Financial Services Authority

Financial Risk Outlook 2006

Promoting efficient, orderly and fair markets

Helping retail consumers achieve a fair deal

Improving our business capability and effectiveness

Financial Services Authority
Financial Risk Outlook
2006

25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

Contents

Foreword

We publish the *Financial Risk Outlook* to raise awareness of the key risks present in our operating environment and to increase understanding of our actions. It also contributes to our objective of promoting public understanding of the financial system. We hope that firms and consumer organisations will find it a useful addition to their own risk management and planning.

The Financial Risk Outlook *highlights the main risks to our statutory objectives and strategic aims*

The Financial Services and Markets Act 2000 (FSMA) sets out four statutory objectives for the FSA: to maintain confidence in the UK financial system; to promote understanding of the financial system; to secure the appropriate degree of protection for consumers; and to help reduce the scope for financial crime. To help us meet these objectives we pursue three strategic aims: promoting efficient, orderly and fair markets; helping retail consumers achieve a fair deal; and improving our business capability and effectiveness.

Our ability to meet our statutory objectives and strategic aims is affected by a range of external factors. These include economic conditions, the performance of financial markets, social and demographic change and legal and regulatory developments. The *Financial Risk Outlook* highlights the main risks to our statutory objectives that we have identified in these areas. We refer to these as our *Priority risks*. The *Priority risks* are the issues that we think pose the most significant risks to our statutory objectives and strategic aims in the next 18 months, although we generally consider a broader time horizon of 5 years.

The *Priority risks*, by their nature, often arise from things that we cannot control directly; but we aim to reduce the likelihood of crystallisation and the extent of any adverse effects they may have. We do this by taking new initiatives and by focusing our existing risk-based activities on areas where the *Priority risks* have the most impact. A recent example, which touches on a number of this year's *Priority risks*, was our decision to look more closely at the hedge-fund sector in 2005.

In addition to our central scenario, which this year is largely benign, we have presented three alternative scenarios, each of which is rather less so. Over the coming months we will monitor the likelihood of these other scenarios materialising and assess whether there is any related need to adjust our *Business Plan* accordingly.

We summarise the most important risks in Section A, Priority risks

The *Executive summary* and the *Priority risks* are presented in Section A. We set out more detailed analysis of the risks present in our operating environment in the context of a small number of scenarios in Section B, *Economic and financial conditions*. We discuss risks identified in the banking, capital markets, asset management, and insurance sectors in Section C, *Developments in industry*. Section D looks at *consumers' engagement with industry*, Section E considers financial-crime issues and Section F presents the legal and regulatory framework.

Regulatory change continues to be a key challenge for firms and consumers (and for us). The *International Regulatory Outlook 2006*, which we published in November 2005, offers a more extensive analysis of regulatory change being driven by international developments.

We welcome comments on the *Financial Risk Outlook*; please send them to: financialriskoutlook@fsa.gov.uk

Executive summary and Priority risks

Executive summary

Our central macroeconomic case is one of continued economic and financial stability. This is in line with consensus forecasts which suggest that the short-term economic outlook will remain benign. Nevertheless, there are considerable uncertainties surrounding this forecast – arising principally from the future path of oil prices, increasing global imbalances, and a slowdown in global consumption.

Risks to financial stability

Economic and financial conditions, *Section B*

These uncertainties suggest that in 2006 the risks to macroeconomic stability and growth are more weighted towards the downside than in 2005. The fact that credit spreads are at historically low levels, in part driven by high levels of liquidity, also heightens uncertainty. These risks are compounded by the continuing, and arguably increasing, threat of disruptive 'events' that would be high impact, but that are very low probability, in nature. Many pricing assumptions for risk, and many cost/benefit decisions relating to contingency planning, derive from past expectations of such very low probabilities, which recent experience may now be challenging. We believe it is now more important than ever that firms analyse and test alternative assumptions, and that they invest appropriately in, and respond proactively to, effective stress testing of their key risks. Firms should also ensure that their business-continuity and disaster-recovery arrangements provide resilience in the event of a range of different types of major operational disruption.

Developments in industry

Banks and building societies, *Section C*

The favourable economic environment has put UK banks and building societies in a strong position, in terms of both capital and profitability. Evidence that the consumer-credit cycle has turned indicates that UK retail banks and building societies may face a more challenging operating environment in the future. However, in the absence of a significant rise in unemployment they should comfortably weather the increase in direct financial costs stemming from an increase in bad debts. The 2006/07 outlook therefore remains benign in this regard. However, firms could still suffer reputational damage if the turn in the credit cycle reveals that they have given credit to large numbers of consumers who are unable to afford their debt repayments.

Investment banks have played a leading role in the design of structured products both to achieve risk transfer and to meet the demand for extra yield that has built up during this period of low interest rates. While product innovation can both benefit investors and reduce risk concentration, it also raises a wide range of concerns – for example, relating to legal and operational risk or the risk of mis-selling (including when the product is sold via a third party). The growth in trade volumes in credit derivatives has also raised an operational risk in capital markets because it has created backlogs in outstanding trade confirmations. Market confidence and financial stability issues may become more important if the credit, equity, or commodity derivative markets do not have sufficient operational capacity to settle trades on a timely basis. So we continue to encourage the industry to address this issue as a matter of urgency.

Capital markets and financial exchanges, *Section C*

Asset management, *Section C*

The asset-management sector has benefited from the generally stronger performance in equity markets in 2004 and 2005, though traditional asset managers continue to face heightened competitive pressures from hedge funds and other alternative investments. Hedge funds, however, found the operating environment more difficult in 2005 because of reduced market volatility. Some strategies have also become less profitable due to large fund inflows. Nevertheless, because of their share of market turnover, hedge funds are playing an increasingly important role in financial markets.

Life insurance *and* General insurance, *Section C*

The insurance industry has faced a testing operating environment in recent years. The underwriting cycle, the impact of climate change, exposure to terrorism and contract certainty continue to pose challenges to general-insurance firms. Life insurers have had to adjust to persistently low inflation and interest rates, increased competition and pension-reform uncertainty. Despite these challenges, firms have made progress in modernising their businesses, and the changes in the regulatory regime are starting to bed in.

Consumers’ engagement with industry

Retirement planning *and* Consumer confidence in investment and long-term savings products, *Section D*

The future for retirement provision in the UK is a critical issue for financial product providers and consumers. Significant changes in the UK’s demographic profile have placed (and will continue to place) more responsibility on consumers to make provisions for their retirement, yet many still have inadequate plans in place for this. In part, this is driven by households channelling their disposable income into spending or, perhaps appropriately, by prioritising debt repayment. However, consumers’ lack of confidence in, and their limited capability in relation to, long-term savings products also plays an important role in driving this trend.

Retail intermediaries, *Section D*

Retail product distribution is changing for a variety of reasons, ranging from regulatory and policy reform to competitive pressures and technological developments. These changes should increase consumer choice, improve the transparency of advice, and increase consumer protection. This presents the industry with new opportunities, but also major challenges. The quality of consumer advice and the level of consumer financial capability will be particularly critical issues, because of the increasing complexity in both consumers’ needs and the products being introduced in the marketplace.

Financial crime

Financial crime, *Section E*

Many of the virtues of our financial system – such as openness, transparency, and ease of use – may be exploited by criminals looking to commit financial crime. In a financial environment of greater technological complexity and growing cross-border transactions, financial fraud risk is on the rise. Consumers are often the weak link in fraud protection strategies, even though they usually bear the burden through higher prices/costs. In response, large firms and law enforcement agencies are not only improving their own fraud detection and prevention strategies but are also seeking to develop consumer awareness in this area as a risk-mitigation strategy.

Legal and regulatory framework

The international dimension to regulation, *Section F*

EU Directives increasingly drive the regulatory agenda in the UK. This is expected to remain so over the medium term. The sheer volume of change driven by international initiatives heightens compliance risk for firms, and puts pressure on scarce resources, potentially with high opportunity cost and increased operational risk.

Auditing and accounting, *Section F*

EU Directives have also brought about great change in financial reporting, as all EU-listed groups are now required to report using International Financial Reporting Standards (IFRS). It is vital that these standards be consistently applied throughout the EU to ensure that confidence in a level playing field across European markets is not lost.

Priority risks

The *Priority risks* are the issues that we think are most likely to threaten our ability to meet our statutory objectives and strategic aims over the short to medium term. We have grouped them together under the headings of two of our strategic aims – promoting efficient, orderly and fair markets and helping retail consumers achieve a fair deal. We have not listed the *Priority risks* in any ranked order.

In the next section of this document, *Economic and financial conditions*, we note the recent developments in the global economy and also consider how three *Alternative scenarios* could affect the *Priority risks*.

Promoting efficient, orderly and fair markets

In a period of low market volatility, it is still important for firms to evaluate how they would respond to extreme risk scenarios

Risks to financial stability, *Section B*

Although the global economy has performed strongly over the last few years, sudden financial shocks could still pose a threat to financial stability. Such shocks can take a variety of forms, such as natural disasters (possibly driven by climate change), global pandemic, political instability in a major economy, a large terrorist attack, or a major corporate bankruptcy. Disruptive events such as these can cause ripple effects throughout the financial system via different transmission mechanisms. In particular, market participants might find it difficult to manage their positions in certain instruments and could struggle to sell large quantities of a position. It is important that firms continually reassess inputs into their stress-testing models to ensure that they are up to date. For example, risks arising from major terrorist events or natural disasters could be thought to have a higher probability now than a decade ago due to changes to the geopolitical environment or climatic patterns.

Stress testing can help senior management evaluate how their firm may respond to extreme, but plausible, risks and so test the risk appetite of their business. In particular, it can help to identify which key parameters and assumptions are more sensitive to market disruptions, and the scenarios under which traditional hedging and risk-transfer strategies may become less effective. It can also help firms to adopt a forward-looking and dynamic view of internal capital requirements and allocation.

Firms are improving their stress-testing practices at differing rates. Our evidence suggests that industry practice in relation to market-risk stress testing remains more advanced than that for other risk types. More firms have developed models that use historical experience to inform hypothetical scenarios, rather than simply re-running past events. However, fully embedding stress testing into their risk management processes remains a key challenge for many firms.

Larger and more complex firms in particular should aim to use aggregated risks in their stress tests. We recognise that there are still significant obstacles to developing effective methodologies and in collecting the necessary data from often incompatible IT systems. Nevertheless, without these systems in place, there is an increased risk that financial conglomerates may not be fully aware of hidden correlations across portfolios. Mathematical models are not a complete solution for effective risk management and firms' senior management should also ensure that they are incorporating risk management into the day-to-day operations of their firm. As well as being of benefit to individual firms, there are significant systemic benefits to firms having more robust risk-management practices, as these enhance the resilience of the financial system as a whole.

Terrorism poses a range of financial-crime, operational and insurance risks

London and other major financial centres are high-profile targets for direct terrorist attacks. This represents an operational risk for firms and a potential source of market disruption.

The 7 July 2005 attacks in London highlighted the risks from domestic terrorist groups and the wider networks that allow them to operate. They also demonstrated the relatively low costs needed to sustain a terrorist cell and launch an attack. The difficulty in identifying terrorist funds continues to pose problems for both law enforcement and financial institutions.

Financial crime, *Section E*

Apart from the human costs of terrorist attacks, terrorist finance also potentially poses significant danger to the reputation of UK financial markets. The international and domestic counter-terrorist financing regime is designed to create a more difficult financial environment for terrorists and their financiers to operate in. The firms we regulate have addressed this by increasing both the costs and risks for these groups, but the threat is constantly evolving.

Life insurance *and* General insurance, *Section C*

The UK insurance industry, both life and general insurers, is also financially exposed to domestic and overseas terrorist events. Although firms have demonstrated their ability to withstand significant shocks in recent years, the potential losses from a single terrorist event could be larger than the private sector is prepared to finance. Government-backed arrangements for reinsurance remain crucial for ensuring availability of direct cover.

Illiquid financial instruments are difficult to value, which raises operational and conflict-of-interest risks

Asset management, *Section C*

Over the past few years, the appetite for alternative, often complex and illiquid, financial instruments has increased. Investments such as private equity, complex derivatives, structured products, and distressed debt can play an important role in the asset diversification and risk management of investor portfolios. These investments help to increase both the depth and breadth of the capital markets. However, they are less liquid than exchange-traded securities and generally more difficult to price and trade, which gives rise to valuation concerns.

Both regulators and trade associations have identified a number of potential operational risks in relation to the valuation of illiquid assets. In some cases, systems that have been developed to value more liquid assets may not be well-equipped to cope with illiquid instruments. As these instruments do not trade frequently, back-office staff and third-party administrators may lack the capacity to value them properly, which has implications for margins, capital, collateral, hedging and reporting.

Uncertainty about the valuation of illiquid assets may also increase the risk of conflicts of interest, or even fraud, to the detriment of the investor and of market confidence more generally. A significant proportion of revenue, of both traditional and alternative fund managers, comes from management and performance fees. Since these fees are a function of asset valuations there may be incentives to overvalue assets. A number of incidences of false and fraudulent valuations have been identified around the globe and we expect an increase in such developments.

The level of outstanding credit-derivative trade confirmations presents operational and legal risks for firms

Banks and building societies *and* Capital markets and financial exchanges, *Section C*

Credit derivatives provide a valuable mechanism through which financial market participants can manage their credit risk, bringing together those who wish to reduce credit exposures with those who are prepared to increase them. The market has continued to grow at a rapid pace and firms such as hedge funds have become increasingly important, as both buyers and sellers of these instruments. Operational and legal risks may arise if the market is unable to keep up with this growth.

Without confirmation that a trade has taken place, parties to the transaction are exposed to legal and financial uncertainty. If a credit event occurs while a credit-derivative transaction remains unconfirmed, doubt as to its legal validity and contractual responsibilities could prevent the transaction from being executed. This uncertainty could create liquidity problems and act as an accelerant in a financial crisis.

The *Financial Risk Outlook 2005* noted the pressure on firms' back-office and documentation procedures as a result of the rapid growth in the credit-derivatives market. Following warnings by us and an initiative launched by the New York Federal Reserve Bank with international regulators in September 2005, the backlog of confirmations now appears to be falling. However, we remain concerned and we and the industry need to work to ensure that the backlog continues to fall.

The risk of financial fraud is increasing

Financial crime, *Section E*

The financial environment is particularly susceptible to fraud because the risk-reward pay-off of fraud is favourable compared to many other crimes. Firms' increasingly complex structures can allow internal fraud to go unnoticed for long periods of time; the internet is providing criminals with opportunities to attack firms; and fraudsters can hide their money trails, often through internet-based products.

As we move increasingly to electronic and online transactions, consumers and smaller firms find it more difficult to keep up with the rapid developments and are thus more susceptible to fraud, or being a conduit for fraud.

The disincentives to commit fraud could be seen to be falling when compared with the potential rewards. Among the competing demands on most police forces, fraud has been a low priority, and prosecutions often lead to expensive and complex fraud trials. Prison sentences for fraud are also short compared to those for other crimes. Consequently, we expect organised criminals to focus their resources increasingly on fraud.

In the short term, the main mitigants to this risk will be increased collaboration within the financial services industry to share information on fraud, and increased consumer awareness. It is likely that current collaboration will initially reduce the occurrence of the most prolific frauds and have an impact on more sophisticated crimes as collaboration increases. Consumer awareness and responsibility have to be seen as vital components of all anti-fraud strategies, as consumers often hold much of the data that is misappropriated.

In the longer term, the Fraud Bill currently before Parliament, the Government's wide-ranging Review of Fraud and the creation of the Serious and Organised Crime Agency (SOCA) are all positive developments and should create more disincentives for criminals to commit fraud.

Financial institutions are dealing with a substantial volume of international regulatory reform

The international dimension to regulation, *Section F*

The volume of regulatory reform and the need to contain the regulatory burden on firms continues to create challenges for the financial services industry and its regulators worldwide. One important issue is achieving a reasonable coordination of, and balance between, the levels of engagement of home and host country supervisors.

We remain particularly concerned about the challenges facing many firms through to 2008 arising from the need to comply with new EU obligations. Firms need to devote adequate resources, including senior-management time, to address implementation issues and manage their compliance risk. Firms that underestimate this challenge are likely to incur significant last-minute costs and/or additional compliance risk.

The European Commission has said that its legislative programme for financial services will enter a consolidation phase during the period to 2010 and that new legislative proposals will have to pass a rigorous cost-benefit process. While this additional discipline in policy-making is welcome, there are several important issues that the European Commission is studying that may give rise to further legislation, including in the fields of asset management, mortgages and clearing and settlement services.

Helping retail consumers achieve a fair deal

A significant minority of consumers could experience financial problems because of their high levels of borrowing

Banks and building societies, *Section C*

Despite signs of cooling in the housing market and a general slowdown in consumer spending, levels of consumer borrowing continue to grow, both in absolute terms and relative to income.

At present the low level of unemployment and low interest rate environment make the cost of servicing the level of outstanding debt affordable for most consumers, but any significant rise in these variables, particularly unemployment, has the potential to expose households as having taken on too much debt. Even in the current benign economic environment, we are seeing signs of growing distress among consumers, including more insolvencies, more late payments on credit cards and a rise in mortgage repossession orders. Our consumer research shows that many consumers with significant borrowing commitments are currently struggling to keep up with repayments. So it is important that, before taking on new debt, consumers assess their ability to service it, especially if their circumstances change unexpectedly.

A situation where significant numbers of households are experiencing debt repayment problems has consequences for the UK economy, providers of credit and consumers. Regulated firms are well placed in terms of profitability and levels of capital to absorb the effects of lower lending growth and increased bad debts. However, significant reputational damage could occur if they are seen (in retrospect) to have given credit to large numbers of individuals who are unable to afford debt repayments. Additionally, mortgage distributors could be accused of mis-selling if they fail to provide the relevant disclosures to the mortgage buyer (as highlighted in our mystery shopping exercise report on mortgage disclosure documents, published in August 2005) or if they fail to take account of the consumer's ability to repay.

Increasingly complex financial decisions will pose a challenge for many consumers

Consumers' engagement with industry, *Section D*

Rising debt problems also highlight concerns over consumers taking financial decisions with inadequate understanding of the potential risks arising from a changed economic environment.

A combination of economic and demographic factors, a shift in responsibility from government and employers to individuals, market innovation, and changing lifestyles have led to increased choice for consumers in financial services. However, increased choice has been accompanied by increasing complexity in both products and wider financial decisions. Increased complexity and uncertainty could lead to consumers buying products that are not suitable for them and/or appropriate for their needs. The sales channel used can have a large impact on consumer understanding, with direct non-advised sales making consumers more reliant on the information used in sales promotions. While consumers need to take time to understand product details, providers and advisers should also help them by providing clear explanations of products and their associated risks, costs and benefits. Consumer confidence in financial products can also be eroded if consumers are not treated fairly throughout the life of a product.

Consumers are also receiving conflicting messages about financial services and planning: whether to save for the long term or borrow and take advantage of cheap credit; and whether to be wary of mis-selling or have faith in providers and distributors of financial products. Many consumers consequently have trouble making sense of this changing environment and making informed and confident choices.

The consumer response to the increase in complexity has been varied. Some consumers increasingly seek advice from a wide range of sources, including friends and family, the media, best-buy tables and financial advisers. Despite this, consumers who are better informed and therefore better equipped to make decisions are still a relatively small minority. There are also many consumers who have become increasingly disengaged from the market. We believe that the trend of increased complexity is likely to continue and have concerns that many consumers will not be able to cope with this.

In particular, it is often difficult for consumers to understand the key features of, and risks associated with, particular products, in some cases because the literature and the sales process fail to make this information sufficiently transparent. There remain concerns that this can lead to unsuitable higher-risk products being sold and promoted to consumers who, in reality, have a low risk appetite and risk tolerance.

Consumers may also find some protection products difficult to understand, either in determining the suitability of the product for their circumstances (for example, when there may be detailed exclusions in the cover provided) or in making a claim under their policy. Variation in the details between different policies makes it difficult for consumers to compare products and assess their value to them. Individuals may need to review some products on a regular basis to ensure that they remain suitable for their needs, and in some instances consumers may, in particular, need to evaluate the impact of the product on their entitlement to state benefits.

Consumers need to take more responsibility for financing their retirement

Consumers' engagement with industry, *Section D*

The size of the population above the state pensionable age is projected to grow to 12.2 million by 2010 (up 9.3% from 2004), indicating that there is likely to be increasing demand for retirement products and advice. Mortality rates have declined, particularly among older age groups, and many people are living longer than they expected. This means that prior retirement plans made on the basis of funding a shorter time period may be insufficient.

Changes in government policy have meant that consumers have more responsibility in financing their retirement. However, our research shows that many consumers focus more on immediate financial concerns than their long-term financial well-being, and confidence in long-term savings remains weak. This means that, while consumers are becoming aware of the challenges facing our ageing population on pension provision, a shift in consumer behaviour to remedy the problem may take some time. However, in the short term consumers should ensure that they regularly review their existing arrangements.

The increase in household debt may impede some consumers from putting additional resources into savings for retirement, or even from making a start on building up a retirement fund. The consequences of this are that some people will need to work until a later age, or make significant changes to their standard of living in retirement. Increasing home ownership and the rise in housing wealth has also meant that many consumers hold a significant amount of wealth at retirement in the form of property.

Industry has responded to the increase in consumers' responsibility for their long-term financial planning by increasing the range of long-term savings products available, such as equity release and income drawdown. Many consumers are also facing the decision of whether to contract out of or back into the State Second Pension (S2P). The pensions market will also see significant changes from 6 April 2006 with the introduction of pensions simplification – 'A-Day'.

A wider range of assets used for retirement saving may entail more complex decisions at the decumulation stage.[1] It can also be very difficult for consumers to understand the costs, terms and conditions and the associated risks of the products they are purchasing. While these products can meet consumer needs during retirement, they are not suitable for all circumstances. Therefore, it is important that consumers understand the risks and benefits associated with a wider choice of products and, where necessary, seek advice.

1 The term 'decumulation' refers to the process whereby wealth accumulated throughout an individual's lifetime through savings and investment products, for example, is drawn down to meet the consumer's needs in retirement.

Economic and financial conditions

Background

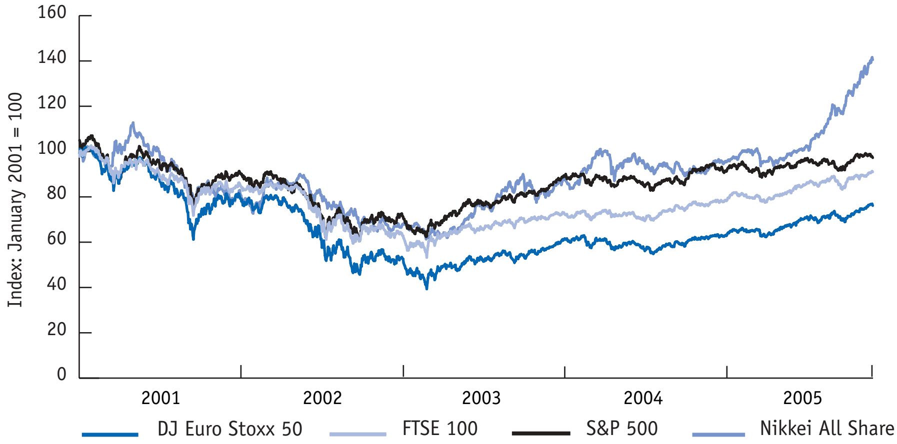
In this section we set out current global economic conditions and the recent performance of financial markets in the UK and around the world. We also look at the prospects for the financial markets and the global economy. The performance of the global economy has been strong and, despite the mild cyclical downturn, the outlook remains generally stable. Many of the factors that stimulated growth in 2004 and 2005 remain in place, but there are still some risks to this central projection. While the short-term outlook remains benign, the global economy has some underlying vulnerabilities that may jeopardise core stability in the long term. Given this uncertainty, we present three *Alternative scenarios* for the global economy and explore the implications for the UK economy and financial services if any one of these crystallises.

Equity and foreign exchange markets

Equity markets continued to rise in 2005 and financial conditions remained benign

Global financial market conditions remained positive in 2005. Leading equity indices in Europe continued to strengthen over the course of the year. However, the major Asian stock markets witnessed even larger increases, fuelled by foreign money in search of higher yields; notably, Japan's Nikkei Index rose to a five-year high. One exception to this positive global picture, however, was the performance of the US stock market. Despite positive economic and corporate news, leading US equity indices moved very little over the course of the year.

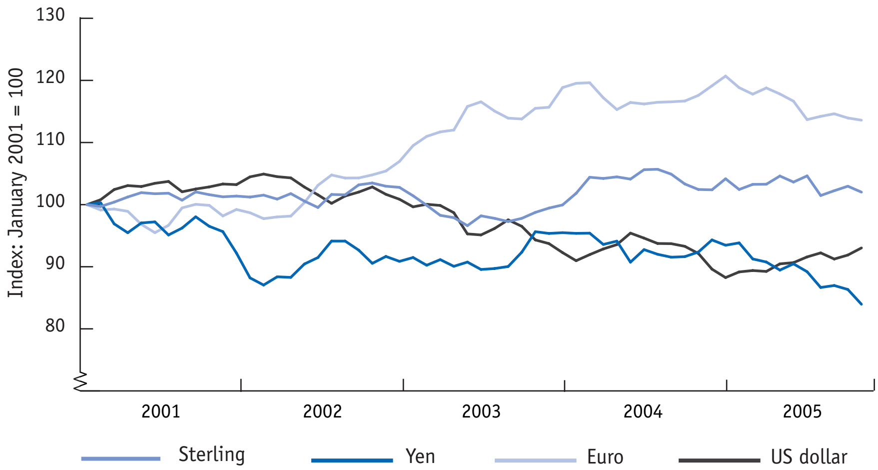
Chart B1: Major international equity indices



Source: Datastream

UK equity prices continued to rise in 2005 – the FTSE 100 index gained 17% over the year – against a background of generally positive sentiment in global financial markets. This reflected, in part, an increase in corporate earnings growth. The FTSE has benefited particularly from higher oil and commodity prices, as it has the largest weighting for natural resources companies of any major market in the world.

Chart B2: Real effective exchange rates



Source: Datastream and FSA calculations

The US dollar rose modestly but the outlook for the dollar remains uncertain

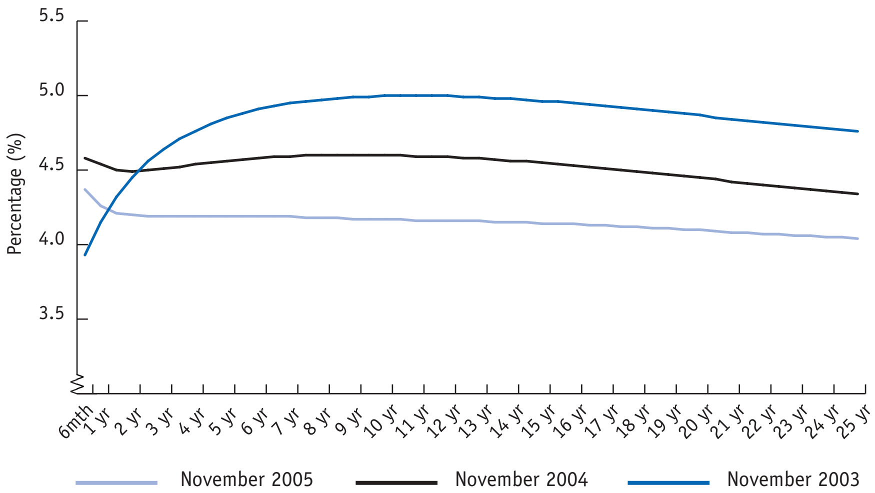
On foreign-exchange markets, the US dollar strengthened modestly despite the continuing large US current-account deficit. Although China shifted its currency peg to a basket of currencies in July 2005, the renminbi has so far risen only slightly against the dollar because of the Chinese government's restrictions on daily currency fluctuations. Sterling depreciated by 9% against the US dollar during 2005, after reaching a 12-year high against the US currency in December 2004. The continuing internal and external imbalances make the future of US-dollar movements uncertain. We consider this further in our *Large and disorderly depreciation of the US dollar and rising interest rates* scenario.

Interest rates and the yield curve

US short-term interest rates rose, flattening the yield curve

US long-term Treasury-bond yields remained broadly unchanged during 2005, despite the Federal Reserve continuing to raise short-term interest rates. This resulted in a gradual flattening of the US yield curve over the course of the year. The UK yield curve, meanwhile, has been mildly inverted since mid-2004. The fact that benchmark borrowing costs remain so unusually low relative to both inflation and nominal GDP growth – former Federal Reserve chairman Alan Greenspan's famous 'conundrum' – has been a subject of considerable debate among policymakers. Further US rate increases will depend greatly on the strength of forthcoming economic data and the actions of Greenspan's successor.

Chart B3: UK yield curve

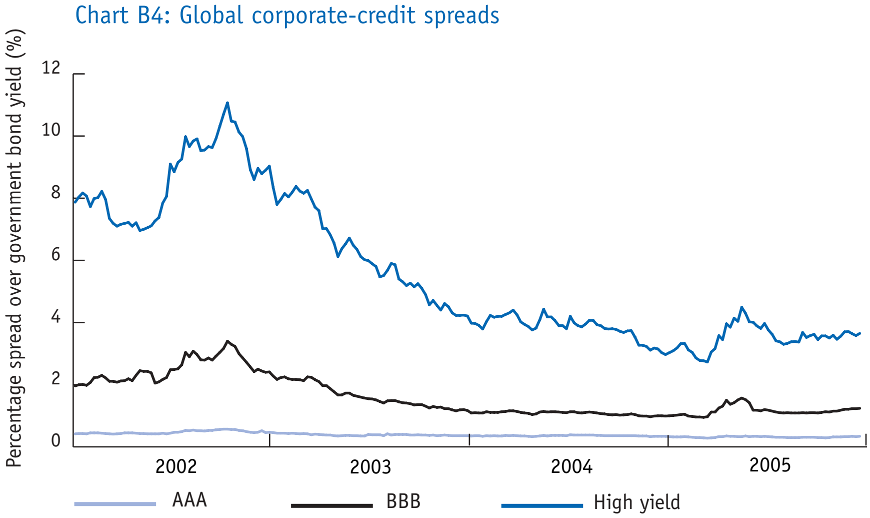


Source: Bank of England

Yields on emerging-market and corporate debt remained low in 2005

Global corporate credit spreads remained historically tight in 2005, although there was a slight widening from the start of the year. This trend was also largely reflected in UK credit markets. In contrast, despite high issuance, yields on emerging-market debt reached record lows, emphasising investor appetite for high-yield fixed-income instruments and improved emerging market fundamentals. Markets were unsettled temporarily by the unexpected profit warnings from and subsequent downgrades of General Motors and Ford in spring 2005, and global spreads widened temporarily. In our view, event risk is accelerating, partly because of continuing high energy prices that are adversely affecting demand and eroding earnings in the corporate sector. A negative event could result in a sudden widening of spreads and high market volatility.

Chart B4: Global corporate-credit spreads



Source: Merrill Lynch

Global economic conditions

Global growth continues to be driven by consumption in the US and production in China

Higher oil prices dampened economic activity in 2005, yet the global economy grew by 4.3% over the year, representing a moderate slowdown from the 5.1% growth rate recorded in 2004.[1] We consider the implications of a possible further rise in oil prices in our *Sustained and significant increase in oil prices* scenario. Global growth continued to be driven by strong consumption in the US and export-led growth in China. However, global current-account imbalances — the large and widening US current-account deficit and the corresponding surpluses among oil-exporting countries and emerging Asian economies — are a continuing source of concern. A decline in demand for US dollar-denominated assets could result in a sharp correction in the value of the US dollar and create volatility in financial markets. We discuss this in our *Large and disorderly depreciation of the US dollar and increasing interest rates* scenario. A rise in protectionist sentiment, which may pose a risk to growth in world trade in the future, has accompanied this increase in global imbalances.

The US Federal Government's budget deficit narrowed significantly in 2005. However, the considerable rebuilding costs following Hurricane Katrina may put pressure on US Government spending this year. In the UK, the budget deficit, as a proportion of GDP, increased moderately in 2005. To date, Eurozone fiscal policies have not provided a discretionary stimulus to the economy.

Growth in the US has remained strong, benefiting from robust consumer demand. Strong profit growth, benign financial-market conditions and an improving labour market have moderated the impact of higher oil prices, allowing US economic activity to continue to outperform the other G8 economies. US GDP growth is generally expected to remain at 3.5% in 2006. However, considerable downside risks remain to this outlook, especially given the risk of a sharp correction to internal and external imbalances.

1 *World Economic Outlook*, International Monetary Fund, September 2005.

Japan and the Eurozone continued their recovery in 2005, albeit at a slower pace

Growth in the Eurozone slowed moderately from the pace observed in 2004. The economic performance of the region continues to be relatively unbalanced; while France and Spain experienced relatively strong domestic demand growth, the Italian economy grew only moderately. The rejection of the EU constitution may have reduced confidence in the market, and may have contributed to the depreciation of the euro. Following a lengthy period of restructuring efforts, however, consensus forecasts indicate that the Eurozone economy now appears set for a period of sustained growth. In particular, prospects for the German economy have improved and domestic demand is expected to enjoy a revival in 2006.

The Japanese economy appears to be achieving a sustainable growth momentum. Improving labour-market conditions are supporting a recovery in consumer spending, and rising profits in the corporate sector are supporting business investment. A positive contribution from external trade should contribute to projected above-trend growth in 2006. Some analysts believe that the economic expansion may also eventually bring an end to consumer price deflation sometime in 2006, although this remains uncertain.

Growth elsewhere in Asia remained strong, driven by China and India in particular. Emerging-market fundamentals have continued to improve, and most emerging markets continued to perform well in 2005. Net private-capital inflows to emerging markets are expected to fall this year, but this is largely a reflection of recycling of petrodollars back to developed markets. China's current-account surplus increased further in 2005. The exchange-rate reform in July 2005 was a step towards correcting the current external imbalance but pressure remains on China to let the renminbi appreciate further. The rest of the region has accumulated similarly high external surpluses. Lagging domestic demand growth in emerging Asia is a source of uncertainty for the whole region and a shift towards domestic demand is required for an orderly reduction in these large current-account surpluses.

The IMF projects that world economic growth will remain stable at 4.4% in the coming year. Global inflationary pressures are expected to remain subdued, although monetary policies will continue to diverge. While many commentators believe that policy rates appear close to their peak in the US, the Eurozone and Japanese authorities appear to be contemplating a moderate monetary tightening after a prolonged period of unchanged interest rates.

Table B1: World output growth (percentage change from previous year)

	Actual	IMF		Consensus forecast		
				Average		Range
	2004	2005e	2006f	2005e	2006f	2006f
World	5.1	4.3	4.3			
Advanced economies	3.3	2.5	2.7			
US	4.2	3.5	3.3	3.6	3.4	2.5-3.9
Eurozone	2.0	1.2	1.8	1.4	1.9	1.5-2.2
Japan	2.7	2.0	2.0	2.4	2.0	1.3-3.1
Developing countries	7.3	6.4	6.1			
China	9.5	9.0	8.2	9.3	8.5	7.5-10.1
India	7.3	7.1	6.3	7.5	7.0	6.6-7.3

Note: Figures for India are percentage changes from previous fiscal year
Source: *World Economic Outlook*, International Monetary Fund, September 2005
Consensus Economics, Consensus Forecasts, December 2005
Asia-Pacific Consensus Economics, Consensus Forecasts, December 2005

Domestic economic performance

The UK economy experienced a mild cyclical slowdown in 2005

Economic activity in the UK as a whole slowed in 2005, as the contribution from consumer expenditure diminished and higher oil prices increased manufacturing costs. The continued expansion of world trade and a weaker currency helped to boost UK export growth, but this was counteracted by robust import growth. A major factor underlying the slowdown in economic activity has been the cooling of the property market, with average house prices remaining broadly unchanged since the middle of 2004. Nonetheless, households have continued to borrow heavily, raising debt levels, as a proportion of income, to record highs. The implications of high levels of household debt are discussed in further detail in *Banks and building societies*, Section D.

Rising energy costs, together with the steady rise in the employment rate, have contributed to an increase in inflation; the consumer price index rose above the 2% target rate in 2005. Reflecting this uncertain outlook, interest rates have remained on hold following the 25 basis points easing to 4.5% in August 2005.

Consumer expenditure growth is expected to remain relatively modest this year, as the household-savings rate nears its long-run average. In contrast, business investment is expected to pick up, reflecting strong profit growth and the relatively low cost of capital. Global growth should also support UK net exports. Overall, the consensus forecast is that the economy will grow by 2.1% in 2006.

Table B2: Selected forecasts for the UK economy

	2003	2004	2005e	2006f
Real GDP growth (%)	2.5	3.2	1.6	2.1
Consumer spending growth (%)	2.6	3.7	1.8	1.9
Current-account balance (£ billions)	-16.8	-23.3	-24.4	-27.1
Unemployment Q4 (millions)	0.91	0.83	0.89	0.96
Inflation CPI Q4 (%)	1.3	1.4	2.3	1.9
Bank of England Repo rate Q4 (%)	3.7	4.8	4.5	4.3
House-price inflation annual average (%)	15.7	11.9	5.2	2.5

Sources: House price inflation from *National Institute Economic Review*, National Institute for Economic and Social Research, October 2005.
House prices are all-lenders mix adjusted series, Office of Deputy Prime Minister. Other figures are consensus forecasts from: *Forecasts for the UK Economy*, HM Treasury, December 2005.
Unemployment is the seasonally adjusted claimant count measure.

Our central scenario for the global economy, as outlined earlier in this section, assumes a relatively benign outlook for the coming year. However, there are considerable uncertainties surrounding this scenario, and the risks to growth currently appear to be weighted to the downside. There are several underlying vulnerabilities that may shift global growth away from its projected path. These include the continuing uncertainty surrounding oil prices, increasing global trade imbalances and the resilience of the US economy. As before, the global economy is subject to event risk: as well as a number of long-standing concerns (for example, natural disasters or political instability), new issues are also emerging, such as the risk of a global pandemic. Given this high degree of uncertainty, we examine some of these vulnerabilities in greater detail in our *Alternative scenarios* described later in this section. We then discuss the impact of event risk in the *Financial Stability* section.

Alternative scenarios

In addition to our central economic scenario, we consider the likely impact of three *Alternative scenarios* on the financial services industry. They are: 1) a sustained and significant increase in oil prices; 2) a slowdown in global consumption; and 3) a large and disorderly depreciation of the US dollar and rising interest rates.

The *Alternative scenarios* are derived from underlying weaknesses or imbalances present in the economy that increase the downside risks to the central projection. The *Large and disorderly depreciation of the US dollar and rising interest rates* scenario, for example, stems from the US current-account imbalances. Similarly, the *Sustained and significant increase in oil prices* scenario is based on the recent increases in oil prices and core supply-capacity constraints in the global energy markets.

The Alternative scenarios *highlight the potential impact of different economic and financial developments*

These alternative scenarios explore the implications of possible economic and financial developments for the UK financial sector that are not captured by our central economic scenario. We look at the transmission mechanisms through which these scenarios can affect the economy and the financial services industry in particular. We focus on key macroeconomic indicators, such as interest rates and unemployment, and other variables which allow us to determine how our statutory objectives may be affected. By assessing the impacts of the three shocks through their transmission mechanisms, we are better able to prioritise the risks to our statutory objectives and strategic aims. This in turn helps us develop our *Business Plan* for the coming year.

Firms and consumers can use the scenarios in their own financial planning and stress testing

The scenarios are not forecasts but a way of identifying how the risks to our statutory objectives and aims would change if certain shocks were to materialise. We do not quantify what the changes in economic and financial variables would be, relative to our central economic scenario; instead we focus on the key implications for firms, consumers and us. We do not assess how likely the scenarios are or which scenario is the most likely to occur. Firms may wish to use the scenarios in their own scenario planning and stress testing.[2]

2 We use the term 'stress testing', in this instance, to describe both stress testing and scenario analysis. However, stress testing typically refers to changing the parameters that affect the financial position of a firm in order to determine the effect on the firm's business. On the other hand, scenario analysis typically refers to simultaneously varying a wider range of parameters. Scenario analyses often examine the impact of catastrophic events, for example simultaneous movements in a number of risk categories affecting all of a firm's business operations, such as volumes, investment values and interest-rate movements. Scenarios generally could also be considered under three broad categories: changes to the business plan, those that involve changes in business cycles and those relating to extreme events. The scenarios can be derived in a variety of ways including stochastic models, analysis of historic experience or a repetition of a historical event. Scenarios can be developed with varying degrees of precision and depth.

Scenario 1: Sustained and significant increase in oil prices

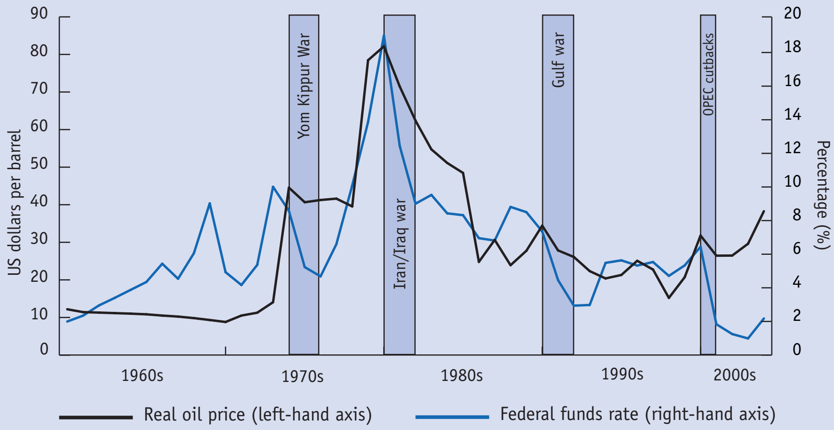
This scenario considers a sharp and sustained rise in crude oil prices and a permanently higher level of trend crude prices thereafter. We assume this would depress economic growth and raise inflation around the world. Countries that are net-oil importers would be particularly affected.

Real oil prices are still below those observed in the 1980s, and the futures markets predict a permanent shift to higher mean oil prices, at around US$45 per barrel, nearly double the recent historical average of around US$25 per barrel.

In this scenario we assume that after an initial sharp increase in oil prices, they subsequently fall, and then stabilise at a permanently higher price level, well above what futures markets are currently predicting. We assume that the monetary authorities will view the price increase as permanent, and react by tightening monetary policy.

Sharp rises in oil and petrol prices are positively correlated with economic recessions in the US and, to a lesser extent, in the UK. High oil prices transfer income from oil consumers to oil producers, and as oil consumers generally have a higher propensity to spend their income than oil producers, this depresses aggregate demand.

Chart B5: US federal funds rate and real oil prices



Note: Figures are annual averages
Source: Datastream, BP oil statistics, FSA calculations

Risks for firms and markets

- Higher costs of production would reduce corporates' real current and future cash flows and we would expect to see volatility in equity markets and widening bond spreads. Any decline in equity markets and bond portfolios would adversely affect companies' pension provision and cause their balance sheets to deteriorate.
- Business investment would fall and some firms might default on their loan repayments. Falling equity markets would also reduce alternative funding sources available for project and venture-capital finance.
- Financial institutions might see increasing losses as some businesses would struggle to meet their debt obligations. Institutions exposed to businesses with significant investments in sectors particularly vulnerable to oil price shocks, such as airlines and car manufacturing, and commercial property, would be especially affected.
- High-risk financial instruments could face greater volatility that is not accounted for in current premia. There has been some hedge fund participation in the oil markets, which might lead to further instability. Operational problems could arise if liquidity in the markets were to be reduced and investors found it difficult to liquidate a large position. Firms would also have to carry additional legal risk, as payments and settlements could slow down and the value of positions could become uncertain.
- Higher input prices could also feed through to core prices, and if inflation expectations were to increase, monetary authorities around the world might be compelled to increase short-term interest rates. Increasing interest rates could cause bond yields to rise worldwide. The current 'search for yield' phenomenon may have depressed emerging-market yields to unsustainably low levels. A significant shock, such as a surge in oil prices, could depress the currencies of oil-importing nations and could also lead to a sharp over-correction and re-pricing of emerging-market debt.
- The deteriorating economic environment could adversely affect life-insurers' balance sheets and the insurance industry would need to ensure that their long-term liabilities would be met despite the short-term volatility.
- Consumers might face difficulties in repaying their mortgages and unsecured loans, as their disposable and real incomes would decrease, and banks and other lending institutions might need to increase their provisions to account for this.

Risks for consumers

- Higher prices would depress households' real and disposable incomes. This might lead to a fall in consumer spending and/or saving. Higher oil prices might also increase unemployment as firms could seek to cut costs, putting further pressure on household finances.
- Mortgage payments might be jeopardised as real incomes would decrease and interest rates increase. This could lead to increasing loan- and mortgage-repayment defaults.
- Equity-market volatility would also affect consumers, as the value of their long-term savings could decline.
- Consumers would also have to de-prioritise their pension planning, as today's consumption would take priority over tomorrow's. This would contribute to the widening of the savings gap, which would be exacerbated by loss of consumer confidence in financial instruments after a period of volatility.

Some ways our work could be affected

- Increased market volatility could make some retail financial products perform less well, potentially crystallising risks to which consumers are exposed through complex products. We might need to allocate more resources to ensuring consumers have not been treated unfairly and understand the consequences of increased market volatility.
- Market volatility would lead to poor performance by some financial institutions that have not hedged their exposures. We might need to work towards maintaining overall market confidence and ensuring the viability of the UK financial services as a whole.
- We would need to liaise with firms more closely to ensure core operations are not affected and that firms' stress testing is managed in line with the changing economic environment.
- We would continue to liaise with the Treasury and the Bank of England to ensure financial stability is not affected by any resulting volatility in financial markets.

Scenario 2: Slowdown in global consumption

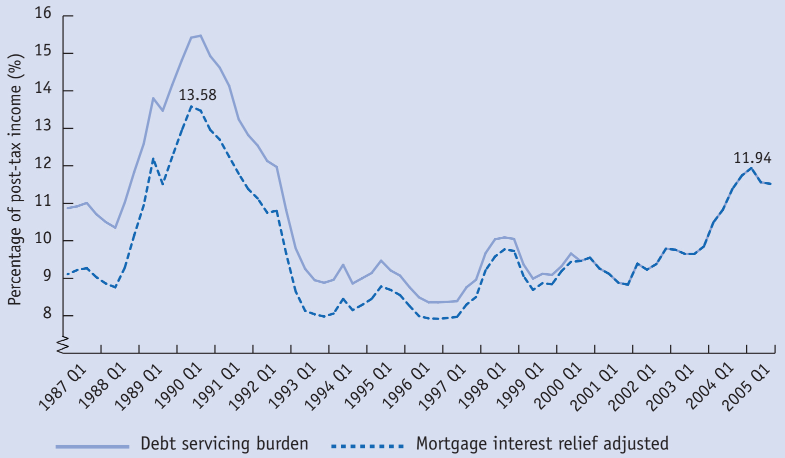
This scenario considers the impact of a sudden and synchronised restructuring of household balance sheets both in the UK and abroad, leading to a global downturn in consumer spending.

Borrowing has underpinned consumer expenditure in several major economies, most notably the US and the UK. This has resulted in a build-up in levels of both secured and unsecured household debt to near-record highs as a proportion of income.

The average proportion of UK household income that is used to service debt has been gradually rising. After adjusting interest payments for mortgage-interest tax relief,[3] the average ratio of debt-service payments to post-tax income is now not far from its previous peak in the early 1990s.

There are signs of growing financial distress among consumers. Credit-card arrears and write-offs on unsecured debt have increased, and there has been a large increase in the number of mortgage-possession actions issued. Personal insolvency numbers have also increased substantially.

Chart B6: UK household sector income gearing



Note: Defined as interest payments on debt and regular mortgage payments of principal by household
Source: Bank of England, Inland Revenue, Office for National Statistics and FSA calculations

At the same time there has been a trend towards greater individual responsibility for financing retirement, healthcare and higher education. An increasing number of consumers must now make important long-term investment decisions, leaving households more exposed to market risks arising from shifts in both property and financial-asset prices.

The transformation of household balance sheets may have increased the vulnerability of consumer spending to negative income or asset-price shocks, or a sudden change in saving preferences. Lower consumer spending would reduce overall economic growth, weakening corporate earnings and possibly raising unemployment. This downturn could be synchronised across countries.

Risks for firms and markets

- If unemployment rose, some consumers might find it difficult to meet debt repayments. Arrears on secured and unsecured lending would subsequently rise, resulting in a higher number of personal bankruptcies and property repossessions.
- Lenders specialising in providing credit to financially vulnerable borrowers could be faced with an increasing number of defaults on loans. Even if credit quality did not decline, lending to the personal sector would slow, reducing lenders' earnings.
- If debt-servicing difficulties rise, many consumers might file complaints against banks and other credit providers for mis-selling loans. This could expose lenders to significant reputational damage.
- Banks would suffer increased credit losses from commercial property and the corporate sector. A slowdown in consumer spending would affect the services sector, while manufacturing would also suffer if foreign demand softened.
- Equity markets might come under pressure. If equity prices were to fall significantly they could undermine the financial strength of the life-insurance sector.

Risks for consumers

- The number of consumers facing financial hardship due to debt-servicing difficulties could grow significantly in a changed economic environment of slower growth and a weaker labour market.
- The risk of a fall in house prices would be heightened, further depressing economic growth and eroding consumers' net wealth. This would be particularly severe given the increasing reliance on housing as a primary pension asset for retirement.
- Consumer confidence in mainstream investment products could be hit if the equity market were to weaken. Pension take-up might decline if consumers were to lose confidence in pension providers, jeopardising many retirement plans.
- Poor savings decisions could be made, with some consumers attracted by higher-risk products. This could increase the number of financially distressed households, and increase the reputational risks for financial institutions if consumer confidence in the markets were to decline.
- Although there are considerable downside risks for consumers in this scenario, one possible upside could be an increase in savings, if consumers were to spend less and save more.

Some ways our work could be affected

- Prudential risk among lending firms could become a higher priority. Risks in the life-insurance sector might also increase. We might need to allocate more resources to ensuring that firms hold adequate capital.
- We might have to allocate more resources to improving financial capability and ensuring that consumers have not been treated unfairly in the past.
- Our consumer information priorities might shift – for example, there might be greater emphasis on informing households of the available options when facing financial difficulties.

3 Prior to 2000, MIRAS (Mortgage Interest Relief At Source) effectively reduced the amount of interest paid by many households.

Scenario 3: Large and disorderly depreciation of the US dollar and rising interest rates

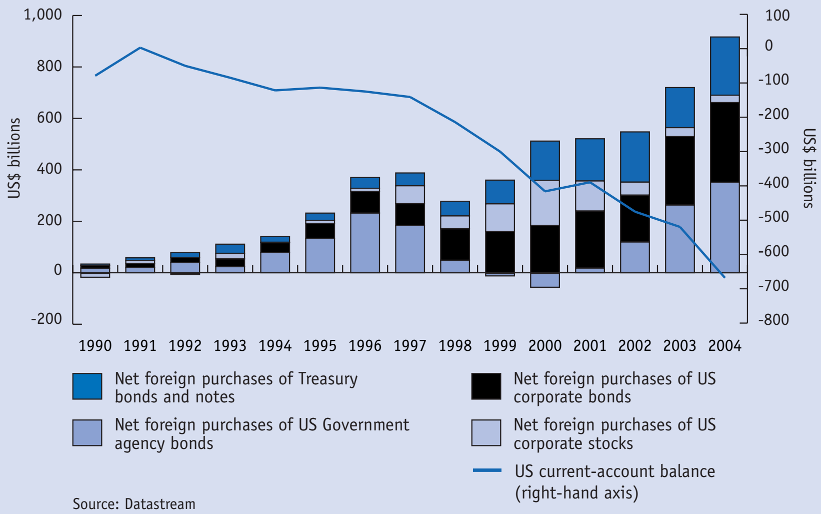
This scenario considers the impact of a disorderly depreciation of the US dollar, triggered by a loss of investor confidence in the US market and slowdown in purchases of or subsequent sale of US assets and a reduction in the flow of capital to the US. We assume that the fall in the US dollar leads to increased volatility in foreign-exchange, equity and bond markets, and higher interest rates in the US and possibly the UK and Eurozone.

The US continues to run a large current-account deficit with the rest of the world. To finance this deficit, over two-thirds of the world's capital flows need to be invested into US dollar-denominated assets.

The US current-account deficit is financed by foreign private investors buying US securities and increasingly by purchases of US public sector assets and securities by foreign (particularly Asian) governments. If the US dollar depreciated, export growth in these countries could fall.

The fairly benign recent economic climate has led to an increase in investment in high-yield bonds and emerging markets. This would probably be reversed as interest rates rose and investors sought less risky investments. There is a risk that this would begin the unwinding of the 'search for yield' phenomenon, and emerging-market bond yields would rapidly increase.

Chart B7: US current-account balance and foreign capital flows to US



Source: Datastream

Risks for firms and markets

- Firms with weak risk management would be affected by increased market volatility. Higher interest rates would weaken the balance sheets of heavily-indebted firms. Consequently, the risk of firms defaulting on their obligations would rise and losses on lending to the corporate sector could increase.
- Increased market volatility would provide hedge funds with more money-making opportunities. Inflows into hedge funds and other alternative asset classes might increase.
- Alternatively, risk aversion could increase if consumers and investors were to lose confidence in the markets. Demand for higher-risk products could fall.
- As interest rates rise, bond portfolios would experience capital losses and the spreads of higher-risk bonds would widen. The falling value of bond portfolios, combined with falling equity markets, would cause the value of insurance firms' assets to fall.
- Complaints from consumers could increase if interest rates were to rise sharply and they were unable to meet their mortgage repayments. Similarly, an increase in interest rates could make it more difficult for firms to achieve the returns that they had been targeting.

Risks for consumers

- The value of many investment products would fluctuate with movements in bond and equity markets, causing some consumers to lose part of their capital. This could have an impact on consumer confidence in these markets and lead to an increase in demand for alternative investments and products offering capital guarantees.
- If confidence across investment products and markets were to fall, investment in general could fall. In addition, to maintain the same standard of living, some consumers might decide to save less in spite of higher interest rates. These two factors would result in the widening of the savings gap. However, for other consumers higher interest rates could encourage them to save more.
- As interest rates rise, the cost of debt rises, so consumers would be faced with higher mortgage repayments and the cost of credit cards and personal loans would rise.
- Consumers who have invested in bond-related products would experience significant capital losses, especially those who have not diversified their investments.
- As the cost of borrowing rises, certain groups of consumers might find it more difficult to take out a mortgage. This could lead to an increase in products such as guarantor mortgages. Demand in the housing market could also fall, causing slower growth in house prices. If house prices were to decline, then some consumers could be left with negative equity.
- Annuity rates would be likely to rise, which would be beneficial for consumers about to buy these products.

Some ways our work could be affected

- We would have to allocate more resources to ensuring firms' risk management remained robust in these more challenging markets.
- Market volatility and rising interest rates would highlight the risks associated with financial products. Shortcomings in consumer understanding could also be exposed. We would have to consider what action would be appropriate to ensure consumers have not been treated unfairly in the past.
- If financial stability risks arose or individual firms suffered difficulties, we would have to work with the Bank of England and the Treasury to sustain or restore confidence in the financial sector.

Risks to financial stability

Our central economic scenario is benign and the overall risks to financial stability from the economic environment are relatively low over the short term. We have highlighted some of the current economic risks that could cause problems for firms and consumers in our *Alternative scenarios*. However, even a fairly benign operating environment does not rule out the emergence of financial shocks that can prompt concerns about the stability of the financial system.

Over the last few years, the importance of event risk has been repeatedly highlighted. We define event risks as unexpected, isolated events, such as natural disasters, global or regional pandemics, large corporate failures, political instability in a major economy or terrorist attacks, which could have far-reaching implications for financial systems worldwide. These events could expose firms to greater downside risk where there are weaknesses in risk management and where firms have moved out on the risk curve in the search for yield. It may also expose operational or legal risks associated with the use of complex, and relatively illiquid, financial instruments that have gained popularity in the current low interest rate environment.

Event risk

The outlook for the global economy is generally benign but there are core vulnerabilities that can make the outlook less certain

The robust performance of the global economy has, in general, contributed to improving the resilience of the financial system. However, this does not mean that the financial system is necessarily in a position to withstand the impact of a significant ‘event’. Increasingly complex financial markets also imply increasingly complex transmission mechanisms for shocks and consequently may pose new risks to financial stability. Given the current environment of high liquidity levels, it is important that market participants consider how they would operate in an environment where liquidity is restricted.

The repercussions of a given event are not restricted to the precise geographical area where the crisis has originated, due to the globalisation of financial and product markets. This means that the ripple effects of a localised event can spread quickly over a wide geographic area and across seemingly unrelated markets.

Disruptive events can also change long-established correlations between financial instruments, which can both increase the inaccuracy of risk-management models and change the valuation of some financial instruments (such as Collateralised Debt Obligations) which factor correlation risk into their pricing models. Increasing complexity in the wholesale markets is a theme that we highlight in several of our *Priority risks*.

An event can have repercussions in several sectors of the financial markets through fairly predictable transmission mechanisms

A major event will have both direct and indirect effects on the financial sector. Natural disasters, for example, directly affect the exposures of insurers and reinsurers. However, the effects on global supply chains – and therefore to the corporate-credit market and consumer confidence – could turn out to be equally important in determining the impact on global finances. Some variables, such as individuals’ reactions to the event, in any potential event-risk scenario are highly unpredictable. Nevertheless, a plausible range of second- and third-round effects of crises (particularly a drying up of liquidity) are more predictable and should be factored into stress testing and scenario analysis.

The ways in which a fairly localised crisis may be transmitted to the wider financial system fall under several broad headings. An event, such as a terrorist attack or a natural disaster could cause:

- **Operational problems for a wide range of firms**. In markets where participants carry unsecured credit risk during settlements, there is a risk that payments might slow down or even stop.
- **A reduction in the supply of and increase in the cost of liquidity**. Market participants may not find it easy to manage their positions in certain instruments and could find it difficult to sell large quantities of a position in an attempt to minimise losses. In such a market, it would also be difficult to establish the value of positions with certainty. This could be exacerbated if participants have not fully or accurately documented such transactions.
- **A variety of legal problems for market participants**. As was exposed by the Herstatt Bank failure in the 1970s, legal finality of settlement can potentially be called into question if a market player faces difficulty. It is also worth noting that relatively new markets in financial products have not been tested in this way.
- **Stress for reinsurers**, which often provide the cover of last resort.
- **A slow down in trading of instruments that are used as collateral to secure payments**, such as certain government bonds or corporate bonds of large issuers.

Our Alternative scenarios *look at the transmission mechanisms through which crystallised risks can be transmitted*

Despite a gentle cyclical weakening in the global economy, the overall risks to financial stability are relatively low at present. Among our three *Alternative scenarios*, the most plausible risks to financial stability are associated with a *Sustained and significant increase in oil prices* and *Large and disorderly depreciation of the US dollar and rising interest rates*. However, if the US or the UK unemployment rates were to increase significantly, the *Slowdown in global consumption* scenario could also crystallise and would have the potential to cause financial stability concerns. In the current political environment there is also the real possibility of a terrorist incident disrupting the operations of some markets or financial institutions. Firms should not derive false comfort from the relatively minor financial repercussions of the 7 July 2005 London terrorist attacks. For this reason we have again highlighted the threat of terrorism as one of our *Priority risks*.

The importance of stress testing

Stress testing can help firms to assess the implications of operational or event risk for their business

Stress testing is an important risk-management tool, which enables firms to assess more effectively the adequacy of their capital. It can also encourage a forward-looking and dynamic view of internal capital requirements and allocation and help senior management test the risk appetite of their business. Sudden and dramatic changes in risk parameters can lead to a situation where markets behave unexpectedly and where traditional risk-transfer products cannot be used – negating, to a degree, the effectiveness of hedging strategies. Testing 'what if' scenarios would strengthen firms' risk-management capabilities by revealing hidden weaknesses and sensitivities to abnormal and particularly problematic market circumstances. From a systemic perspective, there are significant benefits to firms collectively having more robust risk-management practices, resulting in a financial system which is more resilient to a financial crisis.

Evidence to date suggests that stress-testing methodologies continue to develop at varying speeds across the financial sector, and that stress testing as a risk-management tool has yet to be embedded fully into the risk-management processes of most firms. However, as part of the Individual Capital Adequacy Standards (ICAS) regime, stress and scenario testing has developed considerably over the last two years in the insurance sector. Market-risk stress testing is at a more advanced stage than other types of risk stress testing. The use of historical data in stress-testing models has the benefit of being relatively easier to collect. However, such data is not forward looking and may ignore subtle, though critical, changes to the landscape of the financial system, thereby limiting the usefulness of the results to inform future decision making. Anecdotal evidence suggests that in designing stress tests, more firms are using historical experience to inform hypothetical scenarios, rather than simply using past events. It also suggests that firms vary the time horizons over which market-risk stress tests are conducted. Some institutions focus on plausible losses over a one- to five-year timeframe, whereas others pay more attention to extreme events. Some firms are making progress in incorporating market liquidity risk in their stress tests, with two common approaches including extending holding periods for illiquid assets or applying add-ons to historical price changes.

For the stress testing of credit and funding risks, evidence suggests that current practice varies between firms but that current models and methodologies lack the sophistication of market-risk techniques. The key challenges that firms face are the availability of data for past periods of stress and the need to support and inform stress tests by qualitative discussions within firms.

For the larger and more complex firms, a longer-term objective remains the ability to stress aggregated risks, but significant obstacles remain to developing effective methodologies. Inadequacies of information systems compound the costs and practicalities of running such simulations. Disparate IT system architecture makes it difficult for firms (especially larger and more complex firms) to collect data easily across multiple business units, often operating in a variety of jurisdictions. The building of models to a degree of sophistication where multiple variables for each risk group can be calibrated and then re-calibrated also poses an issue. The risk is that financial conglomerates may not be fully aware of hidden correlations across portfolios. The ability to stress aggregated risks may reveal these correlations.

In addition to these technological constraints, difficulties also arise from the different time horizons of risk elements – for example, market risks tend to crystallise quickly, whereas credit risks tend to crystallise over a longer time period. Furthermore, it is inherently difficult to collect data from risk groups such as operational, funding, capital and so on, compared with collecting data from market or credit portfolios. For example, to come up with a credible picture of potential losses arising from operational risks, firms need to examine combinations of (stressed) loss distribution analyses and (stressed) judgemental scenarios.

The importance of disaster recovery

Firms need to ensure that their business continuity plans are regularly tested

Given the perceived increase in risk of major operational disruption arising from events such as terrorist attacks, natural disasters, global pandemics, and so on it is all the more important that firms should have plans in place that would allow them to continue in business in such circumstances. These plans need to be regularly reviewed and tested to ensure that they are sufficiently robust. A particular feature of major operational disruption is that it is likely to interrupt – at least for a time – the normal interactions between financial-market participants. It is vital therefore that firms understand what their key dependencies in relation to suppliers, counterparties and infrastructure providers are and thus where their main vulnerabilities may lie.

Developments in industry

Banks and building societies

There is growing evidence that the UK consumer-credit cycle has turned and that UK retail banks and building societies are likely to face a more challenging operating environment in coming years. Arrears on unsecured lending, particularly on credit cards, have increased sharply since the beginning of 2005 and, although mortgage arrears remain near historic lows, they are now starting to increase.

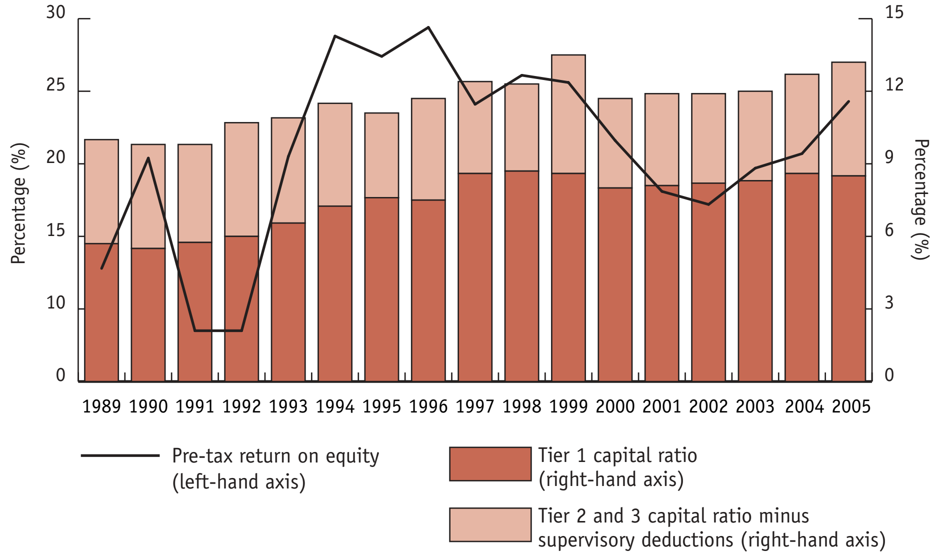
UK banks and building societies are well positioned to cope with this in terms of the strength of their capital base and current levels of profitability. Moreover, initiatives to share positive credit data should help improve the robustness of credit-scoring techniques. Nevertheless, in a context of growing consumer indebtedness, lenders run the risk of reputational damage if the turn in the credit cycle reveals firms to have given credit to large numbers of consumers who are unable to afford their debt repayments.

Performance and financial strength of UK banks and building societies

For the larger banks, slower growth in retail lending has been offset by stronger growth in corporate banking and other financial-market activities

The UK banking sector continues to be highly profitable and well capitalised. The mean return on equity for the nine major listed UK banks rose to 21.1% in the first half of 2005, from 20% in the first half of 2004. Over the same period, the mean total capital ratio for the same group of banks now stands at 12.4%, down from 12.6% a year ago. These positive indicators are reflected in the external ratings of the sector; Moody's average Financial Strength Rating for UK banks is B+, which is the second highest (after Denmark) of any developed banking market.

Chart C1: Major UK banks profitability and capitalisation



Note: Figures for 2005 are for the first half of the year
Source: Bank of England and Company accounts

Income

Banks' interest margins have declined but they supplemented their income from non-interest sources

Income for the nine major listed UK banks grew by an average of 11.9% over the 12 months ending mid-2005, compared to 10.4% over the previous 12 months. Within this, non-interest income continued to grow more quickly than net-interest income. This conscious move to diversify and focus on income from non-interest sources has been prompted partly by competition driving down net-interest income margins. Consequently, net-interest income now no longer accounts for most of banks' total income.

Slowing growth in retail lending, caused, to a degree, by the turning of the consumer credit cycle, was largely offset by strong income growth from corporate banking, international banking and financial markets. The ability of larger banks to achieve profit growth over the past year, despite the slowdown in consumer lending, owes much to a well-diversified business strategy.

Margins

Continuing the trend of the past five years, most UK banks' interest margins declined between 2004 and 2005, particularly within retail lending. This was driven in part by continued competitive pressures and a flattening yield curve (flattening yield curve is discussed in Section B). Banks have responded to this narrowing of margins by supplementing total profitability through various fees – although there is a risk that these volume-related fees could evaporate more quickly in a downturn than interest income.

Costs

Costs for the major UK banks rose by 10.5% over the 12 months to mid-2005 compared to 8.11% over the previous 12 months. However, in the context of rising income, the average cost-income ratio fell by three percentage points to 46.6%. This represents one of the best levels of efficiency among developed markets. Offshore processing and rationalisation of back offices could bring further cost reductions. However, offshoring may also bring with it other risks, such as making firms more vulnerable to risks in the operating environment, discussed later in this section. The prevailing view is that much of banks' achievable cost reductions has already been realised, so future reductions will be increasingly difficult to achieve.

Building societies

Building societies face a more difficult business environment

As with banks, UK building societies' average solvency ratio (including unaudited interim profits) fell slightly from 12.8% in the first half of 2004 to 12.4% in the first half of 2005. Annualised profitability in the first half of 2005 remained stable against 2004 at 0.51% of mean assets, with growth in operating profits being offset by increasing provisions. The challenge of maintaining profitability in 2006 will be made more difficult by slowing mortgage-lending growth and the difficulties some smaller societies appear to be facing in adjusting their cost base to cope with lower margins.

Building societies' market share of outstanding mortgages by value has declined slightly over the last two years and is currently at 18.1%. Furthermore, their share of new mortgages approved has declined more markedly over the same period, to 15.1%. Unlike the banks' share of mortgage lending, the building societies' share is extremely concentrated among a few societies; of the 63 UK building societies, only 4 have a market share of more than 1%.

If 2006 heralds a further decline in net-interest margins, building societies may be prompted to make further moves towards higher-risk lending and attempts to increase non-interest income. As at the first half of 2005 the stock of fixed/capped-rate mortgages represented 43.9% of loan balances. Although this high proportion of fixed-rate loans temporarily delays the effect of margin decline on building societies, it also poses a risk by reducing building societies' flexibility to widen margins in a downturn (to offset increased provisions).

Current loan performance at building societies continues to compare well against averages for the rest of the mortgage market, with arrears levels being substantially lower. There is some evidence of increased risk taking, with the proportion of mortgage loans that fall into the combined high income multiple and high loan-to-value (LTV) grouping continuing the upward trend observed since 2003. However, the main move into more risky lending appears to have been through the purchase of mortgage books from centralised lenders. This has predominantly been in the near-prime, buy-to-let and self-certification markets, where the risks are significantly higher than in societies' existing books. In addition, some societies have started originating 'sub-prime' loans. There is a risk here that the risk/reward equation for these loans is not being assessed correctly by firms which have little previous experience of operating in these markets.

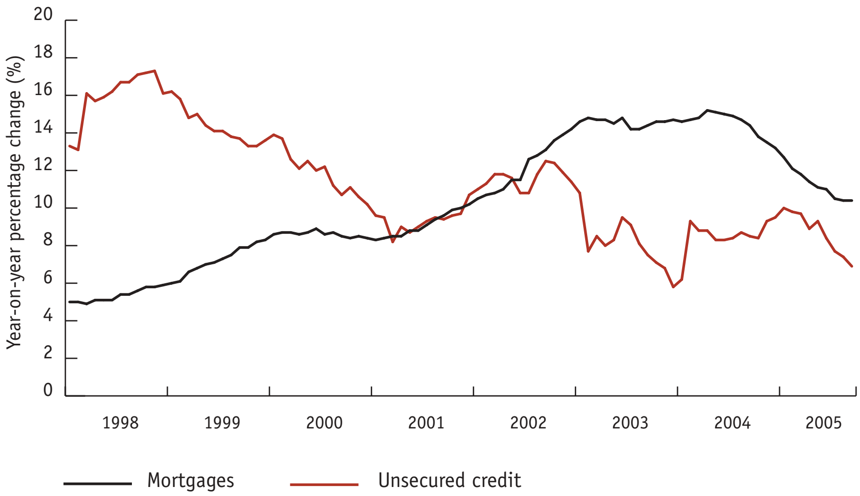
The retail banking credit cycle

The consumer-credit cycle has turned, but so far the slowdown has been quite gradual

After a sustained period of high lending growth and low arrears, there is growing evidence that the consumer-credit cycle has turned. At present this deterioration has mainly been confined to unsecured lending, in particular credit cards, but these signs are often considered to be an early indicator of wider financial stress. If economic conditions worsened, banks' model-based risk-management systems would be tested.

Over the 12 months to end-September 2005, outstanding mortgage and unsecured lending grew by 10.5% and 7.7% respectively. These levels dipped over the course of 2005, but nonetheless remained above the long-term sustainable trend, with the ratio of personal debt to personal-disposable income increasing to 159% by mid-2005. Above-trend volume growth in mortgages and unsecured lending helped to maintain banks' profitability by offsetting the impact of falling interest margins in UK retail banking.

Chart C2: UK growth in outstanding consumer lending

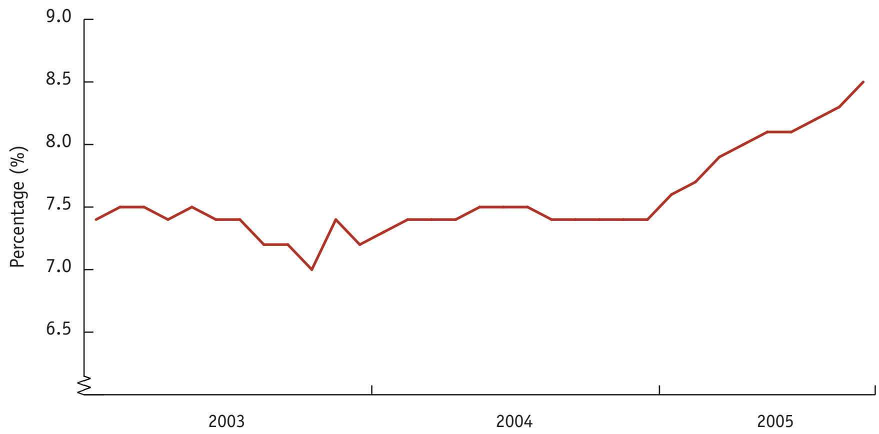


Source: Bank of England

Credit-card arrears are rising relatively sharply …

Credit-card arrears are rising, continuing the sharp increase that began in early 2005. The proportion of balances more than three months overdue increased to 8.5% in September 2005 from 7.4% nine months earlier. This deterioration, combined with what appears to be the beginning of a decline in secured and unsecured lending growth to a more sustainable rate of increase, has prompted some commentators to question the sustainability of the UK banking sector's current returns. Concerns such as these are perhaps reflected in the fact that over the six months to the end of September 2005 the FTSE bank-equity index increased by only 5.5%, compared with a 12% rise in the FTSE 100 over the same period. Additionally, there is the risk that the prospect of declining profitability leads banks to attempt to diversify rapidly, either through acquisitions or organic growth in new product lines, into areas where they lack the experience to effectively manage the risks to the business.

Chart C3: Proportion of UK credit-card balances more than three months in arrears



Note: Monthly data
Source: APACS

The high level of personal indebtedness in the UK may account for some of the increase in levels of personal bankruptcy; levels of personal bankruptcy orders were up 31% year-on-year for the third quarter of 2005. However, changes in UK bankruptcy law – which took effect from April 2004 – probably also account for some of this increase. Further signs of consumer distress can be seen in the increase in the number of households entering into the process of house repossession; the number of repossessions increased by 35% over the 12 months to end-September 2005, albeit from a low base.

… but mortgage arrears remain relatively low

Despite a slight rise, mortgage arrears have remained relatively low. However, there are some signs of stress in certain niche markets; the proportion of buy-to-let mortgages over three months in arrears increased from 0.66% in the second half of 2004 to 0.7% in the first half of 2005. While this level is still very low and remains below the 0.88% for the market as a whole, the speed of deterioration in this market has been notably more rapid than in the wider market. The 'sub-prime' mortgage market, although difficult to gauge, is showing some evidence of significant increases in arrears. However, mortgage lenders can draw some reassurance from the fact that, to date, the housing market has been cooling rather than crashing, which should provide them with support if arrears increase further.

Even if the credit environment in retail lending continues to deteriorate, the highly profitable, well-capitalised and increasingly internationally diversified nature of the UK banking sector means that serious prudential threats are unlikely for the sector as a whole. Stress tests conducted by commercial banks, the Bank of England and us have all highlighted the ability of the banking sector to cope with increasing write-offs.

However, there are two factors which suggest that if credit conditions were to deteriorate sharply there could still be instances of financial stress among lenders. The first is that the asset quality of personal lending is not evenly distributed among firms. As alluded to earlier, there has been a notable emergence of firms providing secured and/or unsecured credit to 'sub-prime' borrowers. The credit-scoring techniques employed for this type of lending have so far proved robust for firms, but most have only been developed during the last decade and have been operated under relatively favourable credit conditions. These conditions have also enabled competition to drive down margins on these products and there is a possibility that the current rates do not correctly price the risk of a downturn.

The second factor is the uneven distribution of debt among borrowers. There is a lack of accurate information on the distribution of debt, largely because banks have only recently started to share more non-default data with credit reference agencies (in the past they only shared details on accounts in default). This development should allow banks to create a more complete picture of the proportion of debt in their loan books held by highly indebted individuals and to make better-informed lending decisions. As more information becomes available on the distribution of personal indebtedness, by firm and by consumer segment, it will be possible to apply more focused stress tests and identify over-indebted individuals for debt counselling.

Firms need to protect their public image and reputation by lending responsibly

At present, despite rising credit-card arrears, the number of cases of debt-servicing difficulty remains relatively low. This is likely a reflection of historically low unemployment and the current low interest rate environment, which makes high levels of outstanding debt relatively more affordable. However, this could change.

If debt servicing difficulties do rise, it is possible that some consumers will claim that they were mis-sold credit. It would be unsurprising if those in debt difficulties sought to blame lenders for their problems, especially given hostile media coverage of banks and the perception of a 'compensation culture' in the UK since the last credit downturn. More generally, banks and other credit providers could suffer reputational damage if they were seen (in retrospect) to have given credit to large numbers of individuals who were unable to afford debt repayments.

Consumers, too, have a role to play in ensuring that borrowing is suitable; they should not assume that they can afford credit simply because it is offered to them. They should make a careful consideration of the level of debt they can afford and take advantage of existing services such as our Debt test to help them determine how close their debts are to becoming unmanageable.[1] Consumers should also seek advice from debt counsellors as soon as they get into difficulty with loan repayments.

1 The Debt test is an online tool (available on our website) which allows consumers to assess how close their debts are to being unmanageable.

Consumer borrowing

As discussed in previous issues of the *Financial Risk Outlook* and in this section, consumer debt levels have continued to rise. Low interest rates, rapidly rising residential property values, changes in cultural attitudes to borrowing, and innovation and competition among lenders are all key factors that have contributed to the growth in borrowing.

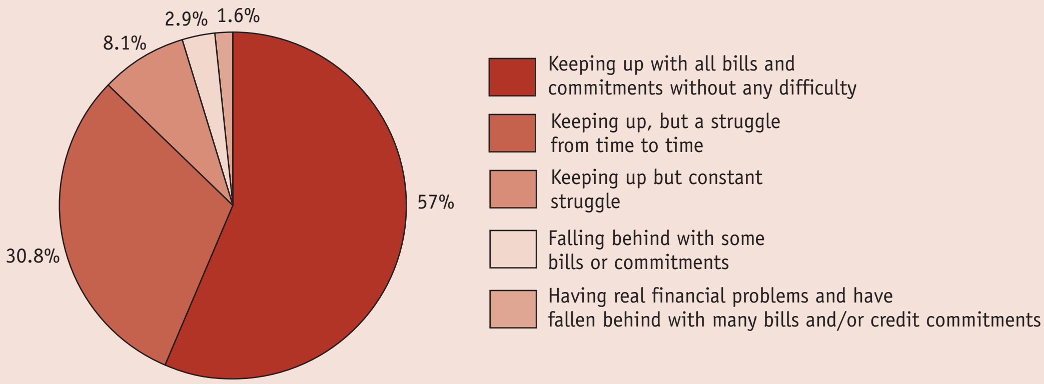
Existing debt levels are not necessarily a cause for concern provided consumers can afford to repay their borrowing commitments, both now and in the future. At present, it appears that most consumers are able to keep up with all of their borrowing commitments. However, there is a relatively small but growing number of consumers who are increasingly showing signs of financial distress. In the context of our central scenario, we would not expect there to be a significant change in the direction or scale of this risk. But we are concerned that many more consumers would not be able to sustain their borrowing commitments under less benign economic circumstances. We would expect the level of arrears, defaults and mortgage repossessions to increase under *Alternative scenarios* that involve a dramatic interest-rate rise or a significantly higher level of unemployment; we discuss this in Section B. If any of the *Alternative scenarios* were to crystallise, or the general economic conditions were to deteriorate, the problems would then be exacerbated, especially if this coincides with a flat or declining housing market.

Our latest survey, conducted in 2005, reinforces our previous findings about the extent of debt penetration: six in ten families in the UK have some form of debt and the average level of debt held by a family with a mortgage is £66,524.

Levels of secured debt reached 117% of household disposable income at the end of the second quarter of 2005, while unsecured debt totalled 24%. This compares with 76% and 20%, respectively, in the late 1980s. However, the ratio of average mortgage payments to average earnings has remained low relative to the peak of the late 1980s. This is because the interest rate environment is now more stable and mortgage rates are much lower in nominal terms, reducing the cost of servicing mortgages. However, historically lower inflation rates mean that the real value of the mortgage will not decrease as rapidly over the course of its repayment.

There was little change in households' ability to cope with their borrowing commitments (see Chart C4). Those consumers who are constantly struggling, but not currently in arrears (an estimated two million families), would be particularly vulnerable if they were to experience further budget constraints as a result of a rise in interest rates or a fall in income. Some 15% of adults in the UK (an estimated 6.6 million individuals) also reported having been three months or more behind with payments on their regular commitments in the last five years, even though this was a period of relatively low unemployment, rising house prices and low interest rates (we discuss the economic conditions in Section B). It is possible that in the next five years an equal, if not greater, proportion of consumers will experience similar financial difficulties. So it is important for consumers to be aware of, understand and mitigate these risks.

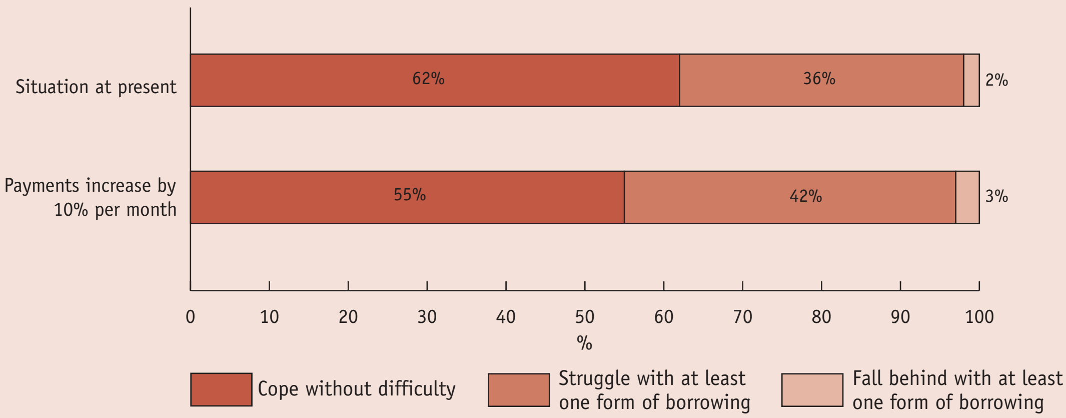
Chart C4: The degree to which consumers with debt are able to cope with bills and credit commitments



Note: Based on a sample of consumers with debt, including mortgages. Figures may not add up to 100% due to rounding.
Source: FSA/BMRB, 2005

The headline indicators for self-reported mortgage affordability look broadly positive (see Chart C5); almost two-thirds of consumers can manage their mortgage payments and other credit commitments without difficulty. However, a 10% rise in mortgage payments would result in the proportion coping falling from 62% to 55%. An estimated 1.6 million mortgage holders said they would expect there to be a significant deterioration in their financial position because of a rise in mortgage payments. This reinforces the need for consumers to understand and plan for interest-rate risk and changing economic conditions.

Chart C5: How consumers cope with mortgage repayments currently and if repayments were to increase



Source: FSA research

Corporate banking

Lending to commercial property continues to grow rapidly

Growth in lending to UK non-financial corporations accelerated during 2005, from around 5% a year in June 2004 to around 11% a year in June 2005. Company trading profits grew by 7.8% in 2004, and credit spreads and the default rate on corporate bonds remained low. However, there are some signs that corporate banking is likely to face a deteriorating operating environment over the coming years:

- consensus forecasts estimate that UK profit growth is slowing – to 4.6% in 2005, then to 4.2% in 2006;
- the number of UK corporate liquidations increased by 12.5% in the second quarter of 2005, the first increase since the second quarter of 2003, albeit from a very low base by historical standards;
- at a global level, Moody's has more issuers on review for downgrade or with negative outlook than on review for upgrade; and
- capital gearing remains high by historical standards, leaving corporate profitability sensitive to either a decline in revenues or an increase in interest rates.

We outline some of the shocks that firms could face in our *Alternative scenarios*; rising oil prices in particular have the potential to add to financial pressures, especially in energy-intensive sectors such as transport. This scenario would exacerbate the already-substantial problems in the US airline and automotive sectors.

Some of the increase in corporate capital gearing in recent years has been driven by the growth of highly leveraged, private-equity buyouts. Although UK banks have been active in providing funding to these deals, they are likely to represent only a small proportion of overall bank lending.

Lending to commercial property continues to grow rapidly. Bank of England data show that the annualised growth rate of outstanding lending to UK commercial property companies was 17% in the second quarter of 2005, which was in line with its average growth rate since 1999. The majority of lending growth to UK commercial property has, in recent years, come from a small number of large banks. This increases the risk that if the market were to deteriorate and problem loans arose, a lack of liquidity could exacerbate a downturn in the market as the active pool of lenders declines. With yields falling gradually since 2002, lending secured on commercial property could be vulnerable. The retail property sector is also showing some weakness as a result of the slowdown in consumer spending.

There is some evidence to suggest that corporate-lending covenants are being relaxed

The continued expansion of global liquidity is providing increasingly competitive, alternative forms of funding to those provided by the syndicated loan market. There is some evidence to suggest that this competition is leading banks to relax covenant requirements to win new business, as opposed to competing purely on price terms. This trend could reduce banks' ability to spot deterioration in the corporate sector quickly (through a breach of covenants) and to react and tighten terms accordingly.

International banking

International diversification continues to increase …

2005 saw a continuing trend of consolidation in UK and global-banking sectors. In addition to Banco Santander's purchase of Abbey National, other significant deals involving UK banks include the acquisition of a majority stake in the South African bank ABSA by Barclays and Royal Bank of Scotland buying a stake in Bank of China.

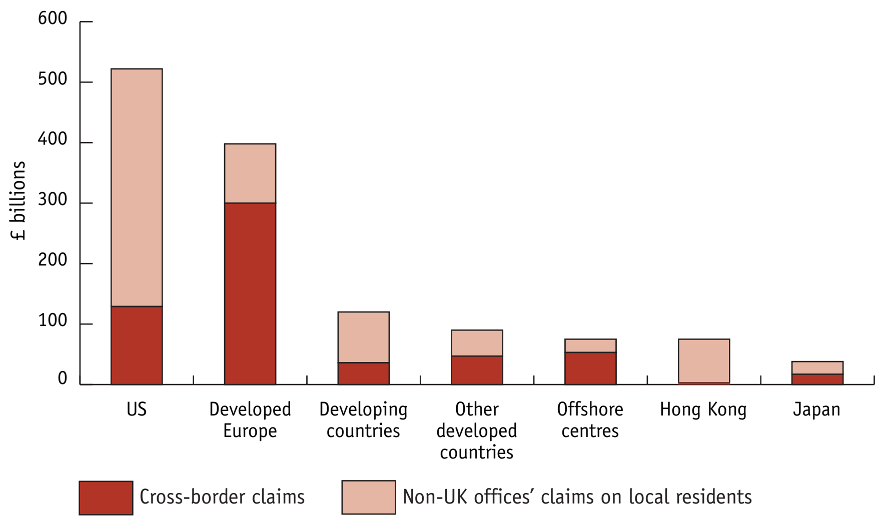
Through this consolidation and organic expansion we are seeing the creation of banks that are operating on a truly global scale. Expansion overseas can provide firms, and the wider financial sector, with diversification benefits if the new markets do not have a significant degree of correlation with UK credit cycles. It also offers access to potentially high-growth markets, where good practice from the mature UK business can be transferred, resulting in higher earnings growth.

… and this can increase as well as reduce risks

However, international diversification can increase, as well as reduce, risk. Cross-border acquisitions have been shown to not always provide shareholder or stakeholder value. There is a risk that the management is distracted from the existing core operations to supervise the acquisition proceedings. In addition, moving to a new area and operating environment, of which the bank may have less experience, can increase the risks for existing customers as well as increase the vulnerability of the bank.

The main overseas retail banking exposure of UK banks is to US consumers. Many of the risks in US retail banking are similar to those in the UK: high levels of indebtedness, much of it secured against the equity created in a period of supernormal growth in property values. This similarly limits the extent of diversification benefit that UK banks operating in the US market will achieve, particularly in the *Alternative scenario* of a global consumer downturn (refer to *Scenario* 2, Section B). More generally, the benefits of having access to high-growth emerging markets need to be weighed against the extra operational risks of running a more complex group, particularly in the area of management control, which has been a significant factor in past problems that have arisen in banking groups expanding overseas.

Chart C6: UK-owned banks' foreign lending (June 2005)



Source: Bank of England

Operational risks

Operational risks form a significant element of banks' overall risk profiles. As banks become ever larger, more geographically diverse and more reliant on sophisticated technology, the importance of good operational-risk management increases.

Significant regulatory reform is underway

In recent times, banks have had to contend with a very high volume of regulatory change, particularly in relation to the development and implementation of Basel Capital Adequacy Framework (Basel 2), and the move to reporting under International Financial Reporting Standards (IFRS). These two changes are intended to result in the benefits of a more risk-sensitive allocation of capital in the banking system and greater, more comparable, disclosure to the market. However, given the scale of the changes, their implementation poses significant short- to medium-term operational challenges for the sector.

These changes are particularly significant in the case of firms applying to use the more advanced approaches to the calculation of regulatory capital under Basel 2, where they need to comply with the 'use test'. This requires that systems for calculating regulatory capital be integrated into other parts of the business including risk management, decision making, credit approval, internal capital allocation and corporate governance functions. This is likely to present firms with operational challenges, as the move to these systems will represent a substantial change to banks' existing practices. Implementation of Basel 2 is likely to require significant planning, systems and staff training costs if firms are to gain approval for using the advanced approaches and are to minimise the operational risks and disruption to existing business activities in the transition.

Increased use of technology brings both costs and benefits

Technological change has had a dramatic effect on all aspects of the banking sector, from the ways in which customers buy products and interact with their banks, to internal processes such as credit assessment and approval. The benefits in terms of improved efficiency as well as new and better ways of banking are enormous, but they also bring with them new challenges. Many of these relate to the new ways in which technology can be used to commit financial crime (refer to *Financial crime*, Section E). Banks need to be aware of the reputational effects of measures to combat fraud that result in the losses from fraud being borne by their customers rather than the banks themselves. Moreover, greater reliance on sophisticated technology and modelling brings with it greater risk that a systems failure can result in business interruption. Consequently, the more that technology is relied upon, the more important it becomes for banks to maintain good operational controls.

Risks can often arise at the interface between systems and their users, or where users are able to override the technology used. The risk that banks find themselves lending to consumers who are unable to afford to repay their loans in full will not be determined only by the credit-scoring system's ability to discriminate between good and bad credits; it is also likely to be affected by the controls and incentives in place for the branch-based and telephone-sales staff. Some credit-scoring systems do not always give a definitive 'accept' or 'reject' decision in response to an application for a loan – in marginal cases they can give staff discretion to decide on the appropriateness of making the loan. The probability that this approach will result in a bad lending decision will increase significantly if sales staff have financial incentives that encourage them to grant loans. This risk can be minimised by giving staff clear guidance on the criteria to use when making lending decisions, by the careful monitoring of the subsequent performance of these loans, and by investigation where necessary, thereby fostering a culture of accountability.

Similarly to the implementation of new technology, the creation of new and innovative products can also lead to increased operational risks, as is highlighted by the backlog in credit-derivative trade confirmations, discussed in *Priority risks*, Section A and *Asset management* later in this section.

Outsourcing is becoming increasingly prevalent

Outsourcing is likely to continue to grow strongly in coming years, particularly if banks feel the need to pursue a cost-cutting strategy in the face of slowing domestic revenue growth. Outsourcing to distant offshore locations in emerging markets inevitably entails greater risk because of the less-developed infrastructure, higher political risk, and jurisdiction and labour-market differences. Such risks are most pronounced in centres that are both offshore and outsourced, over which the 'home' firm has less operational control. Several high-profile incidents of fraud over the past year may have dented consumer confidence in data security at offshore retail operations, highlighting the operational difficulties that firms can face in offshore operations in emerging markets. In addition, there is some evidence to suggest that as a result of poor staff retention in offshore locations, firms have had to take on less-qualified candidates, leading to higher training costs.

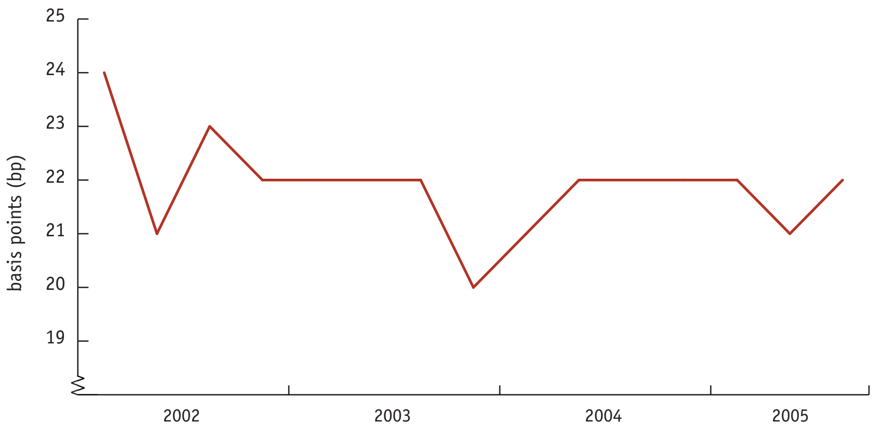
There are clearly cost benefits from outsourcing (both on- and offshore) as well as benefits in terms of increased focus, as banks' own staff can focus on functions higher up the value chain. However, any plans to offshore should be well scoped and thought out in advance, with adequate attention devoted to the development of appropriate governance frameworks and risk-management systems to minimise the associated operational risks.

Investment banking

Investment banking has had another profitable year

The current operating environment is favourable for the investment banking sector, with all major business lines performing well. Mergers and acquisitions, equity underwriting, bond underwriting and secondary trading volumes were all up in 2005 relative to 2004, with European trading and underwriting particularly strong. This, combined with increasing revenues from the structuring and trading of complex structured products and derivatives, has helped raise returns on equity at the major US and European investment banks operating in London.

Chart C7: Net VaR/tangible equity of US investment banks with significant London operations

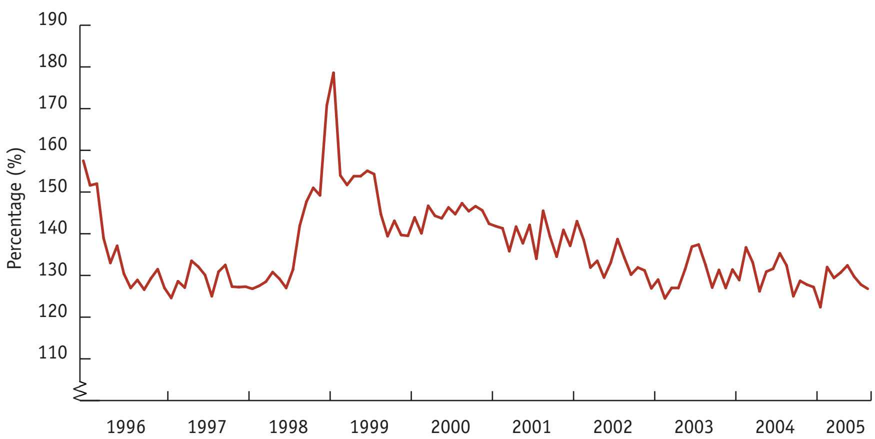


Note: Quarterly data
Source: Published company accounts

Firms' total market positions have grown, although these have been matched by increases in capital

Value-at-risk (VaR) indicators have continued to rise, as have the financial resource requirements of the London operations of US investment banks. However, these increases have been fully matched by an increase in the capital available to firms, which indicates that there has been little change in the net level of risk taking. Average aggregate net VaR (after diversification offsets), expressed as a percentage of tangible equity, stood at 22 basis points at the end of the third quarter, which is in line with the average since 2000 (see Chart C7). The aggregate capital-adequacy ratio of the London operations of US banks, which measures financial resources as a proportion of trading risk, remained stable at around 130% (see Chart C8).

Chart C8: Average capital-adequacy ratio for London operations of US banks



Source: FSA

However, there is a danger of over-reliance on incomplete measures of risk, such as VaR numbers, because they will not capture all of the risks a firm faces, such as liquidity or legal risks. The risks could also be understated if the indicators are calculated over periods that do not contain higher volatility and stress. We continue to encourage firms to develop stress testing and scenario analysis that includes risks not currently captured in VaR models (refer to *Financial Stability*, Section B).

Stress testing is a key element of firms' risk management and one of our Priority risks

The recent benign economic environment and low volatility in both equity and credit markets allowed investment banks to weather the impact of adverse events in 2005 without any serious effects on the profitability or capitalisation of the sector. However, one potential consequence of the long period of low volatility is that new products and markets can develop without their effectiveness in stressed scenarios being tested. The adverse movements in certain sections of the credit derivative market following the downgrade of General Motors and Ford highlights that new markets may not always perform in ways that market participants expect. It also highlights the more general point that firms should not rely too much on the output of complex models, such as models of correlation in collateralised debt obligation (CDO) tranches, particularly in the absence of historical data that demonstrates the behaviour of these models over the cycle.

The rapid growth of new product markets increased operational risks quite sharply in the first half of 2005

In relatively new product markets it is particularly important that firms devote adequate resources to developing back-office processes that match the growth of business by the front office. During the first half of 2005 it became apparent that back offices were struggling to cope with the growth of trading in credit derivatives, particularly Credit Default Swaps (CDSs). A survey we conducted showed that during this period, deal volumes in the London market grew by 50%, but the volume of unsigned trade confirmations grew by 70%. The average 'vanilla' trade confirmation was outstanding for 47 days, while the average 'non-vanilla' – more complex trades – was outstanding for 84 days. Without confirmation by signature that a trade has taken place, both parties to the transaction are exposed to legal uncertainty and hence legal risk if a credit event occurs during this time.

The backlog of unsigned trade confirmations is now falling, following warnings by us and an international initiative we launched with the Federal Reserve Bank of New York and other regulators in September 2005. The latest data shows that while deal volumes rose by 6.85% in September and October 2005, the average outstanding trade confirmations fell by 4.25%. The impact of the bankruptcies of Delphi, Delta and Northwestern Airlines in the US may test the efficacy of the market in ensuring the settlement of the underlying derivative contracts. This risk is one of the *Priority risks* and is also considered in the following section on *Capital markets and financial exchanges*.

Investment banks are playing a leading role in the development of structured products for both institutional and retail investors

The past few years have seen a substantial increase in the volume of structured products sold to both institutional and retail investors. In addition to credit derivatives and CDOs, structures are being created to allow investors to benefit from exposures to hedge funds, insurance products, private equity and other types of financial products. Investment banks have naturally played a leading role in the design of these products, often in devising ways in which the investor can share in the potential rewards while limiting the downside risks. However, firms need to recognise the potential risks inherent in this type of activity. For example, legal risks may be greater where the products are innovative, precedents have not been set and standardised product documentation has not been developed. Second, the risk of mis-selling or of customer complaint may be greater. There have already been a number of cases where the inability of an issuer to demonstrate that it had properly explained the risks involved in complex credit derivatives to the investor has led to substantial damages awarded against the issuer. Third, there is the need to make a full assessment of potential conflicts of interest in developing new markets and to undertake measures to prevent the use of material non-public information.

In some cases, products are structured by investment banks and sold to third-party distributors for supplying the retail and high-net-worth market. In such cases, investment banks need to be confident of the boundaries of their responsibility if incorrect advice is given when the product is sold on by the third party. They should also be mindful of a possibly adverse reputational impact if large numbers of higher-risk structured products are sold to retail investors.

Prime brokerage

Good counterparty risk management by individual firms is key to controlling both their own risks and overall financial stability

A review of recent developments in the hedge-fund industry and of the issues that they raise for us is discussed later in this section in *Asset management*. Here we focus on the relationships between hedge funds and investment banks.

Investment banks have significant exposures to hedge funds through their prime-brokerage and derivatives businesses. At the individual firm level, this exposure is managed by collateral and margining arrangements, to ensure that potential risk exposures are manageable, even at times of market stress. It is therefore important for firms to have robust counterparty risk management policies in place. Counterparties can be highly complex hedge funds where the volume of trading tests the ability of back offices to maintain accurate and up-to-date information on counterparty exposures.

This issue is particularly important given that hedge funds are thought to contribute significantly to the earnings of those firms operating the main prime-brokerage units. Their rapid growth, combined with high trading volumes, has created fierce competition between investment banks to service this industry. The risk is that competition could take the form of a relaxation of collateral and margin requirements, or that investment banks could be reluctant to make margin calls on lucrative clients for fear that it could lead them to take their businesses to another broker.

The investment banking industry has made welcome moves to develop guidelines for good practice in the area of counterparty risk management. Much of this has been carried out by the reconvened Counterparty Risk-Management Policy Group (CRMPG2), an industry-led group originally established in the wake of the near-collapse of Long-Term Capital Management to help promote strong practices in counterparty credit- and market-risk management. The group published a second report in July 2005, updating its earlier work and focusing on market developments in the past few years. Where appropriate we will be using it in our supervisory work as a benchmark against which to measure firms' counterparty risk-management practices and policies.

Our survey of the counterparty relationships of some of the major investment firms with hedge funds has produced generally reassuring results

Even with sound counterparty risk management at individual firms, questions still arise about the collective position of investment banks, to the hedge-fund sector as a whole and to some of the larger funds. One issue is the existence of multiple prime broker relationships. There is a perfectly sound commercial reason for large funds wanting to have more than one prime broker; the hedge fund can pick and choose the best prime broker for each market in which the fund is operating. However, such relationships can present potential risks: brokers may not be aware of the hedge fund's overall exposures; and each may feel comfortable with the margin requirements which they have set for their own exposure, without taking sufficient account of the fact that the hedge fund may have divided what could be an illiquid position between several brokers. Therefore, it is important for all prime brokers to pay sufficient attention to the overall risk profile of the hedge funds to which they are providing services.

We have been collecting information on the hedge fund exposures of a sample of large prime brokers operating in London, in order to help us gain a better understanding of the collective position of the firms. The results of this work have been broadly reassuring. The large exposures of the prime brokers were generally to the larger established hedge funds. Overall, leverage was moderate and, although there were considerable differences in leverage by strategy, these were much as expected. The data showed a healthy margin of collateral over minimum margin requirements (although it should be noted that a factual survey of this sort could not indicate the quality of the collateral or the adequacy of the margin). The exercise confirmed the existence of multiple prime brokerage relationships, but these were mainly in the larger funds, where standards of disclosure by the funds would be expected to be high.

Capital markets and financial exchanges

Market innovation, growth in market activity and regulatory reform continue to create challenges for market entities and us. In particular, firms need to ensure that they continue to effectively manage their operational risk.

Financial exchanges and infrastructure

Consolidation among financial exchanges is increasing

Commercialisation and consolidation have been common trends among market infrastructure providers in the UK over the last few years. Several UK market entities (for example LIFFE, LCH and Crest), who became part of larger cross-border groups, are increasingly working towards achieving synergies across the different national markets and systems they operate. 2005 saw the recognition of NYMEX Europe as a new recognised investment exchange in London. Moreover, the proposed takeover of the London Stock Exchange (LSE) has created significant debate about the structure of the wider UK and European equity markets.

We have consistently taken a neutral stance as to the ultimate ownership of recognised bodies – being appreciative of the international character of the UK financial markets – as long as they continue to meet their regulatory obligations. We therefore work with the UK-recognised bodies to ensure they do not lose control over key functions when they are centralised at group level. We also seek to ensure that a strong corporate-governance framework is maintained in the UK entity and appropriate arrangements for regulatory cooperation are established.

We are mindful of the need to ensure that our regulation does not distort competition, as competition and diversity are likely to enhance market efficiency and market quality. However, these developments also present challenges to the recognised bodies and to us as their regulator. Greater competition and commercialisation increases pressure on recognised bodies, and may drive them to become more commercially aggressive. For example, recognised bodies may look at increasing financial leverage, which may present financial risks in the longer term, or at launching generous incentive schemes, which may lead to disorderly trading. There is also a drive for more operational efficiency, including cost-saving initiatives, which may conflict with the need to maintain adequate regulatory resources. Recognised bodies have a role to play as front-line regulators of their markets. To maintain clean and efficient markets, it is important that they continue to dedicate the necessary resources to key regulatory areas such as market monitoring.

Primary markets and listing rules

Market innovation has given rise to the listing of investment entities with policies and structures that were not envisaged when the existing rules for investment companies were introduced. Consequently, there is a risk that these rules have become outdated. In response to this risk, we are reassessing the existing eligibility criteria and the rules governing investment policies, to ensure that they deliver a modern regime that continues to protect investors while facilitating innovation.

The volume of regulatory reform also presents risks for capital markets

Capital markets are another area affected by the volume of international regulatory reform (which we discuss in our *Priority risks* in section A). In 2005, the IFRS and Prospectus Directive were introduced and, looking forward, the Transparency Directive (TD), for example, has to be implemented in EU Member States by 20 January 2007. The TD will require substantial revisions to the Listing Rules, but we will seek to implement it in a way that incurs minimum disruption to market participants and preserves the international position of the UK's capital markets. Firms need to ensure that they continue to stay abreast of regulatory reforms and effectively manage their operational and compliance risks.

Credit risk transfer

The backlog in outstanding trade confirmations is falling, but remains a risk

The growth in trade volumes, investor diversity and complexity of credit derivatives looks set to continue apace in 2006. As highlighted in the *Priority risks* and *Banks and building societies* sections, the continuing growth in underlying trade volumes and the slow adoption of electronic trading and settlement systems has contributed to the backlog in outstanding trade confirmations since 2002. However, following discussions with international regulators and major dealers in September 2005 to address concerns about operational risks, improvements have been made and the backlog of unsigned trade confirmations is now falling. Nevertheless, we remain concerned about the backlog and we and the industry need to work together to ensure that it continues to fall.

Many industry participants have adopted new protocols to improve the notification of pending assignments and adapt post-credit-event settlement conventions. This has been key in developing a more efficient operations process in the industry. There is a risk that an increase in default rates from the current historically low level will trigger a surge in physical delivery or cash settlement. This could jeopardise the prompt settlement of contracts when combined with the growth in new credit derivative trades and novations of existing positions. Market-confidence and financial-stability issues arise if the credit-, equity- or commodity-derivative markets do not have sufficient operational capacity to settle trades on a timely basis.

Along with the risk-management benefits of using credit derivatives, the subsequent impact on both concentration and liquidity risks must be recognised. The market is relatively concentrated and this may lead to constraints on liquidity in downturn scenarios. Concerns over concentration risk envisaged by the second pillar of Basel 2 may also arise.

Market abuse

We remain concerned that in some areas standards of market conduct may be falling below the required levels and that some firms continue to face high legal, reputational and regulatory risk from not having appropriate systems and controls in place to prevent market abuse. Given that insider dealing and market manipulation are criminal offences, individuals can also face the risk of criminal convictions and prison sentences. We view identifying and punishing market abusers as having an important deterrent effect in maintaining acceptable market standards. We are focusing greater attention on pursuing market abuse committed by institutions, such as investment banks and hedge funds, whether involving market distortion or inappropriate use of or disclosure of insider information by individuals within these firms. This work involves proactive reviews of trading and market behaviour as well as responding to allegations of market abuse.

Some firms are failing to comply with the Market Abuse Directive

The EU Market Abuse Directive (MAD), which was implemented in the UK on 1 July 2005, made some changes to the previous UK domestic regime. Firms must have adequate training and compliance-monitoring programmes in place to ensure that staff are aware of, and understand, the requirements of the MAD and what constitutes market abuse. In particular, firms must ensure that they have procedures in place to identify transactions which they reasonably suspect to be abusive, and make suspicious transaction reports to us as appropriate. Combating market abuse also requires that firms submit full and accurate transaction reports. Recent disciplinary cases have shown failings in this area and highlight the need for firms to review procedures to ensure they are compliant.

Private equity

The role of private equity in capital markets is increasing

Over the last few years, the private equity market has grown in importance both in absolute terms and relative to the public equity markets, and has become an integral and increasingly important sector within the overall capital markets. The market has changed in significant ways:

- the investor base is increasingly institutional;
- the market is dominated by later-stage buy-outs and buy-ins;
- a secondary market in private equity deals has developed;
- information and skills have been commoditised;
- competition has become stronger; and
- the size of the public-to-private market has increased.

Substantial amounts of capital have also flowed into the private equity markets, and the market has grown significantly. For example, investment activity increased by 52% from 2003 to 2004 and over £500 million was raised through venture capital trusts (VCTs) in the 2004/05 tax year, with the market projected to grow further in the 2005/06 tax year. Lending in Europe's leveraged-loan market reputedly reached a record £64 billion in 2004, which represents a 49% rise on the previous year.

As the private equity market continues to mature and develop, we are presented with a number of issues to consider. These include the effect that continued growth in the private equity market relative to the public market may have on the efficiency of the overall capital markets and whether the leverage and illiquidity inherent in private equity structures may increase the risks to financial stability. They also include whether market standards, including those related to transparency and disclosure, remain appropriate given the increasing, albeit indirect, interest of retail investors.

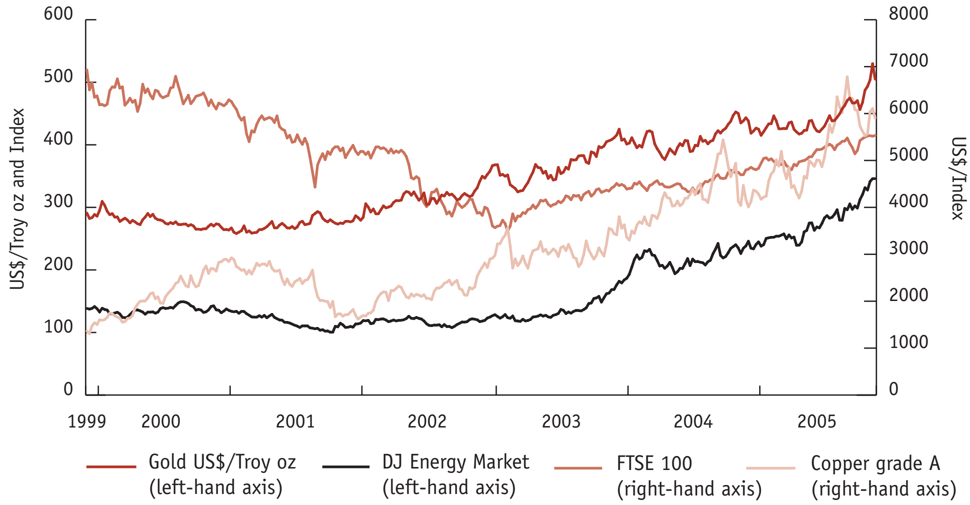
Commodity markets

The trend reported in the *Financial Risk Outlook 2005* has been maintained: investors' interest in commodities as an asset class has continued to grow, hand in hand with a continued move to electronic trading. The International Petroleum Exchange (now ICE Futures) moved to fully electronic trading in April 2005 and has seen trading volumes rise by 18%. Over-the-counter (OTC) energy markets have similarly seen movement from voice brokers to screen trading, although there continues to be minimal take up in the UK of cleared products (a contrast with the US and the success there of NYMEX's Clearport and ICE's OTC-cleared products, especially in gas and power).

2005 was another strong year for commodities

Commodities remain attractive to investors, despite increased market volatility. Record prices were seen across the energy markets during 2005 and copper reached an all-time high, while most base and precious metals also increased in value. Market fundamentals continue to drive the prices in this sector, with global supply deficits being a key factor in increasing prices in these markets.

Chart C9: Movements in commodity prices



Note: Monthly data
Source: Datastream

Strong growth in commodity prices supported growth in the FTSE 100, due to the heavy concentration of natural resource companies in the index. We discuss the interaction between commodities markets and the wider economy in our *Sustained and significant increase in oil prices* scenario.

Asset management

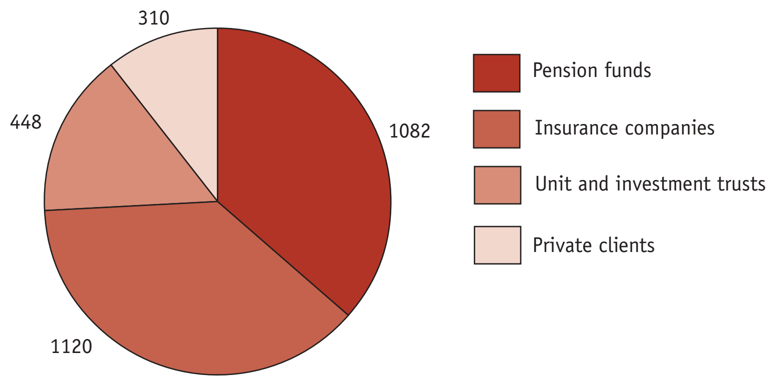
The asset-management sector has responded to the equity market downturn of 2000 to 2003 through reorganisation, cost cutting and outsourcing. Although traditional asset managers will face ongoing competitive pressure from hedge funds and other alternative investments, most companies are now in a better financial position than they were a few years ago and are benefiting from recovering markets. The sector will continue to deal with changes in the way their businesses operate, particularly due to the pace of regulatory change at the European level and in the UK's long-term savings market.

Business conditions

Assets under management continue to recover

After a period of tighter markets and reduced revenues, business is picking up again. The recovery in equity markets and improving retail sales, have resulted in an increase in assets under management. Total assets under management in the UK have increased by 11% since 2002 and are now close to £3 trillion (see Chart C10). The industry continues to be dominated by the assets of pension funds and insurance companies. The UK is the third-largest market in asset management, after the US and Japan.

Chart C10: UK assets under management, split by type (£ billions)



Note: Unit and investment trust figures are net of those held by other funds
Source: International Financial Services London based on Office for National Statistics, Compeer, WM Company, UBS and Investment Management Association data, August 2005

The profitability of asset management is expected to continue to increase in 2006, in large part due to rising markets, but also as a result of cost cutting and the diversification of product sales. Across the industry, profitability increased 9.5% in 2004 with average margins at 23%, up from 21% in 2003.[2]

2 *Asset Management Survey*, Investment Management Association, May 2005.

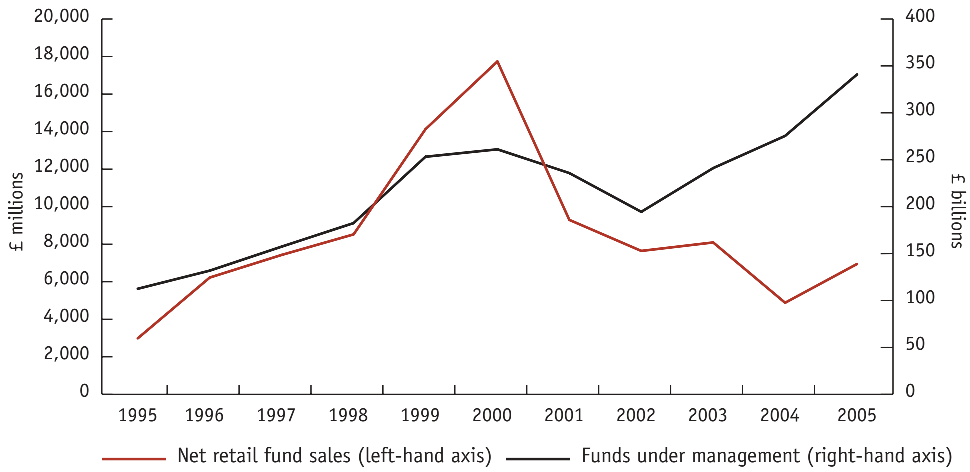
Net sales have increased, but retail confidence in the equity market continues to be fragile

A combination of rising UK equity markets, increased sales of bond and other fund products, and a rise in net-retail sales have pushed retail funds under management over £300 billion in 2005 (see Chart C11). Total fund sales to retail investors have increased 42% from £4.9 billion in 2004 to close to £7 billion in 2005.

However, consumers' memories of the bear market in 2000 to 2003 are not far from the surface and net sales of equity funds to retail investors continue to be poor. For 2005, net retail sales of equity products were an estimated £2.3 billion, one-sixth of the level achieved in 2000 when sales were £14.5 billion, and £0.3 billion less than in 2004.

Reluctance to invest in the equity market has resulted in increased investment in bonds and other products such as capital guaranteed funds. Since 2000, net sales of bond funds have increased 29% from just under £2 billion to just over £2.5 billion in 2005. It is estimated that sales of other types of funds to retail investors, including funds with protections or capital guarantees, are over £1 billion in 2005 and exposure to property funds is growing in popularity. Industry estimates that the value of property unit trusts alone now stands at £15.3 billion.[3] The November 2005 Pre-Budget Report allowed the listing of real estate investment trusts (REITs), which may increase investments by retail investors in the coming years.

Chart C11: UK retail funds under management



Note: 2005 projection based on first three quarters
Source: Investment Management Association

Institutional investors have also increased their exposures to bonds. Since 2000, pension fund managers and insurance companies have reduced their risk appetite in relation to their liabilities, resulting in decreased exposures to equities. The Investment Management Association's (IMA) most recent survey shows that between 2003 and 2004, pension funds lowered their equity weightings from 60% to 56% of total portfolios.

3 Association of Property Unit Trust, figures as at 30 November 2005.

Regulatory developments

Firms need to continue to implement regulatory reforms

At the European level, two initiatives will have a significant impact on fund management, the Markets in Financial Instruments Directive (MiFID) and the Undertaking in Collective Investments and Transferable Securities (UCITS III). Many firms have already taken regulatory changes into account when planning their business strategy for the next few years. Those that have not will need to focus on the implications of these directives in 2006.

MiFID proposes significant changes and Europe-wide standards. Those that will have the greatest effect on fund managers include changes to client classification, conduct of business, financial product promotions, outsourcing of portfolio management services and best execution. These proposed reforms will have an impact on firms' management of investment processes, sales of investment products, and execution and reporting of their trading activities. Although the deadline is subject to revision, asset managers are expected to implement changes by November 2007.

The UCITS III directive seeks to modernise the harmonised regulatory framework for selling funds across Europe. It also extends traditional asset managers' ability to use derivatives for investment purposes. This change enables a significant shift in the nature of investment products and represents a considerable challenge for us in respect of our market confidence and consumer protection objectives. Firms, in particular those marketing funds in the EU, will want to be mindful of the transitional steps. For instance, those firms that operate UCITS III funds will need to be compliant with the Management Directive requirements by 30 April 2006. Finally, funds will need to be fully compliant with UCITS III standards by February 2007.

Increasing use of derivatives

With the growth of UCITS funds and the development of hedge-fund businesses, the use of derivatives is set to continue rising

Up until now, fund managers have been allowed to use derivatives in UCITS funds only for efficient portfolio management (EPM). However, UCITS III allows managers to use derivatives for investment purposes, so we would expect the use of derivatives to increase. Most managers are moving into this area cautiously. Although the directive only requires notification of a firm's intention to trade derivatives for investment purposes in its prospectus, we expect asset managers to continue focusing on Treating Customers Fairly. This will mean ensuring that their communications and valuations reflect the nature of the instruments they are trading and the risks to the client.

Attention to conflicts of interest

Market developments may present new challenges in managing conflicts of interest

Many traditional asset managers have developed single-manager hedge funds. Others are involved in managing complex products such as CDOs. These developments show the innovative nature of the industry but may give rise to conflicts and preferential treatment of clients.

Distribution channels

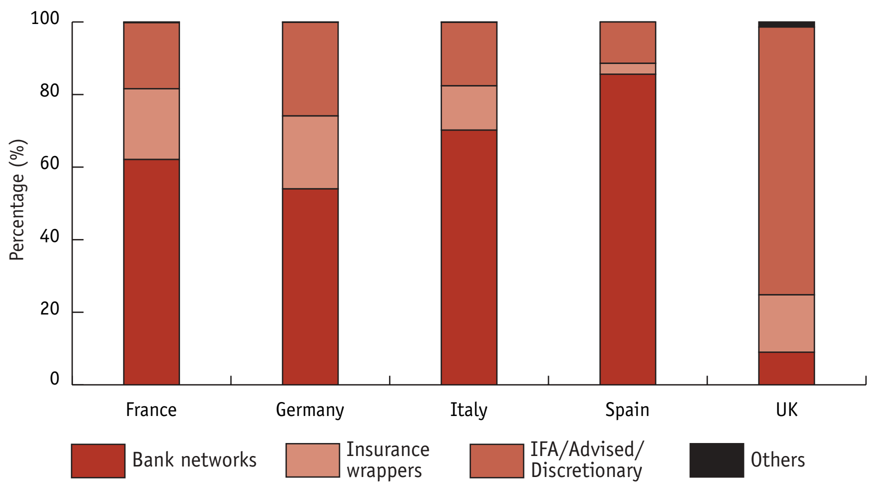
Asset-management firms can be at risk if the intermediaries selling their products are not properly equipped to do so

As discussed in greater detail in Section D, changes in European regulation and the implementation of depolarisation will affect the way in which long-term savings are sold to consumers. Under depolarisation financial advisers explicitly present their fees and commission levels to consumers and firms explain more clearly the services they provide and the ties they have to investment product providers. Following the implementation of depolarisation, advisers can offer 'multi-tied advice' using a selection of investment providers.

The role of independent advice, through its diversity and competitiveness, has been beneficial in distributing investment products to retail investors. Although it is the intermediary that bears the main risks of mis-selling investment products, product providers and manufacturers need to be mindful of their own reputational risk, and need to satisfy themselves that the advisers selling their products have the requisite materials, skills and regard for the customer.

Although difficult to compare, retail market distribution is different in the UK from that in other parts of Europe. Intermediaries are much more a feature of the UK market than of other European markets. In the UK, close to three-quarters of investment products, including collective investment schemes (CIS), fund of funds and structured products are sold with advice, including fund supermarkets, and only 16% through insurance and 9% through bank networks. The picture is very different in Continental Europe where bank distribution dominates, ranging from 86% in Spain to 34% in Germany. Advised sales have market shares ranging from 11% in Spain to 26% in Germany (see Chart C12). It is worth noting, however, that third-party fund distribution through bank networks is growing considerably in Continental Europe.

Chart C12: European retail fund distribution (2005)



Note: Supermarket acitivity included within IFA/Advised/Discretionary category for the UK and within Bank networks for Continental Europe to reflect current market practice. Private bank/discretionary business included in IFA/Advised category. Funds of funds business allocated between Bank and IFA channels.

Source: FERI-Fund Market Information Ltd

Long-term savings and the pension-fund market

Changes in long-term savings patterns and reforms to pension funds will present challenges and opportunities for the industry

The asset-management sector plays a critical role in providing products and services for the long-term savings and investment needs of millions of UK retail consumers. The Pensions Commission published its Second Report on the future of the UK private-pension system and long-term savings in November 2005.[4] It is not yet clear what impact the recommendations will have on government policy or the pensions industry. However, some recommendations, such as the development of a National Pension Savings Scheme (NPSS) could have wide-ranging implications for asset managers. Some estimates are that, if adopted, the initiative will increase the number of long-term savers by 12 million and raise an additional £5 billion in annual pension contributions.[5] This would present significant opportunities for the asset-management industry, but more retail business would mean that the sector needs to continue its efforts to communicate effectively with retail investors through Treating Customers Fairly (TCF) programmes.

Although we do not regulate pension funds, their weight in UK assets under management and the number of beneficiaries means that they affect our objectives of market quality and consumer protection. As seen in Chart C10, asset managers currently manage over £1 trillion in pension-fund assets, so any changes in the pension market will affect UK financial markets in general and the asset-management industry in particular. Most defined-benefit pension schemes are now closed to new members and new schemes are predominantly defined contribution. We expect the defined-contribution model to become dominant over time and asset managers are changing their business models accordingly.

In his Review of Institutional Investment in the UK (March 2001), one of Paul Myners' key criticisms concerned the reliance of pension fund trustees on the advice of a small number of independent actuarial consultants. Recent indications are that trustees are growing increasingly dependent on the skill and integrity of these consultants. There are concerns of potential conflicts of interest between pension-fund consultants that offer services to both pension funds and asset managers. The industry is highly concentrated and some estimates suggest that three firms advise over 75% of the FTSE 350 company pension funds.[6] Consultants, fund managers and trustees will all need to be alert to potential conflicts of interest.

Hedge funds

Inflows into hedge funds have been slowing

London is the leading centre of hedge fund expertise in Europe and estimates put the amount managed by local fund managers at over US$213 billion. Globally, hedge funds had a record year in 2004, with total net inflows of over US$120 billion, but inflows began to slow during the second half of the year (Chart C14). This trend continued in 2005, and overall inflows in 2005 are expected to be about half the size of those achieved in 2004.

4 *A New Pensions Settlement for the Twenty-First Century: The Second Report of the Pensions Commission*, The Pensions Commission, November 2005. The report is also known as the Turner Report.
5 *Win Lose or Draw*, Deloitte, December 2005.
6 *FRS17/IAS19 Pension Liabilities: The Essential Guide to Actuaries and Actuarial Assumptions,* Pension Advisor Review, August 2005.

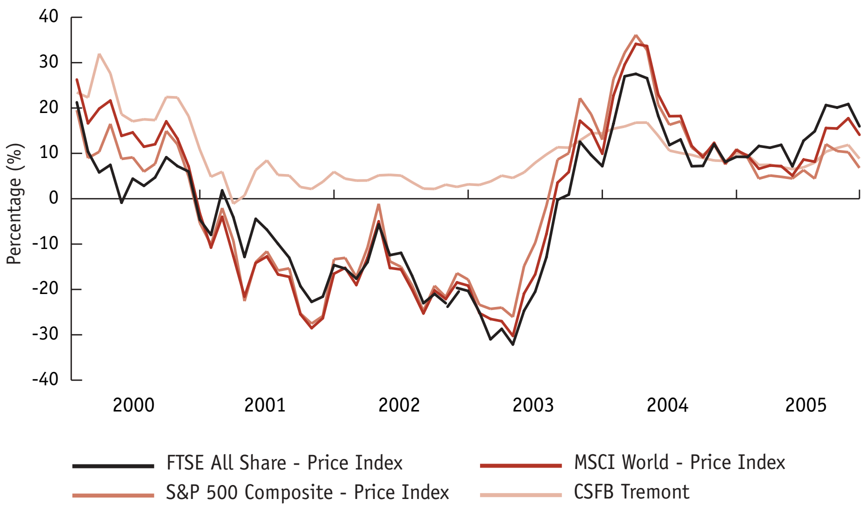
Performance has recently been weaker, especially in relation to more traditional long-only funds

The slowdown reflects several factors. The overall performance of hedge funds has declined, both absolutely and relative to the performance of more traditional long-only funds. Chart C13 shows that the CSFB Tremont index – a broad measure of hedge fund performance across all strategies – showed an annualised return of around 17% in early 2004; by the third quarter of 2005 this had fallen to less than 10%. Moreover, during the last two years, three of the major global equity indices have risen an average of 21% compared with a rise of 18% for the CSFB Tremont index.

During the second quarter of 2005, market and investor sentiment for hedge funds was affected by the credit-rating downgrades of Ford and General Motors, since hedge funds were believed to have taken significant positions in these companies in the bond and credit-derivative markets. In the event, several hedge funds were believed to have sustained losses.

Performance has, of course, varied widely across the sector. Some strategies have continued to deliver strong performance, as have individual funds.

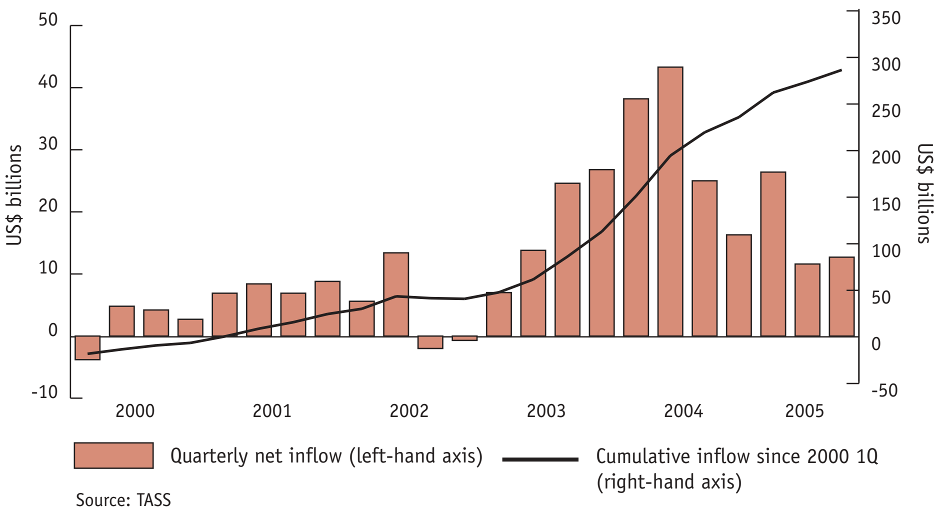
Chart C13: Annualised returns of major equity and hedge-fund indices



Source: CSFB Tremont, Datastream

The overall weight of capital that has flowed into hedge funds is considerable. Estimates put the net inflows since 2000 at some US$300 billion and assets under management by the sector were said to have broken the US$1 trillion mark early in 2005. While the ability of the industry to absorb such large inflows has been impressive, there has been concern that the weight of investments may result in crowding out and underperformance of certain strategies.

Chart C14: Global hedge fund inflows



Source: TASS

Hedge funds play an increasingly important role in financial markets and significantly enhance market liquidity and efficiency. They also offer diversification options for investors. These positive contributions to market dynamics are fully recognised. Nevertheless, as the industry has grown we have had to consider more proactively the issues and the risks that hedge funds pose to our statutory objectives and to consider how we should engage with the industry. We have also felt it important to keep under regular review the question of the appropriate level of access to hedge fund products by the retail or non-specialist investor.[7]

The risk that hedge funds may pose a threat to financial stability, or engender serious market disruption, seems low at present

The failure or significant distress of a large and highly exposed hedge fund or, with greater probability, a cluster of medium-sized hedge funds with significant and concentrated exposures could in theory cause serious market disruption or erode confidence in the financial strength of other hedge funds or of firms which are counterparties to hedge funds. Despite the growth of the industry, our judgement is that this risk remains fairly low. This is mainly due to the steady improvement in counterparty risk management by the major hedge funds in recent years. Although there are now some quite large hedge funds in the market, it would appear that none of them match the size or the leverage of Long-Term Capital Management, whose near failure caused significant market disruption in 1998. During 2005 our surveys of major hedge fund counterparties suggested that leverage by hedge funds remains quite low and that the counterparties' exposures operate with, in general, a comfortable level of collateral over margin requirements. As noted earlier, the hedge-fund sector coped with a degree of market disruption following the credit ratings downgrades of Ford and General Motors in spring 2005.

7 In June 2005 we published two discussion papers on hedge funds: *Wider-range Retail Investment Products: consumer protection in a rapidly changing world* and *Hedge Funds: a discussion of risk and regulatory engagement.*

Hedge funds appear to have increased their investments in less-liquid asset classes during 2005

Hedge funds appear to continue to increase their investments in a range of asset classes which are either inherently less liquid than conventional assets, or whose liquidity is more likely to be reduced in times of market stress. Investments in credit derivatives, including less-liquid tranches of CDOs, in private equity funds and in strategies focusing on investments in emerging markets all became more popular in 2005. Some hedge funds have adjusted their redemption periods to reflect changes in the liquidity of their portfolios. The possibility remains that attempts by hedge funds to realise assets at times of market stress to respond to investor withdrawals could engender liquidity mismatches, leading to enforced asset disposals and, consequently, to volatile and potentially disorderly markets.

Control and operational risks have surfaced in a number of hedge funds

By design, hedge funds are usually small and relatively informal organisations and many of their key staff come from trading rather than management backgrounds. Risk management, operational controls and compliance have all improved greatly in recent years as the industry has grown and, in particular, as institutions, such as pension funds, have become more significant investors. Nevertheless, the potential for managers to grow very rapidly (in a booming sector) and the increasing sophistication of investment techniques, has meant that some managers have not kept up with the changes. Due to the size of the assets and complexity of the instruments they now trade, these managers may no longer have adequate systems and staff to create an effective control infrastructure.

During the first part of 2005, the volume of outstanding unsigned trade confirmations in credit derivatives rose rapidly, as mentioned in the *Priority risks* and *Banks and building societies* sections. Much of the problem reflected difficulties in the back offices of investment banks, but one of the contributing factors was the practice of assigning a credit derivative on to a third party without informing the original issuer. These instruments remained unsigned, exposing all three parties to the transaction to legal risk. A protocol signed in October 2005 under the auspices of International Swaps and Derivatives Association (ISDA) should start to address this issue.

Typically, an independent valuation of UK-managed hedge funds is obtained from a third-party administrator (TPA). This is not the case in all countries – in the US, for example, valuations are often provided by the hedge fund manager. As noted earlier, hedge funds have been increasing their activities in less-liquid asset classes, and this increases the challenges facing the TPA. Where there is no publicly agreed price for an asset, the TPA may have to rely on either a valuation model, which is frequently developed by the hedge fund manager itself, or on price quotes from the hedge fund's counterparties.

Although valuations are an important issue for all fund managers, they will represent a particular challenge for those that invest in more illiquid instruments such as distressed debt, complex derivatives, real estate and private equity. Conflicts of interest can arise when managers provide valuations of complex illiquid instruments to administrators. As manager fees are based on the assets under management and fund performance, there may be a temptation to overstate the value of assets. There is a legal risk for the manager if valuations are materially inaccurate or deliberately misleading. Options for mitigating this risk include the use of independent third-party administrators and price providers, having an independent board of directors, and segregating duties between the portfolio manager and the back office.

Given their growing role in illiquid and complex instruments, valuations are particularly relevant to hedge funds. Going forward, we will encourage the development of guidance and standards through organisations such as International Organisation of Securities Commissions (IOSCO) and build on some excellent work done by trade bodies such as the Alternative Investment Management Association (AIMA). Our approach will aim to encourage improvements in valuation practices by addressing the governance framework and the policies and procedures of funds and fund-management companies.

Life insurance

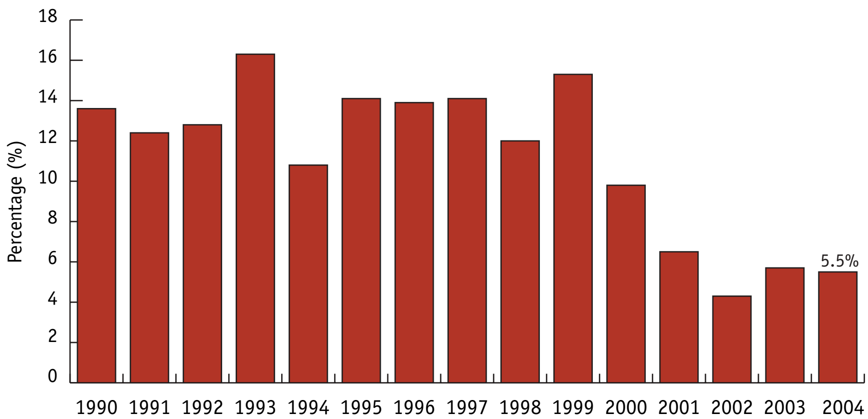
The outlook for the life-insurance sector continued to improve in 2005. The new regulatory regime is bedding in, and firms' capitalisation and asset allocation appear to have reached more of a steady state. Initial results from the new realistic reporting requirements for major with-profits funds are encouraging. But with continuing low inflation, competition from other savings providers, new entrants and the uncertainty over the impact of pension reform, life companies clearly face significant challenges in 2006 and beyond.

Financial position of the life-insurance industry

The capitalisation of with-profits life insurers has continued to improve

The capitalisation of UK with-profits life insurers has continued to stabilise, albeit at a level lower than in the late 1990s. At the end of 2004, the free-asset ratio (traditionally a key statutory measure of solvency for UK with-profits insurers) stood at 5.5%. However, due to the substantial changes in the solvency requirements that we have introduced, measuring the strength of with-profits firms will focus increasingly on the amount of realistic working capital. This is before and after allowing for the risk capital margin (RCM).[8] Initial results from realistic balance sheet analysis are encouraging: over the first half of 2005, the aggregate realistic working capital rose by 9% to £29.2 billion before allowing for the RCM, and by 17% to £18.1 billion after allowing for the RCM.

Chart C15: UK with-profits insurers' adjusted free-asset ratio



Note: Numbers adjusted to ensure broad comparability, due to changes in statutory calculations
Source: FSA

The aggregate RCM fell by 8% to £11.1 billion between June 2004 and June 2005. Although firms have continued to derisk by developing plans for their management's response to stressed situations, the fall largely reflects favourable economic conditions; well-performing equity markets (the FTSE 100 index rose by 14.5% with volatility falling) and lower credit spreads. On the other hand, the 86 basis-point drop in long-term yields over these 12 months had an adverse effect on the RCM. This is because most UK with-profits funds contain policies with guarantees that are either unhedged or only partially hedged.

8 The risk capital margin (RCM) is the amount of capital required to withstand falls in asset markets.

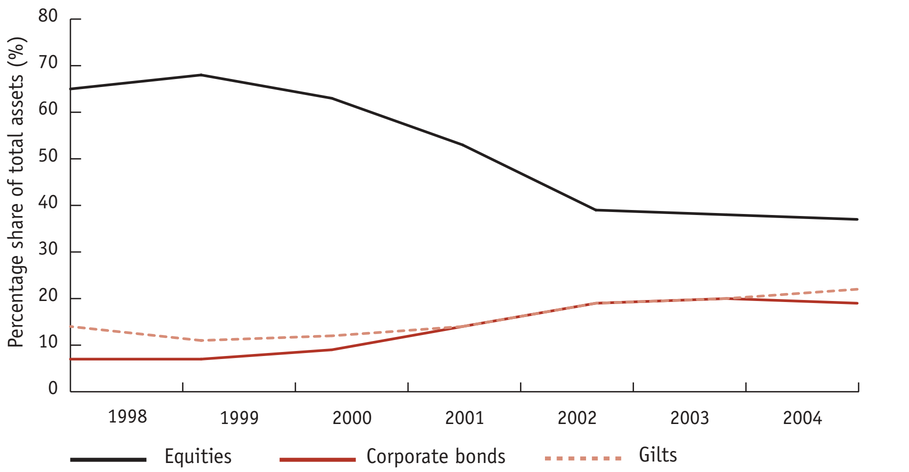
All 37 firms submitting realistic balance sheets to us continued to be able to cover their RCM, many of them from long-term business surpluses rather than shareholder funds.[9] Indeed, in June 2005 three-quarters of all funds could meet their RCM using only the realistic surplus in their with-profits fund, compared with roughly two-thirds in June 2004.

Investment portfolios

Overall, firms' investment portfolios are more stable than two to three years ago

With-profits firms' investment portfolios have undergone significant rebalancing since 2000, with firms cutting their exposure to equities and increasing the share of corporate bonds and gilts. However, data at the end of 2004 suggests that asset allocation, like capitalisation, has stabilised for the sector as a whole, though the experience still varies somewhat by individual firm.

Chart C16: With-profits funds' asset allocation



Source: FSA

Given the duration of life insurers' liabilities, managing the balance sheet could continue to pose challenges for UK life firms. However, efforts to deepen the market for longer-dated, sterling-denominated instruments have begun. Responding to demand from both UK life insurers and pension funds, the Debt Management Office (DMO) began to issue both conventional and index-linked 50-year gilts in 2005. So far, a total of £9.1 billion has been issued. Despite this issuance, the demand-supply balance appears tight – for example, the price of the 50-year index-linked gilt rallied by 5.3% in the two months after it was issued.

Risks are now better understood

The work done on realistic balance sheets and through the introduction of the new, risk-based individual capital assessment (ICA) submissions have given both firms and us a better understanding of the underlying risks. For example, some firms have stress tested their assets and liabilities, not only for simple fluctuations in equity and fixed-income returns, but have also included analysis of the potential impact of changes to the slope of the yield curve in their ICA submissions. However, there is still more work to be done, not least to understand correlations, particularly in stressed conditions, and the effect of diversified activities on capital.[10]

9 Life insurers with with-profits liabilities in excess of £500 million are required to report on a realistic basis. This accounts for some 98% of the market.
10 *Insurance Sector Briefing: ICAS – one year on*, FSA, November 2005.

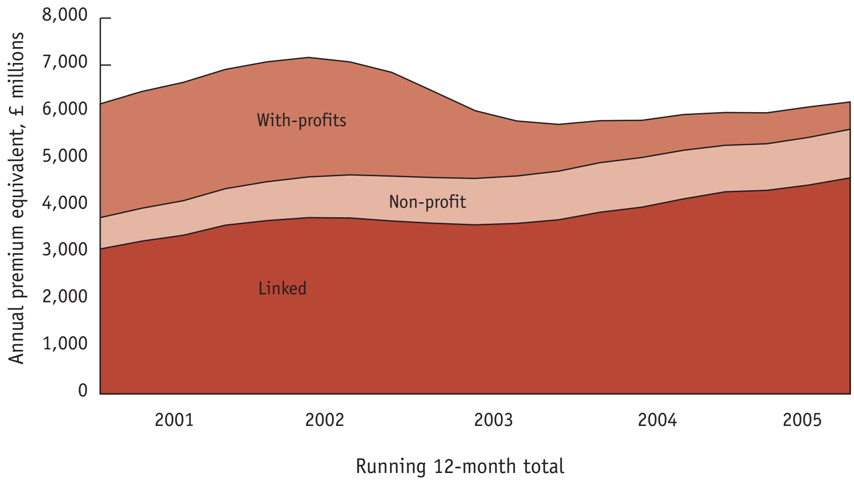
Consumer confidence and product sales

Consumer confidence in life-insurance products is recovering

In recent years, weak equity markets, bonus-payout reductions and legacy concerns over mis-selling all dented consumer confidence in life-insurance products. However, as the UK equity markets have proved stronger, with the FTSE 100 index rallying 74%[11] since the March 2003 trough, there are some signs that consumer confidence is recovering. Overall, new sales of life products grew by 8% in the 12 months to June 2005. Nonetheless, the total volume of new sales is yet to reach the highs seen in 2002.

The mix of new retail business continues to move away from with-profits in favour of unit-linked products. Sales of unit-linked products were up 12% in the year to June 2005, while sales of with-profits policies contracted by 19%. The move away from with-profits to unit-linked products means that investment risks are borne increasingly by the policyholders rather than the product providers; however, as linked products involve firms bearing less risk, they offer correspondingly lower margins.

Chart C17: Sales of new retail life-insurance products (UK)



Note: Quarterly data
Source: Association of British Insurers

Enhanced transparency and disclosure in with-profits

Since April 2004, all insurers undertaking with-profits business have been required to produce a publicly available account of how they run their with-profits business in a document called the Principles and Practices of Financial Management (PPFM). From the end of 2005, they have also had to produce a consumer-friendly version of it. While the introduction of PPFMs has proved a valuable governance discipline for firms' senior management, there remain a number of concerns. These are principally due to the varied quality of the documents and the fact that few financial advisers appear to be using them in the advice process.[12]

11 This figure is based on the increase in the FTSE 100 index between 12 March 2003 and 9 January 2006.
12 *Insurance Sector Briefing: Principles and Practices of Financial Management*, FSA, October 2005.

Closed with-profits funds

Life-insurance firms and financial intermediaries could do more to inform their customers about the implications of closed funds

Closed with-profits funds – broadly defined as funds that are no longer writing new business – manage £85 billion of policyholder assets, or 10% of the long-term insurance savings market. They pose additional challenges to the continuing fair treatment of customers, as the range of options available to firms may be more limited when compared to open funds. Moreover, it is difficult, if not impossible, to give generic advice on whether an individual should keep his or her policy until maturity in a closed fund or surrender it and, for some policies, risk incurring a market value reduction (MVR).[13] So, firms need to communicate in a timely and clear manner to their policyholders on topics such as the existence of guarantees, options and MVR-free dates, as well as on the very fact that the fund is closed to new business. Although effective policy-holder communication is crucial, many consumers are still likely to require assistance, tailored to their needs, in deciding what to do with their with-profits policies. A further challenge for the industry – both providers and distributors – will be to help ensure that consumers can access such advice and help on an ongoing basis.

There have been no new fund closures since 2004, but commercially the landscape has been altered by the emergence of third-party consolidators looking to buy closed books of business, seeking economies of scale and shareholder returns. As many of the consolidators have been backed by private equity firms with potentially much shorter time horizons than policyholders, some commentators have raised questions over the fair treatment of policyholders. We continue to scrutinise closely all consolidating transactions to help ensure fair treatment of policyholders, both at the time of the transaction and in our supervision of the firm.

Pension reforms

Pension reforms pose both operational and strategic challenges for the industry

Given that pensions account for the majority of life insurers' new and existing business, changes in the legislation governing pension provision are clearly significant for firms, and any reform is likely to present both opportunities and challenges for product providers. For example, the new, simpler taxation rules for all types of pensions, which take effect from 6 April 2006 (A-Day), discussed in detail in *Retirement planning*, Section D, could encourage pension savings, and thereby provide growth opportunities for life insurers. However, in the near term, the same changes could present operational risks that could threaten the fair treatment of consumers if not properly managed. For example, insurance firms as providers of pensions have to adjust their systems and controls as well as redesign their products for the new framework.

Over the longer term, many believe that the simplified tax regime could encourage consolidation of existing savings, potentially through some type of wrapper.[14] The recycling of existing pension savings could result in some firms' persistency[15] assumptions proving too optimistic, which may affect their economic capital positions. Wrappers could also be sold by asset management and other firms, resulting in the life-insurance sector as a whole losing market share in the pension business.

13 *Insurance Sector Briefing: Update on Closed Funds*, FSA, November 2005.
14 Wrappers refer to investment structures, such as individual savings accounts (ISAs) and self-invested personal pensions (SIPPs), which are composed of financial products such as collective investment schemes, equities and bonds. These are packaged together to achieve, for example, tax benefits, ease of administration and greater choice.
15 Persistency measures the proportion of insurance policies that stay in force and are renewed.

For consumers, the process of aggregating pensions could be a negative-sum game, given the charges and fees involved in the transfer process. Firms also need to ensure fairness of transfer values for consumers who wish to move their savings to another provider. In addition, timely and efficient handling of open-market options (OMOs) is important for minimising any consumer detriment that could arise from administrative delays. Clearly, issues relating to potential mis-selling or poor advice are the key risks arising from imminent pension reforms from consumers' point of view (we cover these issues in detail in Section D). Any widespread concerns about financial advice given to consumers could also cause reputational damage to product providers as a result of their links with intermediaries. Many, typically larger, insurers have identified this risk and have already provided financial advisers with training and reference materials.

There are also longer-term pension issues arising from the Pensions Commission's Second Report. It recommends, among other things, the creation of a new National Pensions Savings Scheme into which all employees over 21 would be automatically enrolled. The minimum total contributions, combining employer and employee contributions as well as tax relief, would be set at 8% of earnings. With the annual-management charge capped, this proposed reform, put forward for 2010, is primarily aimed at the segment of the population currently not saving for their retirement, rather than at the individuals who already are members of an occupational or a private-pension scheme. Nonetheless, if an industry-led model is adopted, these new savings flows and higher demand for annuities could potentially present growth opportunities for UK life-insurance firms, albeit over the longer term.

Longevity and mortality risks

Unpredicted changes in life expectancy continue to present risks

Assumptions about life expectancy are at the heart of life insurers' business and continued, unanticipated improvements in life expectancy present a significant risk for firms. The Continuous Mortality Investigation (CMI) published proposals for new mortality tables in September 2005 showing significant improvements in mortality compared to the previous estimates. Mortality rates for both males and females in their late 60s are now some 30% lower than indicated by the previous tables, which were based on data from the early 1990s. However, most large life insurers have already taken much of the improvement into account, having strengthened their reserves in summer 2004.

A serious global pandemic could pose difficulties for some smaller firms

A global pandemic, such as an outbreak of pandemic flu, or a catastrophic event could have the opposite effect, resulting in higher mortality rates and hence a reduction in future annuity payments. However, such an event would lead to a rise in payment of death claims. While a firm writing both term assurance and annuities could, in principle, claim some capital relief from 'hedging', the extent to which the two risks truly offset each other needs to be appraised carefully. So far, only a few firms have been able to demonstrate a material benefit where two types of contract have been sold to groups of policyholders with very similar age, sex and location characteristics. A global pandemic would also be likely to have major consequences on general insurers through claims arising from business interruption, travel and medical insurance policies.

Regulatory risks

The industry has responded well to the challenge of regulatory reform in the UK

The regulatory regime for UK life insurers has undergone extensive modernisation over the last few years, as we have sought to introduce a more risk-sensitive capital regime using the Individual Capital Adequacy Standards (ICAS) framework and realistic balance sheets. In addition there are also new rules for life offices setting out what it means to treat with-profits policyholders fairly.[16] Indeed, in the *Financial Risk Outlook 2005* we identified the challenges facing the life industry in managing these changes as one of our *Priority risks*. We believe that firms are making good progress with their risk-management processes, and encouragingly there were no qualified returns when realistic balance sheets formed part of the audited FSA returns for the first time in 2005. It is still early days for the conduct of business requirements, but we will monitor how firms are implementing the new rules throughout 2006.

Industry involvement in the preparation of Solvency 2 is essential

Looking ahead, regulatory reforms will remain topical for UK life insurers due to the Solvency 2 project, which is tasked with setting up new EU insurance solvency rules. The Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), in which we participate actively, is currently engaged in giving advice to the European Commission for drafting the Framework Directive. It is critical that UK firms engage during the drafting process, in particular through participation in the Quantitative Impact Studies (QIS), to help ensure that the Solvency 2 regime is proportionate and more transparent, robust and risk sensitive than the EU directive currently in force.

16 *Insurance Sector Briefing: Delivering the Tiner Insurance Reforms*, FSA, April 2005.

General insurance

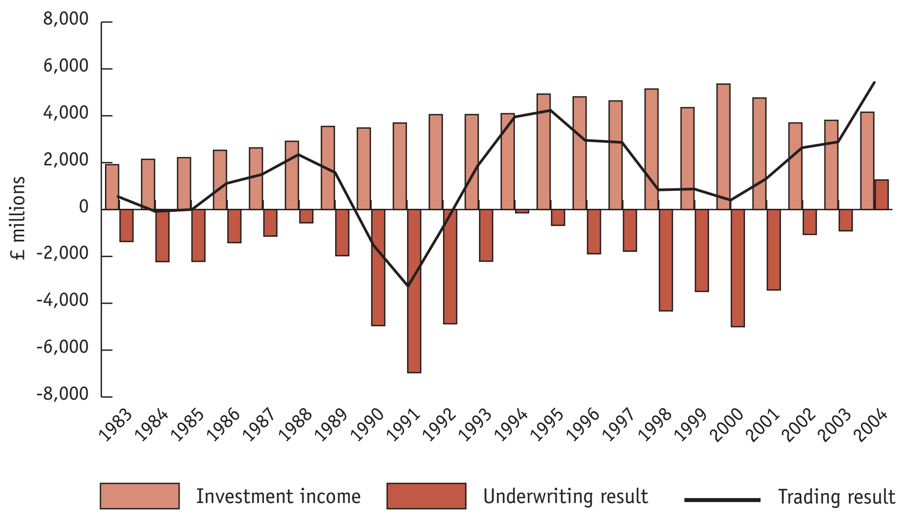
The general-insurance sector is diverse, and the risks faced by the firms vary depending on the types of business they write, the type of clients, and the jurisdiction from which their business emanates. However, a number of challenges – such as the underwriting cycle, the impact of climate change and exposure to terrorism – are shared by firms across the sector.

Business conditions for general-insurance firms

2004 saw the first underwriting profit in 20 years

UK general-insurance firms underwriting retail and commercial risks (outside the London Market) almost doubled their trading result to £5.4 billion in 2004, due to the first aggregate underwriting profit in 20 years. This was largely due to the strong performance of the non-motor insurance classes. In addition, investment income, which has traditionally offset underwriting losses, also rose by 9% as equity markets strengthened and credit spreads tightened.

Chart C18: Worldwide general-insurance business trading results



Source: Association of British Insurers

Competitive market poses challenges to firms …

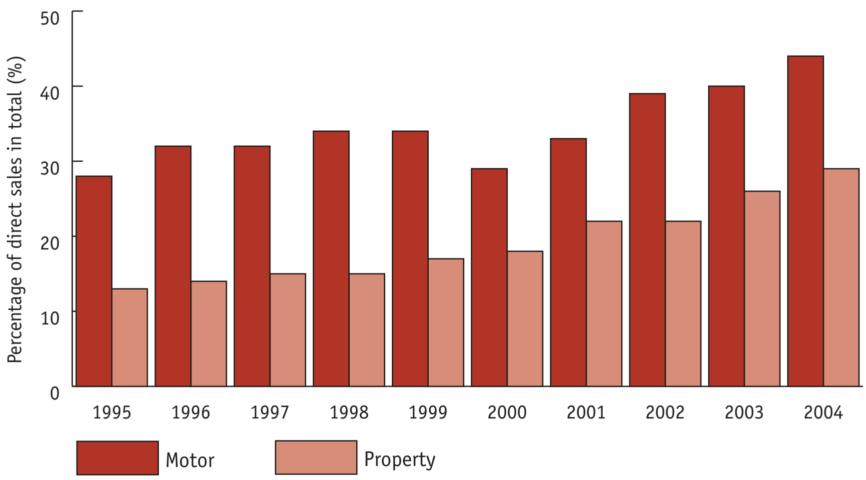
The UK general-insurance market is one of the most mature and competitive insurance markets in the world: over 70% of households purchase motor and home contents insurance and customers tend to shop around, with almost a fifth of customers switching to a different insurance company when renewing a general-insurance policy. Moreover, there are few barriers to entry: in the UK 431 firms are currently authorised to write general-insurance business and the single European market enables cross-border business. Indeed, the UK has seen a steady inflow of new entrants, domestic and overseas, to the retail general-insurance market in recent years. As a result, many retail-insurance products are commoditised: policies are largely standardised and product providers' pricing power is largely limited. While price is an important driver for sales, competitive advantage is also gained from the overall offering including scope of risk coverage and strength of brand. However, some market segments, such as extended warranties and payment protection insurance, appear to suffer from a lack of competition in the distribution of insurance.

To grow, given these market characteristics, insurers operating in the UK continually need to find new ways of analysing and pricing the risks and marketing their overall offering. However, when pursuing new opportunities, firms need to ensure that they have sufficient capital to back claims arising from new policies and that consumers are treated fairly.

… but offers benefits to consumers

Consumers have benefited from this competitive market; in the last two years, both home and motor insurance premiums have grown below the rate of inflation. The continued trend towards buying insurance directly from the insurers rather than using an intermediary, and the number of new entrants offering specialist cover to particularly targeted customer groups, have further reduced the cost of insurance and increased the choice for UK consumers. In 2004, 44% of motor insurance and 29% of home insurance was sold directly, either by telephone or over the internet.

Chart C19: Proportion of direct sales in total retail insurance sales (UK)



Source: Association of British Insurers

We are not an economic regulator and do not wish to restrict consumers' ability to benefit from competition. However, the benefit to consumers of lower premiums brings risks to the financial soundness of individual firms if they make poor underwriting decisions in a very competitive (or 'soft') market and do not have sufficient capital to mitigate those risks. This risk applies to all general-insurance firms, including commercial reinsurance and London Market firms. It is important for firms to manage the risks associated with the underwriting cycle through clearly articulated policies on risk appetite, underwriting and business strategy, and through appropriate oversight of their business activities. In addition, firms' underwriting practice should be consistent with the agreed board policy.

Claimant fraud is one of the largest fraud categories across financial sectors

With estimated costs to the industry of £1 billion and £500 million for retail and commercial lines respectively, insurance claimant fraud is one of the largest categories of fraud and continues to present a widespread risk to the sector. Opportunistic low-value, high-volume fraud perpetrated by consumers accounts for most insurance fraud, which is difficult to combat without alienating honest customers. Without a change in public attitudes to claims fraud, reduction in that type of financial crime will be difficult.

In line with our statutory objectives to help reduce financial crime in the financial services industry, we expect firms to continue to combat claimant fraud. Industry initiatives to share information about fraudulent claims are welcome as they reduce overall costs to honest customers. Progress is being made in this area, with an Association of British Insurers (ABI) survey estimating that £200 million worth of fraudulent claims were uncovered in 2004. In addition, the Insurance Fraud Bureau hopes to identify fraudulent claims perpetrated by organised crime of at least £50 million (and up to £200 million). *Increasing risk of financial fraud* is one of our *Priority risks*, and fraud is discussed in greater detail in Section E.

Climate change and terrorism

Climate change poses a major challenge for both underwriters and consumers

Climate change poses risks to a large number of general insurers, especially in the longer term. UK consumers also need to be aware of the rising risks; the Environment Agency estimates that more than 40% of the five million people living in homes in flood risk areas are unaware of the threat. Consumers should ensure that they take appropriate precautions to protect themselves and their homes, as should banks which have mortgages on homes exposed to flood risk.

Outside the UK, the effects of climate change have been felt most sharply through the increased occurrence and severity of hurricanes around the Gulf of Mexico. A number of weather specialists have suggested that a period of heightened hurricane activity could extend over the next 10 to 30 years, with the past 10 to 30 years having been a period of low hurricane activity. In the aftermath of Hurricanes Katrina, Rita and Wilma in autumn 2005, it became apparent that some firms may rely too much on the output of their catastrophe models without proper consideration of the inputs. In addition, they may not be using other criteria sufficiently in assessing aggregate risks and exposures. It is imperative that firms address this issue urgently. This is a concern that we share with rating agencies and other industry analysts.

Consumers and all insurance firms need to be aware of terrorism risks

The threat of terrorism poses another risk affecting both consumers and all general insurers. Although often considered to be only a risk to commercial insurers, an act of terrorism could also affect retail home and motor policies, group life-insurance policies, health and travel insurance.

As the potential losses from a single terrorist event could be larger than the private sector is prepared to finance, government-backed arrangements for reinsurance remain crucial for ensuring the availability of direct cover. In the UK, Pool Re acts as the government-backed reinsurer, helping to ease the payment of claims following a terrorist attack and ensuring that capacity is available for commercial property risks. Given the significant US exposures of London Market and Lloyd's insurers, the recent extension of the Terrorism Risk Insurance Act (TRIA) is a welcome development from the UK's point of view.

Financial reinsurance

FSA is proposing mandatory disclosure of financial reinsurance transactions

Financial reinsurance[17] was identified as an emerging risk area in our *Financial Risk Outlook 2005*. Despite a number of high-profile cases reported abroad, our work in the last 12 months found that the use of financial reinsurance by UK firms is not widespread, although a small number of contracts have warranted further examination. To ensure a proper assessment of a firm's financial position, and the identification of all relevant risks of such arrangements, we have proposed to make it mandatory for all general-insurance firms, including Lloyd's, to disclose all financial reinsurance transactions in their annual returns, starting with the 2006 returns.

Reinsurance

2005 was the most costly natural-catastrophe year ever

The global general-insurance sector has suffered significant natural catastrophe losses in the US in the second half of 2005, with 2005 likely to be the most costly natural-catastrophe year ever. Most losses were caused by Hurricane Katrina, at an estimated US$50 billion insured losses, while the combined losses from Hurricanes Rita and Wilma are estimated to amount to another US$20 to US$25 billion. These compare to the total 2004 hurricane loss of US$28 billion, itself a high-cost year. Reinsurers also bear a higher proportion of the losses than in 2004, as a large single event – the direct consequences of Hurricane Katrina – means that primary-insurance companies share losses with their reinsurers once losses meet their respective deductibles, and there is no state hurricane fund available in Louisiana, unlike in Florida.

Globally, the US catastrophe losses put pressure on the balance sheets of a relatively small number of significant reinsurers, particularly those specialising in natural catastrophe lines. Although outright credit downgrades have been relatively limited, a number of reinsurers' credit outlooks have been revised from stable to negative. Swift capital raising and the expectation of higher premium rates in 2006 have alleviated fears of capacity shortage. However, as indicated earlier, the heavy losses have led reinsurers to reassess their risk-management frameworks and risk appetite, with a number of firms indicating their intention either to reduce significantly or completely withdraw from certain risks or from the retrocession market. As a result, UK primary insurers may feel an impact in terms of price or availability of cover.

Reinsurance has raised over US$14 billion since Hurricane Katrina

Since mid-September 2005, the global reinsurance sector has raised almost US$22 billion via existing firms and by setting up new insurance companies, with most of the capital being raised by Bermuda-domiciled entities. To put this capital raising into context, the capital raised so far by new vehicles (US$9 billion) is slightly below the US$10 billion attracted by the new group of Bermudian firms, known as 'the Class of 2001', after the 2001 World Trade Center (WTC) attacks.

The swift recapitalisation of the worst-affected firms clearly alleviates some of the concerns about the availability of reinsurance capacity. Indeed, hedge funds appear to be a growing new investor class in reinsurance. Hedge funds are seeking to benefit from returns that are believed to be largely uncorrelated with other asset returns by providing capital to both existing

17 The term 'financial reinsurance' is used to refer to reinsurance arrangements that aim to improve or smooth reported profits, or to improve the reported balance-sheet position.

and new reinsurance firms and by purchasing catastrophe bonds. From a financial-stability viewpoint, it is important to understand the correlations between insurance risks and other risks to which hedge funds may be exposed; *Financial stability* is discussed in Section B.

The effect of the US hurricane losses on the underwriting cycle, which was softening across most lines until late-summer 2005, is not yet clear. Although prices of business lines hit by losses, such as property and offshore-marine policies, appear to be heading higher, the impact on other lines of business is more difficult to evaluate. This is because the January renewal season seems to be late, as many market participants wait for market-clearing prices to be established. The recent capital raising by new reinsurance firms has boosted the global reinsurance capacity (or supply), which may well limit the incumbent firms' ability to benefit from harder pricing in the medium to longer term. Our main requirement, as discussed earlier, is that firms have a clear business strategy agreed at board level, which is in turn executed by their underwriters, and that an appropriate level of capital is in place to support the business.

Lloyd's and the London Market

The hurricane impact on Lloyd's and the London Market firms appears tempered by strong profitability

The London Market and Lloyd's insurers will bear a significant portion of the US hurricane claims given their exposure to US catastrophe and energy risks. The current Lloyd's net loss estimate from Hurricanes Katrina, Rita and Wilma at US$5.2 billion is significantly larger than the US$3.3 billion loss posted after WTC terrorist attacks in 2001. However, given that the last two underwriting years have been strongly profitable, whereas the WTC losses occurred after several years of strain on the market's resources, the market's solvency does not appear to be threatened. Nonetheless, all London Market underwriters need to take steps to limit the potential impact of a large catastrophic event, or a series of events, in 2006 through effective risk management and underwriting discipline, despite the probability of such event(s) being outside the control of firms and regulators.

A series of reforms aimed at improving efficiency and reducing risks from operational failures and weaknesses are underway in the London Market. One of the most pressing areas for reform relates to the lack of contract certainty in the London Market and, to a lesser extent, in the commercial and retail markets. In December 2004, we set the general-insurance market a challenge of finding a market-driven solution to this by the end of 2006. If the market meets our challenge, it will reduce the operational and legal risks to brokers and insurers and improve service and clarity of offering to customers. During 2005, the industry made significant progress. A definition of contract certainty has been agreed by all parties and is being implemented through market codes, supplemented with guidance, training and industry presentations. Although a market-based solution is preferable, we have developed some options for regulatory intervention in parallel with the market's own work. After a formal 'stock take' in early 2006, we will decide whether sufficient progress has been made to meet the December 2006 deadline and whether we need to intervene through new rules and requirements.

Regulatory developments

We introduced conduct of business regulation in relation to sales and claims-handling activities in 2005

Since the implementation of the Insurance Mediation Directive in January 2005, we have had supervisory responsibility for both commercial and retail general-insurance intermediaries. At the same time, we introduced conduct of business regulation for insurers in relation to their sales and claims-handling activities.

Encouragingly, our investigation into the level of unauthorised general-insurance business being conducted revealed only a very small number of firms that were conducting insurance mediation activities illegally. However, we have identified some significant risk issues in the authorised firms, such as a large number of failures in systems and controls regarding client money, poor quality of disclosure, poor selling practices in relation to payment protection insurance and firms' potential failure to identify and mitigate conflicts of interest sufficiently. Although we appreciate that becoming subject to our regulation is a major change to this sector, firms need to ensure they comply with our rules.

2005 saw the approval of the Reinsurance Directive, which will introduce a harmonised basis for reinsurance regulation across the EU. Once implemented, licensed reinsurers will get a regulatory passport that allows them to operate anywhere in the EU, while reporting only to their home supervisor. We already apply the same standards of regulation to pure reinsurers as to direct insurers and therefore we do not anticipate significant changes for UK-authorised firms. However, where changes are required, we expect to consult on the implementation of the Directive in the third quarter of this year, with a view to implementing changes to rules by the end of 2007.

General insurers are now also subject to our new ICAS regime

General insurers have also been subject to our new ICAS regime since January 2005. Although firms' risk-management frameworks generally appear to be improving, their depth of analysis and use of quantitative techniques in determining their individual capital assessment have varied widely, largely reflecting the diverse nature of the general-insurance industry. Many issues have been identified, including reinsurance credit risk, which is central to many general insurers, especially those operating in the wholesale market. Our review work has raised concerns about firms' use of expected default rates, rather than reinsurance default rates at the more extreme tails, to estimate reinsurance bad debts. In addition, some firms have given intra-group reinsurance more favourable treatment than external reinsurance. Work on ICAS will continue this year, and will require substantial resources, both firms' and our own.[18]

18 *Insurance Sector Briefing: ICAS – one year on,* FSA, November 2005.

Consumers' engagement with industry

The social and demographic context

Long-term demographic and other social changes in the UK present significant challenges for government, consumers and firms. Consumers face increasing individual responsibility for planning their financial needs in retirement.

Demographic changes and trends in the UK

The ageing population creates challenges for consumers and firms

The old-age dependency ratio (the number of people above pensionable age over the number of people of working age) is rising. This presents significant challenges for the financing of retirement and the policies that are adopted to cope with this demographic shift. The continued discrepancy between current and future demands on consumers' finances and their ability or willingness to meet those demands is the fundamental reason for the existence of a savings gap. The increase in individual responsibility means that consumers have to adjust their financial plans to make increasing personal provision to meet their current and future needs. Some consumers may also find it difficult to plan for the long term given the level of uncertainty over pension policy. Therefore, it is crucial that consumers have the capability to make an informed choice when planning for their financial future.

The latest projections estimate that the UK population will increase by 12% from 2004 to 2031 – from 60 million in 2004 to 67 million by 2031. The projected rise is driven by a combination of natural increase (the growth in population caused by more births than deaths) and the rate of net inward migration. The net migration which is built into the population projections is predicted to fall from 255,000 a year in 2004/05 to 145,000 a year from 2007/08 onwards. The migration trend shows that in recent years both the inflows and outflows have increased, but with an overall net inflow, comprised mainly of those of working age. Despite the level of net migration, the old-age dependency ratio is forecast to rise from 27% in 2005 to 44% in 2035.[1]

1 *2004-based national population projections*, Government Actuary's Department, 2005.

While projections of an ageing population and rising old-age dependency ratio have been made consistently over the past few years, the rate at which such changes will take place is less clear. The uncertainty surrounding population projections presents significant risks for both firms (also discussed in *Life insurance*, Section C) and consumers who are planning for future provision. Longevity improvements can be difficult to predict over time because of developments in medical science, changes in consumer lifestyles and environmental and social factors. Hence, previous estimates have tended to underestimate the improvements in longevity.

A number of risks are associated with increased longevity. Greater life expectancy tends to increase the maturity mismatch between assets and liabilities in pension funds. This can lead to lower relative returns from assets and more expensive annuities. As a result, consumers receive less retirement income for a given outlay into annuities. In the past, the burden of longevity risk fell more on employers who had offered their employees a defined benefit on retirement. However, with the shift towards defined-contribution pension schemes, the risks arising from greater longevity are increasingly being borne by the consumer. Nevertheless, while product providers tend to factor the increase in longevity into their calculations, consumers often do not take it into account in their savings decisions. This is part of a trend of increasing individual responsibility, which the *Financial Risk Outlook* has been commenting on since our first issue. The trend shows no sign of abating as consumers increasingly have to bear long-term care and medical costs, which present significant challenges for them in their financial planning. Both firms and consumers will need to be aware of the implications of these demographic challenges to ensure that they are met by an appropriate response.

The financial consequences of lifestyle changes

Lifestyle changes, such as moving abroad or divorce/separation, can have financial consequences for consumers

The death of a partner or a relationship breakdown can trigger financial problems for consumers. The divorce rate increased for the fourth successive year in 2004 to the highest number of divorces since 1996 (14 divorcing people per 1,000 married population).[2] People going through the process of a break up can face a complex set of financial decisions over pension splitting, property sharing, ownership of investments and liabilities for debt.

The difficulties faced by consumers after the death of or separation from a partner could be exacerbated if the relationship was not legally recognised. The trend away from marriage in favour of cohabitation is projected to rise from 2 million couples in 2003 to 3.8 million by 2031 with the number of 'never marrieds' exceeding the married in 2020.[3] Many cohabitees (who may have entered into significant financial arrangements with their partner) do not fully realise the current limits of their legal rights in areas such as pensions, inheritance or property ownership after the loss of a partner through either relationship breakdown or death. The implementation of the Civil Partnership Act 2004 in December 2005 gave same-sex couples who form a civil partnership greater financial security in terms of tax advantages and inheritance rights, although some survivor benefits are currently not necessarily guaranteed.

2 *Divorces fell slightly in 2004 in England and Wales*, National Statistics News Release, August 2005.
3 *2003-based marital status projections for England and Wales*, Government Actuary's Department, 2005.

Migration trends indicate that a growing number of people choose to work, live or retire abroad; latest figures show that a record number of 208,000 British citizens left the UK in 2004. Moving abroad involves a complex set of considerations about financial matters, including moving from different regulatory and tax regimes, as well as different inheritance and property laws. There is a growing demand for financial advice to help people who are faced with these decisions when emigrating. However, there is a risk that many consumers do not fully understand the financial risks associated with moving abroad and may suffer detriment as a consequence.

Shift in individual responsibility and financial capability

Consumers are having to take more responsibility for financing education, healthcare and long-term care, as well as their retirement

As discussed earlier in this section many consumers are now faced with increased financial responsibility throughout their lives, from paying childcare and education costs through to healthcare and retirement provision. While some consumers are able to manage their finances and adapt to the changing environment, others are failing to make suitable provision, either because of a lack of awareness of the changes taking place, lack of financial capability or a lack of financial resources.

The increase in the number of working parents now means that the cost of bringing up children represents a major expense for many families and many parents now face substantial childcare costs; the average cost of a nursery place for a child under two years of age is over £7,300 per annum.[4] The cost of education can also be a considerable expense for parents, whether it is through the cost of private school fees (for around 7% of children in England)[5] or the 'education premium' that is paid for houses within the catchment area of well-performing state schools (which can add up to a third onto the value of a house)[6]. Parents may increasingly require advice on the purchase of appropriate financial products so they can meet these needs, some of which may involve the purchase of products of a complex nature, such as income protection or equity release (complex products are discussed later in this section). Paying educational costs may mean that parents use funds that would otherwise have gone towards their own long-term savings, and this may mean a reduced standard of living in retirement.

Consumers may take on more debt and reduce long-term saving to finance education and the purchase of a house

The responsibility for financing higher education has also fallen increasingly to the individual, with universities able to charge students higher top-up fees from 2006. Some parents may choose to meet the increased costs of university, but for many students the cost will be met by the repayment of debt from future earnings. The amount of student debt has been rising steadily and in 2005 the average debt owed by a graduate leaving university was £13,501.[7] Although the debt repayments can be spread over a number of years, the amount of debt often restricts the availability of funds for other expenditures, such as making a start on saving for retirement or raising a deposit to buy a house. Increases in the level of student debt could increase the number of indebted individuals in the future (we discuss consumer borrowing in more detail in Section C). In the longer term, students with a Child Trust Fund will have the option to put the proceeds of the fund towards their education costs or to meet other expenses in their early adult life.

4 *Parents pay inflation-busting cost of childcare*, Daycare Trust, January 2005.
5 *Statistical first release: Schools and pupils in England*, Department for Education and Skills, September 2005.
6 *Capitalising the Value of Free Schools: the impact of supply characteristics and uncertainty*, Economic Journal, November 2004.
7 *11th Barclays Annual Graduate Survey*, conducted by NOP World Financial for Barclays, April 2005.

The large increase in house prices in recent years has reduced the affordability of housing for many young people and first-time buyers. Some firms have responded with innovative products to meet these new needs, including products that allow parents to increase the amount their children can borrow by covering part of the loan with their income. While these solutions enable their children to progress within the property market, it is important that parents fully appreciate the debt liability they are taking on and the impact of diverting funds away from other areas such as retirement provision.

Pension provision is another key area where consumers are having to take more responsibility. The shift from employer provision of defined-benefit to defined-contribution pension schemes, for example, has meant that more consumers have to take responsibility for their own retirement provision, both in terms of decision making and taking on more of the associated risks. A significant proportion of consumers think that the minimum income that the state currently guarantees pensioners will not provide them with the standard of living they hope for in retirement. Despite this, a large number of consumers have failed to make alternative pension arrangements or are contributing to a pension at an inadequate rate.[8] We discuss *Retirement planning* in greater detail later in this section.

Consumers' ability to cope with the financial responsibility they increasingly face is varied. Many people, particularly those living on low incomes, cannot access mainstream financial services such as bank accounts and affordable credit. In the UK, 1 in 12 households lacks access to a bank account of any kind.[9] Households which experience financial exclusion have limited financial choices and, as a result, incur higher transaction costs. This can cause greater financial strain and unmanageable debt levels, which can contribute to some households being trapped in a cycle of poverty.

The provision of advice to consumers to help them understand the options available in managing the increase in responsibility is also varied. Some of the most vulnerable consumers who struggle with their day-to-day money management do not find it easy to gain access to basic financial advice. Firms can play a key role in helping consumers to make decisions about appropriate products by ensuring that product descriptions are clear. Similarly, advisers can help consumers identify suitable products and help them fully understand the risks and benefits offered by the different products available.

8 FSA/BMRB research, 2005.
9 *Promoting financial inclusion*, The Treasury, December 2004.

Retirement planning

Many consumers have inadequate plans in place for financing their retirement. A range of measures for pensions reform is being debated to encourage individuals to save for their future, but in the short term they may face uncertainty about the appropriate action to take. Pensions simplification will bring significant benefits, but consumers and their financial advisers will need to understand the implications for their arrangements. A shift in consumer behaviour to remedy the problem may also take some time.

The Pensions Commission's Second Report, published in November 2005, addresses the deficiencies it highlighted in its First Report. The recommendations include: creating a low-cost nationally funded pension savings scheme to which employees would automatically be enrolled; the phased raising of the state pension age to take account of longevity improvements; abolishing the option to contract out of the state second pension (S2P); the linking of state pension indexation to average earnings; and reducing means-tested benefit elements. The Government will consider recommendations from the Pensions Commission's Second Report before publishing a White Paper scheduled for spring 2006.

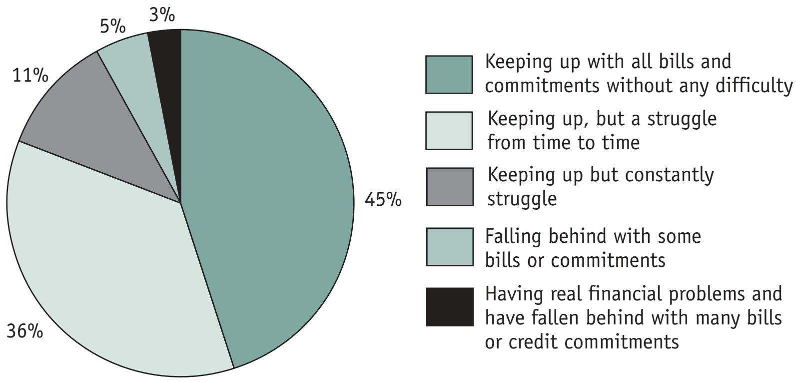
Consumer planning for retirement

A significant proportion of consumers are not making adequate provisions for their retirement

A significant number of consumers do not have sufficient resources or arrangements in place to meet their future retirement needs. The Pensions Commission's Second Report highlighted the weakness in voluntary pension saving: in the 2003/04 tax year 11.7 million workers were not making any contribution to a private pension, representing an increase of 400,000 people since 2002/03. While consumers' awareness may have been raised by the media's focus on pension issues over the past few years, it may still be difficult for consumers to weigh up the various options open to them with confidence while the policy environment remains in flux. Some consumers may be reluctant to save sufficiently for retirement while there is uncertainty over what the future state pension provision may be and how it will interact with private pension arrangements.

We have undertaken survey work to better understand consumers' plans for their retirement provision. We found that about 63% of non-retirees indicated that they or their partner had an active occupational or personal pension – or a plan into which contributions had been made in the past – but 37% had none. The most common reasons given for not having made such arrangements were affordability, not being in employment for long enough or reliance on the state pension. Although some without personal pension provision appeared to be managing their finances without any problem, about 20% said they were often struggling with their finances, indicating that there is little room in their budget to make additional pension provision (see Chart D1).

Chart D1: The degree to which consumers without private pension provisions are able to cope with bills and credit commitments

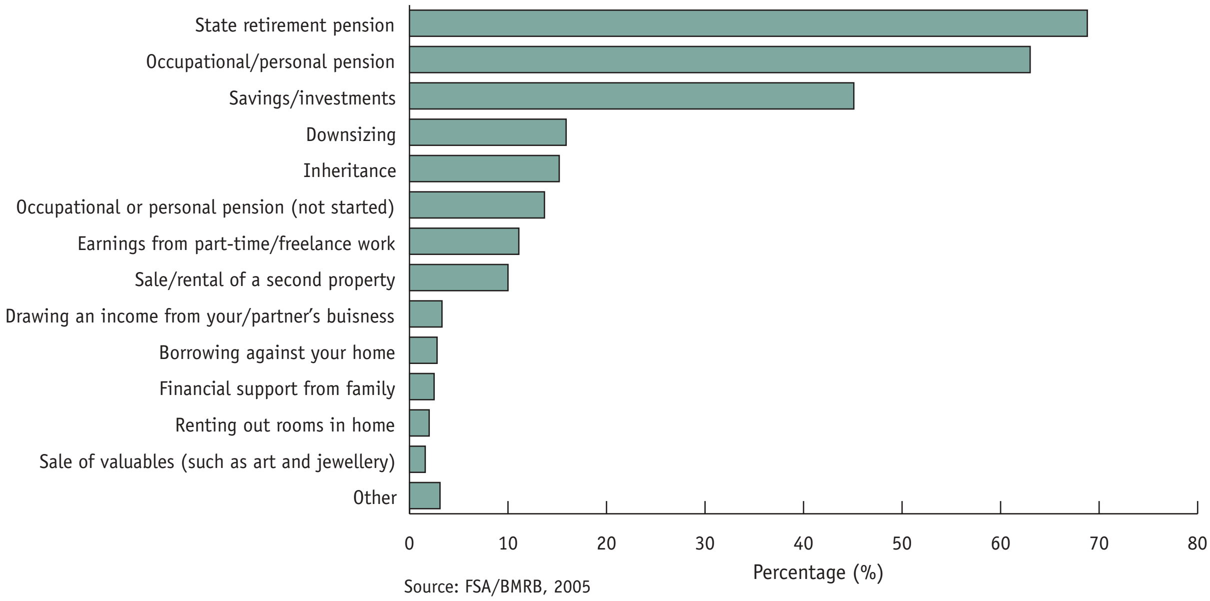


Note: Based on sample of consumers without private pension provision
Source: FSA/BMRB, 2005

Most consumers base their retirement income plans on state pension provision …

The most commonly mentioned source of retirement provision was the state pension. However, the results also show the extent to which consumers are planning to use non-pension fund sources, such as savings and property. The results are presented in Chart D2 below.

Chart D2: The resources consumers plan to use for their retirement



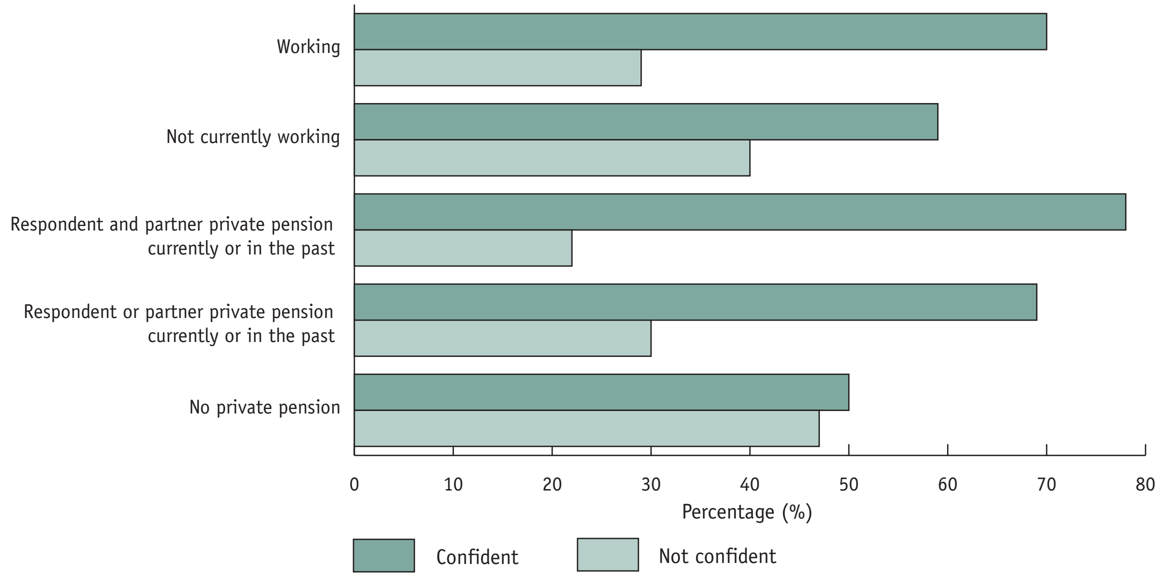
Source: FSA/BMRB, 2005

While the results show the popularity of different sorts of assets that consumers may use for income in retirement, whether they actually are able to do so may depend on several factors. There is a clear risk that many consumers do not fully understand the possible limitations of their plans in creating a financially secure, realistic and reliable retirement provision.

... despite the fact that many believe their income in retirement will not be sufficient

Not surprisingly, consumers aged 50 and over typically have more advanced retirement plans. Most of those surveyed were confident that their household income in retirement will be sufficient to meet their lifestyle expectations (see Chart D3). However, a significant minority – 29% of those currently employed and 40% of those currently out of work – believed that their household income in retirement will be insufficient. They gave the following reasons for this: inadequate pension provision and/or savings; inability to set up a private pension; and concerns over the performance of their pension fund.

Chart D3: Whether consumers are confident that their household income in retirement will be sufficient



Source: FSA/BMRB, 2005

Employees who are eligible for the S2P, which provides the entitlement to a second tier of state pension benefits, can decide whether to be a member of S2P, or to contract out of the scheme, which means using a proportion of their National Insurance contributions to build up a contracted-out funded pension. In some instances, past decisions taken by consumers may not have delivered the expected benefits due to lower-than-anticipated market performance. Our research published in 2005 suggested that, with government policy unchanged, some consumers may be financially worse off by contracting out.[10] However, several aspects of contracting out may be important to some people, such as greater flexibility over when and how the pension can be taken. Therefore, consumers face a difficult decision and some may be in a state of inertia, either failing to review their current arrangements or failing to take any action.

10 *Contracting out of SERPS/S2P to an Appropriate Personal Pension: A quantification of relative impact*, Oxford Actuaries and Consultants for FSA, August 2005.

Property and asset mix in retirement planning

The large increases in property prices in recent years have led many consumers to regard property as a low-risk, high-return investment class. Increasing housing wealth has enabled many consumers to release equity from their house before retirement, and some may wish to continue to use their house as a source of finance during their retirement. A lack of confidence in equities has meant that many consumers have felt more secure putting their savings into property rather than equity-based investments (we discuss consumer confidence in the next section).

A large proportion of consumers plans to use their property to help finance their retirement

Our research on retirement plans indicates that there is considerable appetite among consumers for releasing equity from their home by downsizing. However, many may not have considered how they would approach the task, or the potential size of fund that they would be able to release. In addition, the process of trading down from a family home to a smaller house may depend on housing market conditions at the time of retirement – a large cohort of retirees seeking to trade down from family homes could tend to depress relative prices of such properties. Similarly a large number of retirees seeking smaller homes may bid up the prices of these sorts of homes, particularly when this is set against the backdrop of an increase in single households and smaller family sizes. Therefore, market conditions may mean that the amount of money raised may fall short of what was anticipated and the costs associated with moving house (such as legal fees, stamp duty and agent fees) may further reduce the amount released by a change in property.

Equity release and income drawdown

Some consumers may seek to borrow against the value of their housing asset to realise some of the value from their housing wealth. While the recent volume of sales of equity release and income drawdown products has been modest, it is likely to be a growth area given increased longevity. An Institute of Actuaries Report suggested that equity release sales could be as high as £2 billion per year by 2010.[11]

Consumers should carefully consider the risks associated with equity release and income drawdown before purchasing one of these products

Consumers seeking equity-release products need to ensure that the product they choose meets their needs today and consider carefully whether this continues to be the case should their needs change in the future. For example, some equity-release products may make it difficult for the consumer to move properties. Consumers may also need to take advice on the impact that these products may have on any state benefits they receive, the tax implications of actions taken with the money released and the costs involved in taking out an equity-release product. Consequently, it is important that product providers and financial advisers carefully explain the implications of these products to consumers.

11 *Equity Release Report 2005*, Equity Release Working Party, January 2005.

Consumers considering income withdrawal as an alternative to buying a lifetime annuity will also need to take advice on the potential benefits and risks of such a decision. Intergenerational wealth transfer may see a growing number of better-off retirees with larger pension pots and a growth in demand for drawdown products. Low annuity rates may also encourage more consumers to look into income withdrawal. While these products may be appropriate for some consumers, it is important that they be fully aware of the risks involved. The risks could increase following the introduction of the simplified pension regime (A-Day) on 6 April 2006. The upcoming change will increase the maximum drawdown level to 120% of a level single-life lifetime annuity, which will leave a smaller fund to remain invested, and increase the review period from three to five years. Consumers will need to ensure that their individual arrangements are reviewed on a regular basis, so that the performance of their fund can be checked and appropriate action taken if necessary.

Pension tax simplification

A-Day (6 April 2006) will simplify the existing pension tax regime, but may also create challenges for firms and consumers

The taxation changes coming into effect on A-Day should result in a simpler regime, with the existing eight pension tax regimes being consolidated into a single regime. This will bring considerable consumer benefits, but also present some complexities in the short to medium term during the implementation of the new regulations. Consumers will need to be made aware of the risks and opportunities that the changes present to their pension arrangements. Also, financial advisers will need to understand fully the implications of the new tax regime for their customers as well as the transitional issues that may arise. This is a particularly important issue for consumers who are either approaching retirement within the transitional arrangement period, and who may have more choices if they delay retirement until after the A-Day rules come into effect, or are planning to take their pension before the age of 55.

Self-invested Personal Pensions (SIPPs) enable individuals to manage their own pension schemes and have so far been primarily attractive to more affluent individuals. In its Pre-Budget Report in December 2005 the Government reversed its earlier decision to grant favourable tax treatment to residential property and more 'exotic' asset classes, such as wine and stamps, held in SIPPs. However, it kept open the future possibility of indirect investment in residential property, for example real-estate investment trusts (REITs).

The Treasury has consulted on proposed changes to the eligibility rules for establishing a pension scheme. The preferred option set in this consultation document would mean that SIPPs would become regulated from April 2007. Some of the underlying investments currently included in SIPPs may already be regulated and come with the protections of the Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS). However, other investments do not and would not become directly regulated activities.[12] Consumers making SIPPs investments will need to consider carefully the suitability of the investment as part of their wider portfolio of retirement assets.

12 *Proposed changes to the eligibility rules for establishing a pension scheme: A consultation document*, The Treasury, September 2005.

Consumer confidence in investment and long-term savings products

It is becoming increasingly important that consumers make long-term provisions for their retirement. However, consumer confidence in long-term savings products is low and if this is not addressed consumers may find that they do not have sufficient income in retirement to provide the standard of living that they expect.

Consumer confidence in long-term savings products remains at a low level

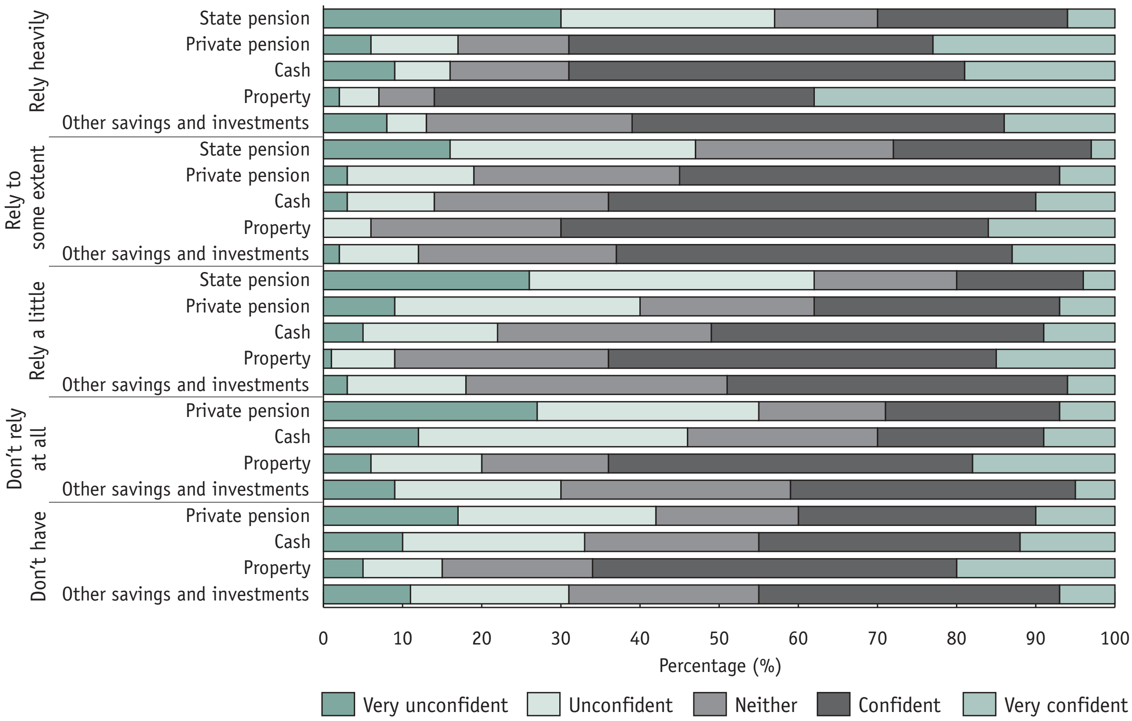
In Section C and previous issues of the *Financial Risk Outlook* we have highlighted the fragility of consumer confidence in investment and long-term savings products. Industry data show that sales of retail investment products have been slow to pick up following the equity bear market of 2000 to 2003. A lack of confidence may mean that consumers save and invest less, which affects revenue growth and profitability for retail intermediaries, asset managers, and, to a lesser extent, banks and insurance firms. As well as representing a risk to the financial performance of some firms, lack of consumer confidence presents a risk to our objectives, as consumers are less likely to take advantage of the services the financial sector can provide. This is a particular concern in the context of the savings gap and increasing individual responsibility for financial provision. This section provides evidence about the levels and drivers of consumer confidence in investment products.[13]

Consumers are increasingly confident in financial products the more they rely on them

There is a relationship between the level of consumer confidence and the extent of reliance on financial products: the higher the level of consumer confidence, the more consumers rely on financial products for their long-term future. Chart D4 illustrates the relationship between confidence and reliance for a range of different savings and investments. Our research confirms the extent of the lack of confidence: 43% of consumers are not confident that financial products will provide for their long-term future. This underlying lack of confidence makes it less likely that consumers use financial products to address the savings gap and their own retirement provisioning.

13 Based on research carried out by IFF Research for the FSA in October 2005.

Chart D4: Confidence and reliance in savings and investments for providing for a long-term future



Source: IIF Research consumer survey on behalf of FSA, October 2005

Those without pensions tend to lack confidence in them, which then may create a self-reinforcing cycle of insufficient pension provision. Of the consumers surveyed, the most noted reasons for not being confident were economic conditions and not trusting financial companies or the Government, with a fear of the stock market coming fourth. In contrast, property or cash savings also have the confidence of those without them or who do not rely on them. More favourable attitudes to cash or property could skew planning for the long term away from pensions, even when a pension may be more appropriate for the consumer.

Consumers have experienced variations in property prices yet still take a long-term view that property is a safe investment. While there is no guarantee of continuing house price growth, without a prolonged contrary result in property returns this view is unlikely to change significantly. In contrast, adverse economic conditions (such as our *Sustained and significant increases in oil prices* scenario) or greater market risk (such as *Large and disorderly depreciation of the US dollar and rising interest rates* scenario) could exacerbate the reasons for lack of confidence in financial investments.

Retail intermediaries

Regulatory and policy reform, competition and technological developments continue to create challenges for distributors of retail financial products. These changes are designed to benefit consumers through increased competition and choice, more transparent advice and improved consumer protection. However, retail intermediaries need to manage their operational and legal risks very carefully to ensure that they keep up with the pace of regulatory change and financial innovation and that the quality of advice does not suffer.

Changes in the structure of the sector

Over 90% of the retail intermediary firms we now regulate are small firms. The inclusion of mortgage and general-insurance firms within our remit now means that the UK-regulated retail intermediaries sector comprises financial adviser firms, general-insurance intermediary firms and mortgage advice firms. Some firms engage in more than one of these activities. There are also over 700 accountants and solicitors who offer similar intermediation and advice services in addition to their ordinary business.

Table D1: Structure of the UK retail intermediary sector

	Number of retail intermediary firms	Appointed representatives
Financial adviser	4,800	10,301
General-insurance intermediary	10,053	9,647
Mortgage advice	3,572	3,475

Note: Appointed representatives act as agents for authorised firms.
Source: FSA

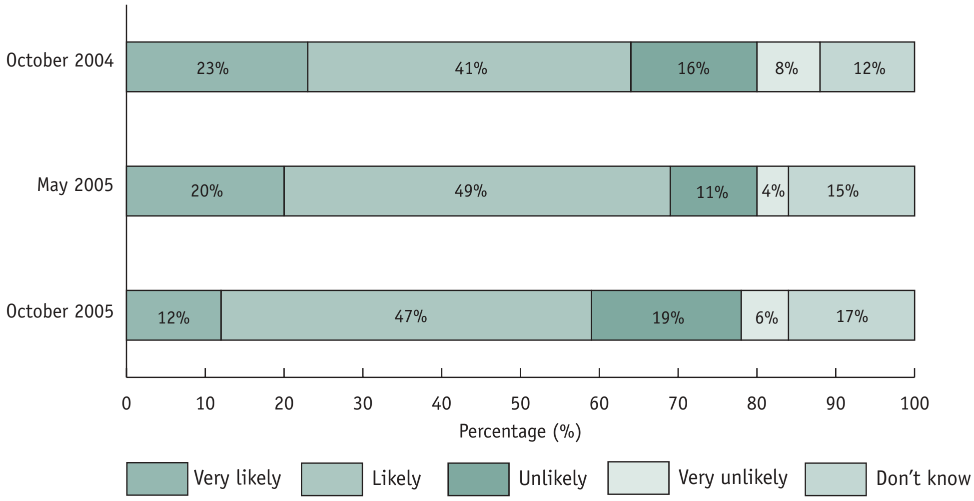
Structure of intermediary business models – sustainability of the sector

Market consolidation has increased

Some firms have struggled to remain profitable because of a variety of factors including a lack of consumer confidence, the impact of depressed stock markets in previous years, and operating costs. However, many firms continue to operate successfully despite these pressures and the sector has been fairly resilient despite some high-profile failures. Key trends have been market consolidation, with continuing mergers and acquisitions activity, and the restructuring of networks for mortgage intermediaries as a response to regulatory change. However, concern remains about underlying business models for many firms, which are characterised by lack of capital, low growth and lack of innovation. As described earlier, consumer confidence in long-term investment products is fragile, and increasing levels of indebtedness mean some consumers may begin to adopt a debt-repayment financial strategy rather than seeking to save and invest. Our central economic scenario of a cooling housing market and moderated consumer spending is unlikely to stimulate demand for new business for retail intermediaries, and we would expect conditions to worsen should any of our *Alternative scenarios* begin to take shape.

In the absence of any likely short- to medium-term increase in revenues, firms will need to identify cost-cutting measures and increase productivity to remain viable. There has been an increase in the adoption of new technologies, particularly wrap platforms and fund supermarkets[14] and it is likely that this trend will continue for the foreseeable future.

Chart D5: The likelihood of firms not currently using a wrap platform, deciding to use one in the future



Note: All respondents that have not used a wrap platform within the past 12 months. Figures may not add up to 100% due to rounding
Source: NMG IFA Census, October 2005

However, lack of capital is a major barrier preventing many firms from taking up the potential opportunities offered by technology, and there is a continuing reliance on investment from the major providers. There is a risk that the sector could get caught in a spiral of decline with falling revenues, increasing costs of conducting business, increasing competition from banks and a lack of investment in low-growth firms, leading to significant structural change in the sector over the next three to five years.

14 Wrap platforms are web-based tools designed to enable financial advisers to manage the underlying assets within their client's portfolio. A fund supermarket offers funds of a wide range of providers, often via the internet, on a single site and allows the funds to be held in a single account.

Impact of regulatory change

Depolarisation has been a key regulatory reform for retail intermediaries

Retail intermediary firms are facing increasing pressure to manage their legal and operational risks carefully in order to keep up with the pace of financial innovation and regulatory change. One such change has been the full implementation of depolarisation in June 2005. This was largely a permissive change that allows firms to develop new and innovative business models. Some of these changes will only materialise over the medium to longer term as the market settles into the new framework. For example, we have seen limited appetite so far for intermediaries to move towards multi-tie models. However, other aspects of the regime – such as the requirement for 'independent' firms to offer a fee option, and the introduction of new 'Keyfacts' disclosure documents ('menu' and Initial Disclosure Document) for all firms advising on packaged products – have had a more immediate impact on firms.

We are committed to carrying out a full post-implementation review of depolarisation that assesses the effect of the changes against its objectives. We plan a rolling programme of work over the next few years including an assessment of consumers' understanding of the new information about the status of their adviser and the cost of advice, as well as how they respond to it. It is too early at this stage to make any meaningful evaluation of the effectiveness of the changes, but firms will need to be mindful of the potential impact of greater transparency about their remuneration arrangements, among other things.

Firms need to ensure that they comply with the standards required by our rules

Mortgage intermediaries were brought within our regulatory scope by domestic legislation on 31 October 2004, while regulation of insurance mediation was introduced on 14 January 2005 in line with the EU's Insurance Mediation Directive. Our thematic reviews, which include mystery-shopping research, have identified some early problems in the way intermediaries have adapted to, and complied with the new regimes. We found many instances of firms failing to provide the relevant disclosure documentation for mortgage sales and many insurance intermediaries failing to provide information about suitability, product costs and exclusions.[15]

Failure of intermediaries to maintain sufficient standards of compliance in any of the regimes in which they are authorised may mean consumers receive poor-quality advice. In 2006 we will continue our programme of supervisory work to check firms' compliance with the new regime. We will also be carrying out the first phase of a review of mortgage and general-insurance regulation.

The quality and availability of financial advice is increasingly important

Many consumers have never sought financial advice when buying a financial product, but factors including product complexity, the increasing need for consumers to take responsibility for their financial situation and the need for many consumers to save and invest more towards their retirement, are likely

15 *The sale of payment protection insurance: mystery shopping results*, FSA, November 2005. *Mortgage Disclosure: mystery customer report*, FSA, August 2005.

to increase the requirement for advice. However, consumers who have relatively limited financial means, who cannot afford to take much risk and who have little experience of dealing with advisers, tend to be less likely to seek financial advice in the first place. There is also clear evidence that firms are generally reluctant to provide advice to those consumers likely to engage in lower-value transactions.

In April 2005 the Government launched a range of 'Stakeholder' products. These were designed to be simple, low-cost products with an element of risk control. At that time we made rules allowing these products to be sold through a simplified sales process – Basic Advice – more proportionate to the simplified nature of these products, while maintaining the appropriate degree of consumer protection. This simpler process was designed to be more cost effective, increasing the range of distribution opportunities for firms marketing Stakeholder products, and ultimately increasing the potential for those consumers to receive advice.

While it will take some time for this market to develop fully, firms can consider this option in developing their overall distribution strategies. Despite limited activity to date, this could ultimately lead to greater segmentation in the advice market.

We have continued our programme of work under the high-level principle of Treating Customers Fairly. Many retail intermediary firms are small but this does not mean that this principle does not apply to them. Firms' failure to apply this principle could lead to misleading financial promotions, remuneration models that serve the interest of the adviser above the needs of the consumer, and/or poor-quality advice leading to customers being sold inappropriate products.

Following a consultation process, advisers may be required to prepare for the introduction of a more comprehensive disclosure regime for packaged-investment products. Firms, whether affected directly or indirectly, will also need to start preparing for the Markets in Financial Instruments Directive (MiFID).

As discussed earlier in this section, A-Day will bring considerable benefits for consumers. However, as with any transition to a new regime, there is a danger of confusion and of misleading advice being provided during the transitional period. This risk is compounded by the complexities of pension- and tax-related issues. In the short term, advisers will need to ensure they understand the new tax regime as well as transitional issues, identify how this affects their clients and be able to explain the new regime adequately to them. Consumers will also need to be aware of the risks and opportunities that the changes present.

The changes, especially the transitional arrangements, will generate numerous opportunities for advisers to review their clients' financial situations. Firms need to be able to respond to consumer needs for advice in this area, and consider carefully how to communicate the changes to their clients.

The Treasury is consulting on our possible regulation of SIPPs, with an effective date of April 2007 as the declared favoured option for introducing a new regulated activity. Authorised advisers and other intermediaries will need to consider carefully their actions on SIPPs in the interim period between now and possible regulation in April 2007. We will be monitoring promotional material during this period and liaising with trade bodies about encouraging their members to behave appropriately. Firms will also need to understand that their actions during the interim period, including those by senior management, may be taken into account by us when applications for new or extended permissions are made for SIPPs business.

Consumer understanding and promotion of complex products

Complexity in product design can make it difficult for some consumers to understand the nature of the product they are buying or to appreciate the risks they are taking on. Complexity is one dimension of the inherent risk level associated with a product; other factors that we include in our assessment of product risk are liquidity and performance. In seeking product solutions to many of the financial responsibilities that consumers face, they may be offered more complex products as an alternative to cash savings. While more complex products may offer significant benefits for some consumers, their inherent complexity makes them an unsuitable purchase for others. Complex products can be opaque, where the underlying asset of the product is not clear to the consumer. If consumers cannot fully understand the nature of an underlying investment, then it is difficult for them to make an informed judgement on the amount of risk they are taking on. Other products may contain features that offer protection or guarantees, the terms of which may be difficult for consumers to understand. Products offering capital guarantees may be very attractive to consumers who are looking for capital security. However, some consumers may not fully realise the potential return they sacrifice in exchange for the guarantee.[16]

Similarly, consumers may focus on past performance or the targets for return quoted in promotional material rather than considering the potential downside of poor performance. Consumers may find past performance information particularly persuasive, especially when markets have performed well over a sustained period, but they may not fully consider the likelihood of these returns recurring in the future. They may have also failed to consider the appropriate holding periods for these investments. Consumers may also find it difficult to understand the projections given as illustration, the impact of charges on the product or even how the product compares with others on the market, and may therefore struggle to evaluate the product's appropriateness or suitability.

Firms offering complex products should consider carefully the potential benefits and risks of their product to the consumer in order to ensure that they are clearly communicated in all financial promotions. Research indicates that consumers have an appetite to read about the products they are considering purchasing, and that uncertainty about the financial environment can make consumers want to understand these products better.[17]

There has been a large increase in the number of new cases seen by the Financial Ombudsman Service (driven mainly by the volume of mortgage endowments complaints), and this trend is expected to continue in 2006. The way in which firms deal with consumer complaints can play an important role in creating confident consumers. A recent survey we commissioned pointed to a link between the extent to which consumers felt they had been sold a financial product that was unsuitable for their needs and the proportion who went on to make a complaint. Nearly one in ten of UK adults said that they thought they had been sold a financial product that was unsuitable for their needs within the past five years; most of these were endowment products. Just under half had actually made a complaint to the firm they thought responsible for the mis-selling. While 39% of those who made a complaint were able to resolve the problem with the firm, 60% were not.

16 *Consumer understanding of financial risk*, FSA, November 2004.
17 *Helping consumers improve their understanding of with-profits policies*, FSA, August 2004.

Financial crime

Financial crime can distort markets and competition. It has significant costs to society, poses reputational, legal and regulatory risks to firms and reduces consumer and investor confidence in the financial sector. We continue to advocate a more risk-based and proactive approach to financial crime and to collaborate with our partners in the private and public sectors.

Rapid technological change means firms need constantly to innovate to protect themselves

In a globalised world where information is a commodity, financial crime has developed the same complex and shifting organisational structures as legitimate sectors of the economy. Indeed, criminals are often exploiting the virtues of our economy, such as openness, transparency and ease of use. Criminals are able to move illegitimate money and also relocate themselves relatively freely and quickly. International cooperation on law enforcement and regulatory action is increasing but there is a need to ensure that it keeps pace with the quickly evolving methods of organised criminals.

Fraud

The prevention of money laundering has been high on national and international agendas for a number of years, whereas financial fraud has had a lower priority among the competing demands on law enforcement. Yet evidence suggests that financial fraud is a significant problem; the Government estimated that fraud cost the UK economy £14 billion in 2000.[1]

Fraudulent techniques have evolved rapidly over the years and firms have had to find new ways to deter and detect fraud and to recover losses. The Fraud Bill currently before Parliament and the Government's wide-ranging review of fraud are welcome, as the complexity of some frauds and the cost of detecting and investigating fraud for firms and law enforcement continues to hinder progress. It is important that the private sector contributes effectively to the review. Many commentators also agree that there is scope for a national fraud strategy.

The introduction of Chip and PIN technology has reduced the number of fraudulent card transactions. However, we expect card fraud to continue evolving. Fraudsters may move away from 'skimming',[2] stealing and intercepting card details in the post because Chip and PIN technology makes

1 *The economic cost of fraud*, NERA report for the Home Office and Serious Fraud Office, March 2000.
2 'Skimming' is the act of electronically copying a card's magnetic strip details and putting them onto another (counterfeit) card.

fraudulent face-to-face transactions increasingly difficult. However, we have seen an increase in Card Not Present (CNP) fraud and may also see an increase in fraudulent card use in jurisdictions that do not yet use Chip and PIN technology.

Table E1: Plastic card fraud losses on UK-issued cards

Type of fraud	January to June 2004 (£ millions)	January to June 2005 (£ millions)	Percentage change (%)
Card not present (CNP)	70.2	90.6	29
Counterfeit	66.1	45.6	-31
Lost /stolen	60.5	44.3	-27
Mail non-receipt	36.5	22.8	-37
ID theft on card accounts	19.2	16.1	-16
Total	252.6	219.4	-13

Source: APACS – The UK Payments Association

We support continuing efforts, such as awareness campaigns, that encourage consumers to take more responsibility to reduce these and other types of fraud. In the medium term, the adoption of two-factor authentication[3] for online transactions should be significant in mitigating CNP fraud.

As reported in *Financial Risk Outlook 2005*, cheque fraud continues to be a problem, possibly as Chip and PIN technology makes card fraud more difficult. The figures collated by APACS (the UK Payments Association) show that cheque fraud has continued to increase, albeit at a slower rate. Losses from cheque fraud for the first six months of 2005 totalled £29.3 million, an increase of 20% from 2004.

Identity theft has increased, creating challenges for firms and consumers

Identity theft has also increased rapidly in recent years. The latest figures from CIFAS, the UK Fraud Prevention Service, show that for the first three quarters of 2005 identity fraud increased by 12% year-on-year. The opportunities for identity fraud are increasing as consumers are identified by several different public or unsecured data sources. For example, documents containing personal information can be intercepted in the post, raided from rubbish bins or even taken from publicly available websites and used to impersonate the consumer. The removal of barriers between financial products and customers, a growing trend in recent years, can have the unwanted effect of facilitating identity fraud by minimising or automating identity checks. In addition to the financial costs, the non-financial costs to consumers, such as the time and effort spent amending their credit and account records, can be significant.

Organised criminals primarily seek to obtain information, such as personal or security data, that they can then sell on or use for profit. Plastic card data, for example, can be obtained in bulk in the UK, sold overseas to be verified and uploaded onto counterfeit cards for eventual resale in a third country to realise the funds. The proceeds of these crimes can be laundered within a similar shifting or international network, or funnelled to terrorist groups. While firms are able to develop sophisticated defences against identity theft or

3 Two-factor authentication is a security process in which the customer provides two independent means of identification. Usually this involves 'something you have' and 'something you know' – for example a keyring-sized security device and a password.

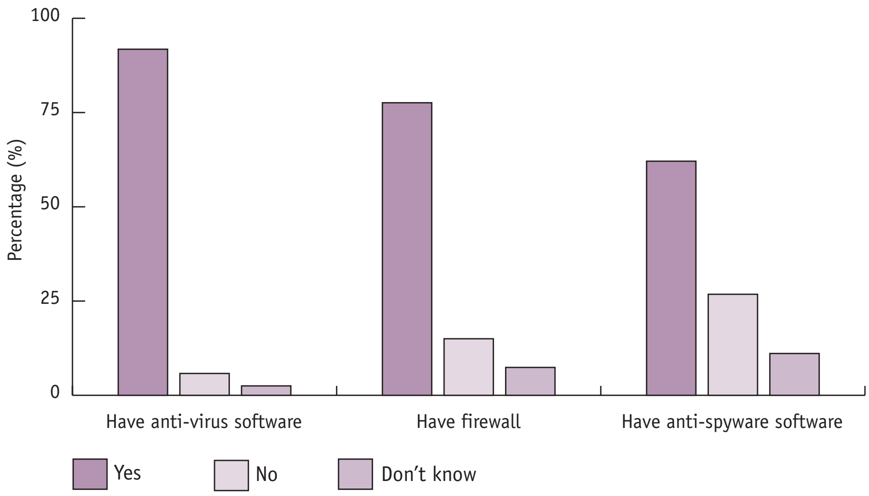
fraud, consumers may be uneducated about the risk or even complacent due to an assumption that they will not be directly liable for fraud losses. A number of industry initiatives and media campaigns have been set up to raise consumer awareness and it is hoped that consumers will take more responsibility for their personal data in the future. However, non-financial firms which hold personal and financial data, especially small firms, also need to ensure they have sufficient protections in place to guard against fraud.

Information is a commodity to fraudsters

In this environment firms need to deter, detect and recover fraud losses. Indeed, the principal response to financial fraud in the UK is action by firms, mainly through anti-fraud systems and controls which must constantly evolve to counter the threat.

The evolution of e-banking fraud over the past few years has shown that internet 'hackers' are increasingly profit oriented and will target consumers' lack of IT sophistication. Although the losses have been relatively low (£14.5 million in the six months to June 2005), they rose by over 300% from the same period in 2004.[4] Our recent survey suggests that most consumers are concerned about this fraud and are taking steps to protect themselves.[5] The vast majority have anti-virus software installed on their home computers and many also have a firewall and anti-spyware software on the computers they use to access their bank accounts. However, a significant proportion of consumers do not adequately protect themselves from all online threats enabled by broadband technology – three in ten either do not know when they last updated their software, last updated over a month ago or never update their software. An overwhelming majority (95%) also feel their bank has at least some responsibility in providing online protection, and almost half feel their bank is solely responsible. Worryingly, nearly a fifth (18%) of home internet bankers (an estimated 2.1 million people) either had not updated their anti-virus software in the last month or had none installed and thought it was solely the banks' responsibility to safeguard against fraud. This fraud is likely to be an increasing risk as new technology is increasing consumers' exposure at the same time as the threat is becoming increasingly sophisticated, thus heightening the cost of defence.

Chart E1: Type of protection



Source: FSA research

4 APACS press release in association with Card Watch, November 2005.
5 Research conducted by NMG Research/ IPSOS on behalf of FSA in October/ November 2005 to examine consumer attitudes and behaviours in relation to internet banking. Sample base: 1,508 respondents interviewed face to face.

We have seen an increase in the number of consumer awareness campaigns regarding online fraud, such as the Government and private sector sponsored 'Get Safe Online' campaign. We are also seeing the first examples of firms directly subsidising consumer protection products and piloting new anti-fraud strategies, such as two-factor authentication. Some industry commentators have suggested that consumers should take more responsibility for online fraud losses, giving them direct incentives to protect themselves.

Responsible consumer action is important in tackling fraud

With 'phishing'[6] losses relatively low, providing direct security measures, such as anti-virus software or two-factor authentication, may not yet be cost effective for banks. Firms may choose to provide such products as a way to maintain confidence in online banking or may market them as unique selling points. In the longer term firms may provide these security features with conditions attached or provide discounted fees for 'careful' customers as a way to encourage consumers to protect themselves against fraud.

Consumers are nevertheless accustomed to free banking and comprehensive fraud guarantees. Our survey suggests that over three-quarters of customers would simply stop banking online if liability were shifted. Consumers are also afforded a level of statutory protection against fraud losses. Therefore, in the absence of a liability shift in the near to medium term, firms will have to encourage consumers to protect themselves against fraud.

There has been a reported increase in corrupt employees facilitating financial crime

As firms have increased their perimeter security to prevent financial crime, there has been a reported increase in the corruption of employees by organised crime, as discussed in *Financial Risk Outlook 2005*. This type of insider fraud is an evolution of the low-value, high-volume attacks perpetrated by organised crime and is a separate risk to the potentially prudential risk of a high-impact internal fraud that firms have always faced. If corporate profitability were to decline, firms and employees might be under extra competitive pressure to maximise business and reach targets. This would increase the risk of significant internal frauds. Criminals may also increasingly attempt to corrupt employees to circumvent anti-money laundering controls in the future.

Anti-money laundering and countering terrorist finance

A risk-based approach to anti-money laundering should raise defences and give firms greater flexibility

There is a growing risk that UK-based financial services providers cannot identify the ultimate consumer of their product or service, as financial products and services have become increasingly complex and globalised. Although it is not always a legal requirement for firms to identify ultimate investors, it could pose anti-money laundering (AML) and counter-terrorist finance risks for firms.

The emergence of new products that utilise the internet or other new technologies represents dynamic development of new financial services, but also risks being abused by money launderers or terrorist financiers to store and move criminal monies anonymously. We can expect the use of new internet and communications technology as a money laundering and terrorist financing method to increase due to their anonymity, speed and global nature of these technologies.

6 'Phishing' refers to a scam in which an email is sent falsely claiming to be from a legitimate enterprise in order to persuade the user to surrender private information that will be used for identity theft.

We believe that a risk-based approach to AML will help mitigate these risks by allowing firms to tailor their defences to the level of risk implicit in their business. Such an approach offers the prospect of a more cost-effective and proportionate response against money-laundering and terrorist financing.

However, there is a risk that firms will fail to take advantage of the risk-based approach that encourages them to implement bespoke systems and controls to minimise the risks to their business models. If firms continue with policies that pursue a 'tick-box' approach, aiming to minimise regulatory risk rather than overall money-laundering risk, they may still be vulnerable to financial crime. This is especially true when criminal behaviour is likely to evolve more rapidly than the regulatory framework can change. Furthermore, the reputational risk experienced by firms can be better mitigated by reducing the extent to which it is possible for their business to be used for financial crime, rather than avoiding the risk of discipline by the FSA.

Anti-money laundering remains a high priority for us

While we and the Government have recently emphasised the importance of anti-fraud controls, it is important that AML systems are also kept up to date. The progress of recent years may be undone if firms misconstrue the recent focus on fraud by the Government and the FSA as a de-prioritisation of the need for robust AML systems and controls. The enforcement action that we took in November 2005, which included the first approved person to be fined for AML-related breaches, demonstrates how seriously we continue to take AML risks.

It is vital that firms continue to review and strengthen their AML systems. Know Your Customer (KYC) and active customer-account monitoring for suspicious transactions are increasingly important as there is some evidence that criminals may be using customer accounts that were originally opened for legitimate purposes to channel illegitimate funds through the financial system. In part, this may be a response to firms' strengthened money-laundering defences but it nevertheless highlights the importance of ongoing account monitoring.

However, despite the real benefits the AML regime has delivered, there is a continuing risk that firms' investment does not always deliver the information that law enforcement requires. For this investment to be effective, timely feedback from law enforcement on what types of suspicious activity firms should be identifying and reporting is needed. However, this feedback can be lacking because suspicious activity reports (SARs) are only one component of complex and lengthy criminal investigations and because of problems with the SARs regime itself.[7]

Un-actioned and un-actionable SARs, which firms are legally obliged to file, put strain on law enforcement resources. Indeed, the central finding of a recent report commissioned by the Association of Chief Police Officers of England, Wales and Northern Ireland was that SARs appear to be underutilised by law enforcement.[8] This tension has reinforced the perception within some sections of the industry that their investment in the AML regime is disproportionate to the benefits.

7 *UK Law Enforcement Agency Use and Management of Suspicious Activity Reports: Towards Determining the Value of the Regime*, Matthew H Fleming (Research Fellow, Jill Dando Institute of Crime Science, University College, London), June 2005, pages 42-46.
8 Ibid., page 63

This tension has coincided with a number of legal changes to the AML regime and organisational restructuring of the SARs regime.[9] Although these changes aim to ensure that the AML regime keeps pace with complex money-laundering methods, there is a risk that firms will lose faith in the AML regime, resulting in more defensive disclosures that only aim to minimise legal or regulatory risk.

The creation of the Serious Organised Crime Agency should help give the anti-money laundering regime new focus and stability

However, the creation of the Serious Organised Crime Agency (SOCA) in 2006 could provide more stability and direction for the AML regime. SOCA will have increased legislative powers and a higher priority for passing information to the private sector. It will also have a clear strategic mandate for the SARs regime and the responsibility of following up the Lander Review.[10] Also, the EU's Third Money Laundering Directive will require the timely feedback and follow up to SARs and the maintenance and publishing of comprehensive statistics on matters relevant to the effectiveness of the AML regime.

Information security

Firms should not underestimate the risks to their information security

Firms continue to face significant high-impact information security (IS) threats from organised crime. Although the frequency of these threats is relatively low, the significance of the risk should not be underestimated, and the risks in the near term are real and evolving. A recent (failed) multi-million pound attack on a UK-based institution demonstrated the potential size of the risk.

Technology currently favours attack rather than defence, as firms have to constantly defend all their IT systems (both physically and virtually), while criminals can exploit a single weakness in the system. In addition to IT systems, information security now involves vetting and monitoring all those who have access to information or who control physical access. If firms suffer more high-profile attacks, IS concerns are likely to rise up firms' agendas and help mitigate the risks in the medium term.

So as firms and financial criminals race to outwit each other, a technological 'arms race' is developing. This risks leaving consumers, and to a lesser extent law enforcement and us, at an informational disadvantage. We may also see an increase in the number of attacks on financial data held by non-financial firms. Currently third-party holders of personal or financial data are not liable for financial losses incurred through identity theft or information theft and may not have the financial incentives, apart from reputational damage, to secure their customers' data. Indeed, it is unlikely that the consumer or the bank will know where such data was compromised.

9 Ibid., pages 46-51.
10 Sir Stephen Lander, Chair-Designate of SOCA, has been asked by the Chancellor and the Home Secretary to undertake a review of how the SOCA can make best use of SARs. The final report is expected to be delivered in March 2006.

The legal and regulatory framework

The international dimension to regulation

EU legislation has been the driving force behind much of the new regulation affecting the European, and consequently the UK, financial-services sector in recent years. We are currently in a period where the workload arising from the international agenda is relatively heavy, with no signs of this abating in the short term. This heightens compliance risk and firms must ensure that they devote adequate resource to managing this risk and addressing any implementation issues.

The International Regulatory Outlook *offers a more detailed analysis of regulatory reform*

Many firms will continue to face significant implementation challenges arising from the roll-out of EU initiatives between 2006 and 2008. These are discussed in detail in the *International Regulatory Outlook*, published in November 2005. However, it is worth summarising the current position regarding the Markets in Financial Instruments Directive (MiFID) and Capital Requirements Directive (CRD), given their relevance to a range of our stakeholders and the importance of near-term developments on both Directives.

MiFID is a wide-ranging Directive, constituting a major element in the EU's Financial Services Action Plan (FSAP). The Directive is intended to promote a single market for wholesale and retail transactions in financial instruments. MiFID widens the scope of investment services requiring authorisation by Member States and the range of investments falling within the ambit of regulation. It is also set to improve significantly the 'passport' for investment firms, to facilitate cross-border activities across Europe on the basis of Home State authorisation.

The implementation challenges posed by MiFID are significant, and as a consequence the implementation deadline has recently been extended to 1 November 2007. Our approach to domestic implementation will depend significantly on the shape of the detailed 'Level 2' measures, currently being finalised within the scope of the framework set by the Directive ('Level 1') adopted in April 2004. In parallel with implementing the MiFID requirements – which directly affect important parts of the FSA Handbook – we shall be looking, through a simplification programme, to rationalise adjacent existing Handbook material. Our consultation and implementation programme will need to take account of uncertainty over the timing of agreement on the Level 2 provisions, which is unlikely before the second quarter of 2006.

The Basel Capital Adequacy Framework (Basel 2) will be implemented in the EU via the CRD. This will be a major step in achieving a more risk-responsive approach to prudential regulation as the CRD introduces a modern framework for credit institutions and investment firms across the EU. We plan to publish our second consultation paper on UK implementation of CRD in February 2006 and put final rules in place in October 2006.

In October 2005, the US regulatory agencies postponed the implementation of Basel 2 until 1 January 2009. This will have no impact on the European timetable for implementation via the CRD. However, we will be working with the US authorities to ease the practical problems that could arise in the meantime from the disparity between the requirements for UK-based groups with significant operations in the US and for US-based groups with significant operations in the UK.

Progress on international prudential standards also includes the continuing discussions on Solvency 2, designed to achieve an EU-wide proportionate and risk-sensitive capital framework for insurers. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has provided comprehensive technical advice on a number of issues to the European Commission. Active industry involvement – particularly via the Quantitative Impact Studies – will be crucial in shaping the future development of the Directive. We also urge firms to engage with developments now to help ensure that the resulting legislation is proportionate and incorporates robust cost-benefit analysis. It is particularly important that medium-sized and smaller firms engage with this process.

Consolidation phase

The European Commission has stated in its Green Paper on Financial Services Policy 2005 to 2010 that its legislative programme for financial services is entering a consolidation phase and that it is 'committed to act only where European initiatives bring clear economic benefits to the industry, markets and consumers'. The Commission indicated that it did not envisage a new legislative programme on the scale of that seen during 2000 to 2005. The Commission's subsequent White Paper characterised the coming period as one of 'dynamic consolidation'.

We may see EU initiatives for asset management, retail financial services and clearing and settlement in the future

However, there are several issues that are being examined in EU fora that could lead to possible new EU initiatives. In addition to Solvency 2, there could be developments in relation to asset management, retail financial services (including mortgages) and clearing and settlement. This could amount to a significant future agenda with implications for UK regulation. Given past experience, it is important that firms, trade bodies and consumer groups with an interest in these areas engage with EU policymakers at an early date if they wish to contribute to this process.

In July 2005, the Commission published a Green Paper on mortgage credit in the EU. It is concerned that national markets are not integrated and that the full range of mortgage products is not available in each Member State. The paper is supported by a study produced by London Economics[1] which concluded that any benefits from integration would not be evenly shared across Member States. Indeed, the UK would be the least likely to gain because its mortgage market is already diverse and widely accessible.

1 *The Costs and Benefits of Integration of EU Mortgage Markets*, London Economics report for the European Commission (DG Internal Market and Services), August 2005.

However, the London Economics study does not identify sufficiently the respective costs and benefits of specific measures; so the study does not provide a sufficient basis for identifying the 'optimal' selection of measures intended to facilitate integration. Therefore, we believe that there is a need for more detailed analysis of these costs and benefits. There is no evidence that harmonising consumer information provisions (which is likely to be expensive) will promote integration. Given this, we consider that the case for Commission action on consumer information has not been made. In addition, while there may be real benefits from more integrated markets, there may also be linguistic, cultural and legal issues, as well as regulatory ones, that limit such integration. The Commission has said that a White Paper is likely to follow in 2006 but that stakeholders should not assume from this that legislation is inevitable.

Given the recent emphasis on cost-benefit analysis by the Commission, it is important that any cost-benefit analyses undertaken for other initiatives, such as asset management or clearing and settlement, should be of high quality.

Better regulation

We use market-failure analysis as our starting point for assessing the case for regulatory intervention. It first requires the demonstration of a market failure which is not self-correcting and which relates to our statutory objectives. We then use cost-benefit analysis to determine whether any regulatory initiative is justified, and if so the most proportionate response.

We would like to see market-failure and cost-benefit analysis used more widely

Given that such a large proportion of new UK rules and guidance derives from EU and other international policy initiatives, we believe that similar analysis should also inform policy development at the EU level. This would not only help us in meeting our statutory requirements, but would help to ensure that regulatory actions taken in a broader context are proportionate to the problem under consideration. The FSA can be given responsibility for implementing decisions that would not necessarily pass the market-failure and cost-benefit analysis tests that we apply in the UK. In particular MiFID, which has not been subject to a comprehensive EU-wide cost-benefit analysis, may be such a case. We strongly support EU Commissioner Charlie McCreevy in his wish that all new EU regulatory initiatives are subject to proper analysis. We therefore welcome the European Commission signalling the importance of applying cost-benefit analysis in the financial-services arena, including the introduction of Impact Assessment Guidelines (June 2005). We also welcome the launch by the Directorate General for Internal Market and Services of an evaluation programme to monitor existing Internal Market rules on a regular basis.

Accounting and Auditing

Financial reporting is also in a period of significant change. Since January 2005 all EU-listed groups have been required to comply with International Financial Reporting Standards (IFRS) which is seen as the biggest change in financial accounting since the introduction of the 4th and 7th Company Law Directives. It is important that these standards are applied consistently throughout the EU to ensure that there is a level playing field across European markets.

Accounting

The Financial Reporting Council (FRC) is the relevant regulatory authority for most matters pertaining to accounting and audit in the UK. We aim to work collaboratively with the FRC to ensure that we are managing effectively the risks and opportunities that relate to our objectives (notably maintaining market confidence) and arising from our role as the UK's Listing Authority.

All EU-listed groups are required to comply with International Financial Reporting Standards

The International Accounting Standards Board (IASB) seeks to set standards that are principles-based and that do not seek to provide detailed answers for every accounting problem. Principles-based standards rely on the experience and judgement of preparers, and the ability of auditors and users to apply them appropriately to their circumstances. However, the pace and scope of the transition to IFRS in the EU means that experience is very limited. Consequently, there is a risk that local markets, industries, and individual companies will develop guidance or interpret the standards in ways that are not consistent. This would compromise the objective of creating truly comparable accounting standards across the EU. Some investors could then lose confidence in IFRS and there may appear a division between expectations and what IFRS can deliver.

Convergence of accounting standards in the EU, US and Japan is continuing and should help companies in one marketplace access investors in other markets without incurring the costly exercise of performing reconciliations to the local Generally Accepted Accounting Principles (GAAP). However, there is a danger that this drive for convergence could lead to unintended consequences in the UK. Many preparers and investors are, in particular, concerned about the risks of any significant move away from principles-based to more rules-based standards. This could potentially lead to an erosion of confidence in the quality of reporting and audit and, therefore, reduce confidence in the market.

Auditing

The EU 8th Company Law Directive on statutory audit will take effect from 1 January 2008. The Directive covers auditor independence, implementation of international auditing standards, public oversight arrangements for auditors and the role of audit committees. One significant proposal is that EU-listed companies have an audit committee to monitor their internal controls, audit and risk management. The audit committee would be required to include at least one person who is independent and has competence in accounting or auditing and would be responsible for the appointment of the auditor. Concerns have been raised in the UK that there maybe a shortage of suitably experienced non-executive directors and that these additional requirements may be challenging to fulfil, leaving companies in breach of the requirements of the Directive.

There are risks associated with the concentration in the market for audit services

Following the merger of PriceWaterhouse with Coopers & Lybrand and the collapse of Arthur Andersen, there has been a concentration of audit services for large companies. The market now comprises four global networks of affiliated firms – the so-called ‘big four’. Should the reputation of one (or all) of the ‘big four’ be impaired, or were there to be a major problem at one of the firms leading to a contraction to three companies, there would be a significant impact on confidence in international and domestic markets.

The Department of Trade and Industry and FRC have recently commissioned a study on how the concentration of audit firms affects the provision and quality of audit services. The Securities and Exchange Commission in the US is also undertaking a three-year inquiry into the issue. However, the problem is global in that the ‘big four’ firms have global brands and structures that comprise networks of local partnerships which are subject to domestic laws and regulations. Consequently, individual regulators do not have the ability to regulate those firms as a whole, but simply the local entity.

There is therefore growing debate among national regulators relating to the oversight of and risks to markets from this global market concentration.

ISBN: 1-84518-399-1

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk