce growth, investment, competitiveness, jobs and pensions income across Europe.

Undertakings for Collective Investment in Transferable Securities (UCITS): The UK is seeking consistency with the standards of the Alternative Investment Fund Managers Directive in the UCITS V proposals unless there is a compelling reason to deviate as this already sets an extremely high standard of investor protection. The UK would also specifically support a mechanism for contractual discharge of liability and to allow national depositary regimes to continue.

Shadow banking: The UK Government has consistently argued that all financial institutions and activities, whether shadow banking or otherwise, that cause bank-like risks should be subject to appropriate regulation. This should be based on sound evidence which takes full account of the potential positive contribution to growth that shadow banking could make and a balanced approach that balances risks and potential benefits.

Annex 2: Follow-up action by the UK authorities on other key FSAP recommendations

This Annex presents the follow-up actions reported by the UK authorities to key FSAP recommendations that are not covered in sections 2-4. The actions mentioned below have not been evaluated as part of the peer review and are presented solely for purposes of transparency and completeness.

Recommendations	*Steps taken to date and actions planned (including timeframes)*
Overall Financial Sector Oversight	
Establish a forum for ensuring good governance and coordination among organizations in the new regulatory structure (HMT).	The Financial Services Act 2012 establishes a range of requirements and mechanisms covering the coordination between the new regulatory authorities. These include requirements for the regulators to consult each other when (for example) making rules, supported by a broader duty to coordinate requiring the regulators to coordinate their functions whenever their actions might have an adverse effect on each others' objectives, and a requirement on the PRA and FCA to establish an MoU covering matters of common regulatory interest. The overlapping memberships of the PRA board, FPC and the board of the FCA (as well as the Monetary Policy Committee) are crucial. This will support the flow of information across the different bodies and an understanding (link) of their approaches and likely reactions to events. At a working level, it is supported by the existence of dedicated teams responsible for co-ordinating analysis, and sharing information, across the FPC, FCA and PRA.
Enforce public disclosure by banks, insurance and securities firms, including publishing prudential returns as appropriate (FSA).	During the passage of the Bill, the Government considered whether it would be helpful to require the authorities to establish a forum to oversee this coordination. The Government's view was that the authorities will coordinate with each other at many levels on a day-to-day basis (for example, through supervisory colleges covering dual regulated firms) – and so effective coordination would best be achieved on a flexible and non-statutory basis, rather than requiring the authorities to establish a single specific forum to do so. Insurance: The Tiner Reforms, which were initially set out in *The future regulation of insurance* (November 2001) and *The future regulation of insurance: a progress report* (October 2002) and were summarised in *Delivering the Tiner Reforms* (April 2005) included the streamlining of FSA insurance regulatory data. All aspects of the annual returns are publicly available. Upon implementation of Solvency II the scope, granularity and frequency of regulatory data collection will increase significantly. The PRA continues to work with the European Insurance and Occupational Pensions Authority to develop the framework for this data collection. Re changes to bank reporting requirements, see also the micro-prudential response in relation to EU CRD-related reporting requirements included in [table 4E]. In addition, see paragraph 66 of The PRA approach to banking supervision, April 2013.
Insurance Sector Oversight	
Increase the frequency and number of randomly conducted "transaction examinations" for both the largest and some smaller insurers (FSA).	The new PRA supervisory approach will increase the frequency and intensity of firm examinations in particular for those firms that pose a significant risk to the PRA's objectives. For the largest firms the PRA intends to increase the use of skilled person reports on specific areas to provide assurance of compliance with the standards the PRA expects of firms.

Securities Market Oversight	
Clarify in legislation that the remit of the conduct authority includes market integrity and transparency to ensure adequate emphasis on issues other than consumer protection (HMT).	The Government has legislated through the Financial Services Act 2012 to give the FCA a distinct operational objective of protecting and enhancing the integrity of the UK financial system, alongside two further operational objectives of protecting consumers and promoting effective competition in the interests of consumers.
Increase intensity of supervision with greater use of "bottom up" analysis of firm operations using on-site examinations, including thematic work, to supplement the "top down" risk analysis (FSA).	Conduct Supervision-the FCA has developed a new supervisory model based on three pillars. The first pillar involves firm supervisory work. 'Bottom-up' analysis of the firms in the securities market follows from an initial Business Model and Strategy Analysis which highlights areas of potential, or actual, conduct risk within a sector. It informs firm specific work subsequently carried out by the supervisors over the next regulatory cycle and where applicable, supervisors conduct 'deep dives' to look specifically at firms' operations in the securities markets, ranging from product development, sales, execution and post transaction services. The second Pillar involves thematic work. Thematic work is generated by risk maps maintained by the relevant sector team. For securities firms, these risks are captured by the Wholesale Firms and/or the Capital Markets sector team's risk maps. Thematic work involves visiting a range of firms to carry out detailed work on a specific and clearly defined topic. The third pillar involves event-driven work where specialist teams manage the issues presented by specific events or issues arising either in a single firm cutting across a number of firms. The intensity of micro-prudential supervision and the use of analysis is addressed in Annex A and responses to earlier questions. Moreover, section II of the PRA approach documents outlines the use of analysis to inform supervisory assessments and the factors influencing the intensity of supervision.
Payments and Securities Systems Oversight	
Establish close monitoring of concentration of banks' payment and settlements activities (BoE, FSA).	The BoE is the regulator of CCPs, securities settlement systems and recognised payment systems in the UK. The Bank has developed indicators to monitor concentration of banks' payment and settlement activities. The Bank regularly shares data and liaises with the PRA and FCA on supervised firms where appropriate. Since the FSAP, the Bank has sought to reduce the degree of concentration in the provision of access to the CHAPS large value system. As a result, one large indirect participant has joined, reducing concentration, and some others have committed to join over the next three years. Euroclear UK & Ireland has begun analysing data on tiering and is discussing settlement bank status with several large members of CREST.
Undertake a unified assessment of the real time gross settlement (RTGS) infrastructure, including an assessment of the finality of transactions (BoE).	The BoE conducts such assessments under its own risk framework. The last such assessment was undertaken in 2012.
Crisis Management	
Establish appropriate resolution tools and framework for potentially systemically important nonbank firms that are not covered by the Special Resolution Regime (Tripartite).	Following the consultation 'Financial sector resolution: broadening the regime' in August 2012, the authorities have been giving further consideration to the need for resolution powers, or similar powers, for critical FMI. HMT has already consulted on the design of a special administration regime for payment and settlement systems. The consultation closed on 19 June and the government is currently reviewing the responses. Special Resolution Regime transfers powers have been extended to CCPs, and the UK is pursuing further technical amendments to the Financial Collateral Arrangements Directive to enable a stay on close-out of contracts in resolution.