Financial Risk Outlook 2008

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
2008

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Contents

Foreword 1
Executive summary 2

Section A Economic and financial conditions 5
Central economic scenario 5
Global financial market conditions 9
Alternative scenarios 13

Section B Priority Risks 19
Existing business models of some financial institutions are under strain as a result of adverse market conditions 19
Increased financial pressures may lead to financial firms shifting their efforts away from focusing on conduct-of-business requirements and from maintaining and strengthening business-as-usual processes 25
Market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system 28
A significant minority of consumers could experience financial problems because of their high levels of borrowing 30
Tighter economic conditions could increase the incidence or discovery of some types of financial crime or lead to firms' resources being diverted away from tackling financial crime 34

Section C Industry focus 39
Banks and building societies 39
Retail intermediaries 46
Asset management 49
Capital markets and financial exchanges 52
Life insurance 55
General insurance 58

Index of charts, tables and figures 62
Glossary 63

Foreword

The *Financial Risk Outlook* describes the issues that we think currently pose risks to our ability to continue to meet our statutory objectives and strategic aims. In publishing the *Financial Risk Outlook* we hope to raise awareness of these risks, improve risk mitigation and increase understanding of the financial system and our actions.

The Financial Services and Markets Act (FSMA) sets out our four statutory objectives: to maintain confidence in the UK financial system; to promote public 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 developments and changes in our external operating environment. These include changes in economic conditions, the performance of financial markets, social and demographic change and legal and regulatory developments. The purpose of the *Financial Risk Outlook* is to describe the main issues arising out of these and other developments that we think pose the greatest risks to our statutory objectives and strategic aims.

We refer to the key risks identified in the *Financial Risk Outlook* as the *Priority Risks*. They are primarily issues that we think will be of particular importance over the next 18 months. This year we have restructured the *Financial Risk Outlook* so that there is a more detailed discussion of each of the *Priority Risks* and their potential implications. After we describe the current *economic and financial conditions* in Section A we discuss the *Priority Risks* in Section B. In Section C, *Industry focus*, we look at other sector-specific risks not captured by the *Priority Risks*.

The *Priority Risks*, by their nature, often arise from circumstances that we cannot control directly. Nevertheless, we aim to reduce the likelihood of crystallisation and the extent of any adverse effects they may have. We do this by taking initiatives and by focusing our existing risk-based activities on areas where the *Priority Risks* have the most impact. Our *Business Plan*, which we publish in February 2008, sets out how we will address the risks identified and describes our other priorities for the year ahead.

Firms may also wish to use the *Financial Risk Outlook* as an additional tool in their own risk management and planning and thus put into place arrangements for mitigating the risks outlined. To help firms consider how they should respond to each *Priority Risk* and other sector-specific risks we have included key messages for firms at the end of each *Industry focus* chapter.

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

Executive summary

This year's *Financial Risk Outlook* is focused on the risks arising from the events of the second half of 2007 and the less benign economic outlook that we expect over the next 18 months. The tighter financial conditions have led to the emergence of new risks and also highlighted some aspects of *Priority Risks* covered in the previous editions of the *Financial Risk Outlook*.

Consensus forecasts, on which our *Central economic scenario* is based, indicate a less benign economic outlook for the UK and global economies than we have experienced in recent years. The risks to this central case have increased considerably in the year since we published the previous edition of the *Financial Risk Outlook*, and the distribution of these risks is weighted heavily to the downside. Financial market conditions deteriorated considerably in 2007 as investors reassessed risks in their portfolios and risk premia began to rise. As a result, financial markets could be more vulnerable to external shocks and the impact of shocks on firms could be bigger than it was in previous years. The operating environment for firms remains difficult and it is likely that these conditions will persist, particularly if investor confidence in some markets and financial institutions remains low.

The recent tightening in financial conditions may have exposed some firms' business models as being potentially unsuitable in more stressed financial conditions where, for example, access to liquidity is restricted. This has put pressure on measures of prudential risk for some firms, such as capital and liquidity. The restricted availability of certain funding sources could force some lenders to shrink their mortgage businesses, which would have direct consequences for the real economy and consumers. The lower supply of secured credit and tighter lending standards for mortgages are likely to add further pressure on already highly-indebted consumers. We therefore expect to see a growing number of consumers experiencing debt-repayment problems in 2008.

Despite the more difficult economic and financial conditions, firms must not divert attention away from focusing on conduct-of-business requirements and our high-level principles. In particular, firms will need to ensure they treat customers fairly, continue to tackle market abuse and other areas of financial crime, and address other conduct-of-business requirements. We will continue to focus on other longer-term risks not discussed at length in this document. These include longevity, the future for the retail distribution of financial products, conduct-of-business issues, and climate change, which remain important to us and should also remain important to firms.

Priority Risks

- Existing business models of some financial institutions are under strain as a result of adverse market conditions.
- Increased financial pressures may lead to financial firms shifting their efforts away from focusing on conduct-of-business requirements and from maintaining and strengthening business-as-usual processes.
- Market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system.
- A significant minority of consumers could experience financial problems because of their high levels of borrowing.
- Tighter economic conditions could increase the incidence or discovery of some types of financial crime or lead to firms' resources being diverted away from tackling financial crime.

Economic and financial conditions

Central economic scenario

Consensus forecasts, on which our *Central economic scenario* is based, indicate a less benign outlook for the UK and global economies than in recent years. Higher inflationary pressures, weaker outlook for the US economy and more fragile financial markets have contributed to a more vulnerable outlook for the UK economy and financial markets. More difficult financial market conditions are likely to persist for some time, which increases the downside risks to firms and makes the financial sector more vulnerable to future shocks. There is a risk that credit conditions will tighten further, which would increase the existing pressures on consumers' finances and spending. The downside risks to the central scenario have increased considerably since we published the previous edition of the *Financial Risk Outlook*.

Global economic conditions

Global economic growth remained robust in 2007, but the outlook for the next 18 months is considerably less benign than in recent years. Global GDP growth is now estimated to have slowed to 3.6% in 2007 from 3.9% in 2006, and is projected to moderate further to 3.3% in 2008.[1] There is now greater uncertainty over the forecasts as downside risks to the global growth outlook have significantly increased and there is also a concern that financial market developments in the second half of 2007 could exacerbate these risks. The financial market dislocation is affecting the real economy, for example through a reduction in the amount of credit that is available for some consumers and some corporates, which will adversely affect consumption and investment plans in the future.

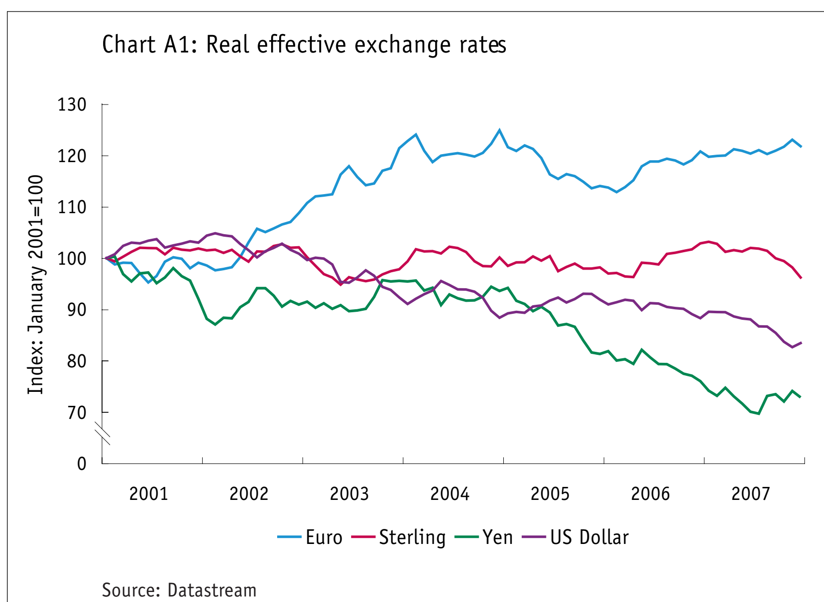
The outlook for the US economy appears particularly uncertain, with considerable variability in market forecasts for real GDP growth in 2008 (0.8% to 2.6%).[2] After having grown below trend for most of 2006, economic growth in the US recovered in the second and third quarters of 2007 as investment and net exports rose to offset pressures on private consumption. However, the US economy began to look increasingly fragile towards the end of 2007 due to deteriorating credit quality in the housing markets and the problems in the financial market. In the first half of 2008, it is likely that US consumer spending will slow due to lower mortgage equity withdrawal, tighter credit conditions and as variable-rate mortgages are reset. Falling housing construction and higher energy prices are also likely to exert downward pressure on domestic demand. US consumption demand is a significant component of global demand, and should the US growth moderate more sharply than is projected, it is likely that the rest of the world would also be affected as US demand for exports from the rest of the world would fall.

1 *Global Economic Prospects*, World Bank, 2008. Consensus market forecasts for global growth are 3.7% and 3.2% for 2007 and 2008 respectively.
2 *A Digest of International Economic Forecasts*, Consensus Forecasts, 14 January 2008.

As the US economy began to deteriorate, the US dollar depreciated against most major currencies in the course of 2007, reaching record lows against the euro and the Swiss franc in the second half of the year. Sterling appreciated by 7.7% against the dollar by 9 November, before depreciating at the end of 2007, ending 2.3% up on the year. The relatively weak dollar has enabled domestic US consumption to grow, while facilitating the easing of monetary policy elsewhere and thus supporting global demand. However, alongside high oil and other non-energy commodity prices (as well as shipping rates), the depreciating dollar has added to inflationary pressures, particularly in dollar-linked economies. The financial market dislocation also affected the foreign exchange markets as investors' risk appetite began to fall and they began to roll back carry trades. This resulted in the strengthening of the low-yielding currencies (for example, Japanese yen and the Swiss franc) against higher yielding currencies (for example, the Australian dollar).

The 'flight to quality' during the financial market dislocation led to falling government bond yields in the major economies. Liquidity problems in the major financial markets, together with relatively low actual inflation (despite evidence of increasing inflationary pressures), prompted many central banks to either lower benchmark borrowing rates or halt the tightening cycle. In response to tightening conditions in the money markets, the Federal Reserve cut the federal funds rate by 50bp in September and by 25bp in both October and December. As a result of concerns over the weakening economic outlook and continued deterioration in financial market conditions, the Federal Reserve announced a 75bp cut in the target policy rate on 22 January 2008, ahead of its scheduled policy meeting at the end of January. Market expectations are for further cuts in the US policy rate in 2008.

Chart A1: Real effective exchange rates



Source: Datastream

The Bank of Japan also paused in its tightening cycle keeping interest rates unchanged in 2007 as lower wage growth continued to exert downward pressure on inflation. However, the market expectation is that the Bank of Japan will resume its tightening cycle in 2008. As financial market conditions and the growth outlook for the euro area began to deteriorate, the ECB continued to pause at 4% in the second half of 2007 after having raised policy rates twice in the first half of 2007. The market expectation is that the risks to euro area policy rates remain on the upside in 2008, due to continuing upside pressures on inflation.

The euro area

Changing expectations of the differential in monetary outlooks and policy rates between the US and the euro area resulted in a considerable appreciation of the euro against the dollar. However, despite the strong currency, euro area export growth remained robust in 2007. Economic growth for the euro area is projected to slow to 1.8% in 2008 (market forecasts for growth in the region range from 1.3% to 2.3%) from an estimated 2.6% in 2007 and 2.9% in 2006.[3] Although the financial market dislocation affected consumer and business confidence in the second half of 2007, many of the economic fundamentals, such as low unemployment and robust corporate earnings, are likely to provide some support to euro area growth. However, the risks to growth remain skewed to the downside with some pressure from financial market developments and the strong euro. Inflationary pressures also resurfaced in 2007 as a result of rising food and energy prices.

Emerging market economies

Economic activity in emerging markets continued to expand robustly in 2007 and emerging markets appeared not to be affected by the immediate financial market dislocation in the second half of 2007. However, while emerging markets have benefited from globalisation, many emerging

3 Ibid.

market economies are now also more vulnerable to contagion effects from developed economies. This means that the effects of a weaker global economic and financial environment are also likely to be felt in emerging economies.

Stronger economic policies and improved financial positions make these economies more resilient to external shocks. Improved financial standing has also made emerging economies attractive to foreign investors. Large capital inflows and strong economic activity have resulted in the re-emergence of inflationary pressures, particularly in India and China. Despite tighter monetary policy in 2007, the Chinese economy remains close to overheating, with the economy estimated to have grown by 11.4% in 2007. As global growth slows, Chinese economic growth is also forecast to moderate to 10.4% in 2008.[4]

Table A1: World output growth (percentage change from previous year)

	IMF			Consensus forecast		
				Average		Range
	2006	2007	2008f	2007	2008f	2008f
World	5.4	5.2	4.8	3.7	3.2	
Advanced economies	2.9	2.5	2.2			
UK	2.8	3.1	2.3	3.1	1.8	-0.1 - 2.3
US	2.9	1.9	1.9	2.2	2.0	0.8 - 2.6
Euro area	2.8	2.5	2.1	2.6	1.8	1.3 - 2.3
Japan	2.2	2.0	1.7	1.9	1.5	0.9 - 2.0
Developing countries	8.1	8.1	7.4			
India	9.7	8.9	8.4	8.6	8.2	8.4 - 9.3
China	11.1	11.5	10.0	11.4	10.4	10.0 - 11.4

Source: *World Economic Outlook*, IMF, October 2007
Consensus Economics, Consensus Forecasts, January 2008
Asia-Pacific Consensus Economics, Consensus Forecasts, January 2008
Note: Figures for India are percentage changes from previous fiscal year.

Domestic economic performance

Through 2007, the domestic economic environment remained strong, but consensus forecasts point to a slowdown in economic growth for 2008. According to consensus estimates, the UK economy expanded by 3.1% in 2007, up slightly from 2.9% in 2006.[5] As global economic growth slows in 2008, UK GDP growth is forecast to slow to 1.8%. There is significant variance between the forecasts for 2008 (range is -0.1% to 2.3%), and the risks are skewed to the downside. Tighter credit conditions, in the form of a reduction in the availability of credit and higher credit costs, are likely to reduce spending. If economic conditions deteriorate, or house prices fall, profit growth for some financial firms could slow.

In response to growing concerns over inflation, the Bank of England tightened monetary policy in the first half of 2007, raising rates by 25bp, in January, May and July. After pausing at 5.75%, the Bank of England lowered interest rates by 25bp in December 2007 reflecting concerns about the impact on UK output and inflation from the deterioration in financial market conditions and tightening in the supply of credit to households and businesses. However, it will take some time before the impact of lower rates will feed through to the economy.

Interest rate effects come through with lags, and the cumulative 125bp increase from August 2006 until December 2007 is unlikely to have yet fully fed through to the economy. Higher interest rates affect the affordability of debt repayments, particularly mortgage repayments. Over the next 12 months, approximately 1.4 million fixed-rate mortgages will come to the end of their fixed-rate term. For many consumers, this will mean that the cost of their mortgage will increase significantly (an average of £210 a month if they simply revert to their lender's standard variable rate). Furthermore, the pressures in money markets in the second half of 2007 have made wholesale lending more expensive which together with a reassessment of credit risk has prompted the majority of lenders in the non-conforming market to make increases of 100bp or more in pricing.

Tighter credit conditions are likely to add further risks to the growth outlook as consumers' ability to spend and finance their house purchases comes under pressure. Consumers' disposable income has also been reduced by higher energy prices and subsequently higher utility bills. Concerns already persist over household-debt levels, and the number of individuals experiencing debt-servicing difficulties has increased sharply. This has occurred against a background of rising employment and above-trend

4 Ibid.
5 Ibid.

economic growth. More difficult conditions for consumers could have significant implications for financial firms.

The financial market dislocation that began in the second half of 2007 and still continues has resulted in an increase in uncertainty and risk aversion, which pose risks to the UK economic outlook. This, particularly if house-price growth softens or even turns negative, could result in lower consumer confidence, which could put further pressure on domestic demand.

Table A2: Selected forecasts for the UK economy

	2005	2006	2007e	2008f
Real GDP growth (%)[1]	1.8	2.9	3.1	1.8
Consumer spending growth (%)[1]	1.5	1.9	3.1	1.7
Current-account balance (£bn)[2]	-30.5	-41.9	-58.0	-54.4
Unemployment (%)[3]	4.9	5.4	5.4	5.5
Inflation CPI Q4 (%)[2]	2.0	2.3	2.1	2.2
House-price inflation annual average (%)[4]	3.2	10.5	4.8	0.0

Source:
1 *A Digest of International Economic Forecasts*, Consensus Forecasts, January 2008.
2 *Forecasts for the UK Economy*, HM Treasury, January 2008.
3 *National Institute Economic Review*, National Institute for Economic and Social Research, October 2007.
4 *House Prices*, Q4 2007 Press Release and Forecast 2008, Nationwide.

Global financial market conditions

Financial market conditions weakened considerably in 2007 as investors reassessed risks in their portfolios and risk premia began to rise. As a result, financial markets could be more vulnerable to external shocks and the impact of shocks on firms could be bigger than it was in previous years. The operating environment remains tight and it is unlikely that conditions will return to what investors have experienced in recent years.

As a result of relatively low interest rates, easy access to credit and strong growth in the available funds for investment, global liquidity remained abundant until early 2007. The resulting large pool of accessible financing drove down the returns from traditional lower-risk investments in developed nations, encouraging investors to search for yield in less well understood and potentially riskier asset classes. The low-volatility environment, combined with a favourable economic backdrop, encouraged the view that the inherent riskiness of traditionally high-risk investments had fallen, meaning that investors were effectively under-compensated for the risk that they were taking on. The benign operating environment began to turn in early 2007. The first indication that financial conditions would tighten came in February/March 2007, when volatility and investors' risk aversion increased and there appeared to be a small correction in the markets' pricing of risk. Financial market conditions deteriorated sharply in the second half of 2007 and it is likely that stressed financial market conditions will persist for some time. As a result of the recent events, the markets are now vulnerable to future external shocks.

What began as concerns over credit quality in the US subprime mortgage market crystallised in a correction in the pricing of risk across financial markets, particularly credit and money markets, and a flight to quality in August/September 2007.

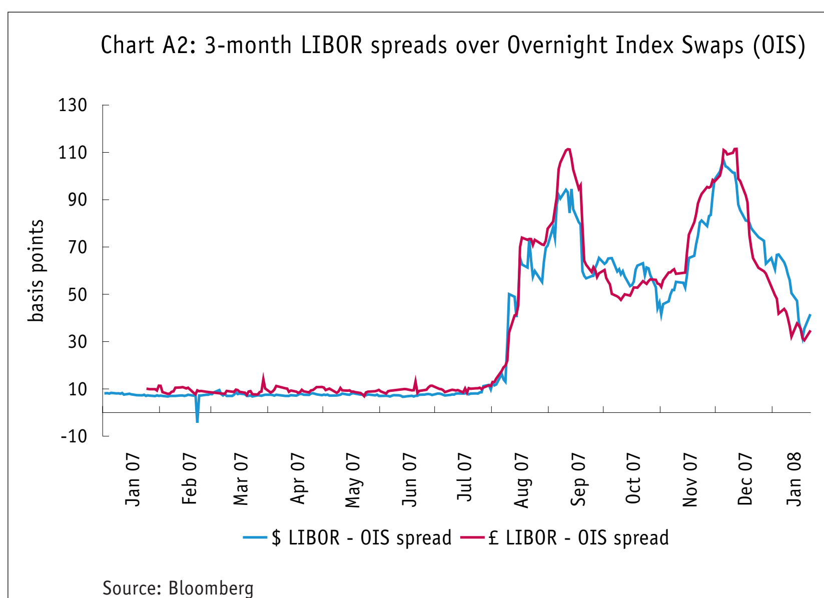
The correction in subprime assets and increased risk aversion spread across the credit markets as market participants became concerned that the increased use of securitisation over the past few years could have facilitated contagion via structured investment vehicles (SIVs) and structured products such as asset-backed collateralised debt obligations (ABS CDOs). The events illustrated the lack of transparency in financial markets, as it became apparent that investors across several different markets were unaware of who ultimately held the subprime mortgage risk; a negative consequence of the dispersal of risk throughout the financial system. This problem was instrumental in fuelling contagion across markets. The uncertainty over the distribution of the losses resulted in a flight to quality to Government bonds and increased demand for liquidity. Concern over the value of illiquid instruments and fear that large quantities of asset-backed commercial paper (ABCP) were linked to US subprime mortgages led to the virtual closure of the ABCP market to new issuance and a sharp rise in spreads in the money markets. These events resulted in a prolonged financial market dislocation and considerable funding problems for many firms. The most visible example was seen in the problems encountered by Northern Rock.[6]

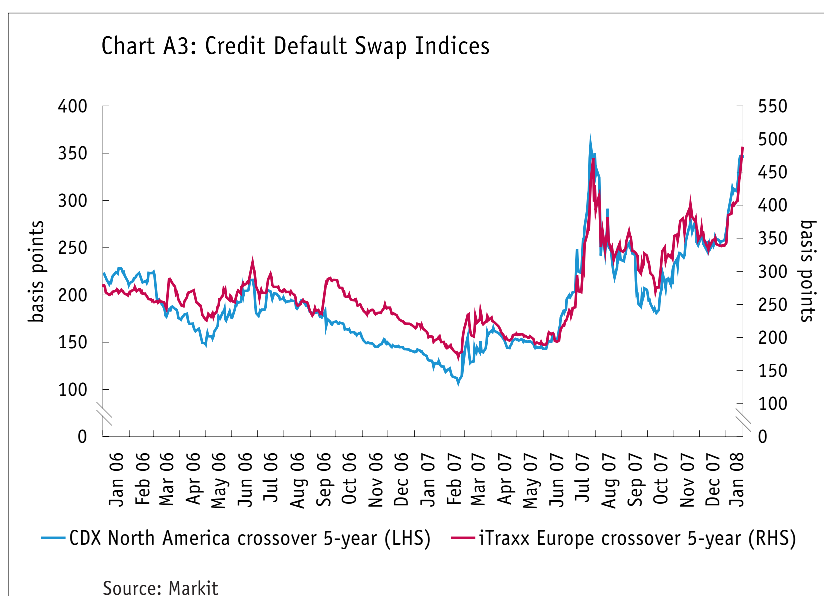
Developments in the real economy could also add to pressures already present in the financial markets. A shock to the real economy could constrain the availability of credit, which in turn could cause the economy's health to deteriorate further. This is not our central scenario, but it is a risk that could have significant implications were it to crystallise. The risk of a more difficult economic outlook also raises the risk of credit problems spreading beyond subprime debt into credit card lending, commercial property, other kinds of leveraged lending and, ultimately, the broader corporate sector. Moreover, innovative and complex financial vehicles have contributed to credit creation over the last few years; much reduced issuance of these instruments is likely to cause the amount of credit available in the economy to fall. All of these vulnerabilities reduce the ability of the financial system to cope with a financial crisis. This fragility is heightened by the fact that recent financial events have undermined confidence across a number of participants in the financial system.

There is a risk that credit conditions could tighten further over the next 18 months, further exacerbating the already stretched financial market conditions. Financial market volatility is likely to remain high as the financial markets return to a new equilibrium. It is difficult to ascertain what any new equilibrium

6 Please refer to the Bank of England's Financial Stability Review (25 October 2007) for a detailed description of the events that occurred in the financial market in Autumn 2007 and also an account of the events that led to the funding crisis at Northern Rock (p.10-11).

for financial markets will be in the aftermath of the reappraisal of risk, which still continues. While financial market conditions have calmed from the height of the dislocation in the latter half of 2007, financial markets may need to adjust to new conditions that reflect reduced availability of cheap credit and higher volatility than experienced in recent years. It is likely that liquidity conditions will remain tighter and that financial markets will not return to the conditions market participants have got used to in recent years. Moreover, the potential impact of financial market or economic shocks on firms is likely to be greater now than it was a year ago.





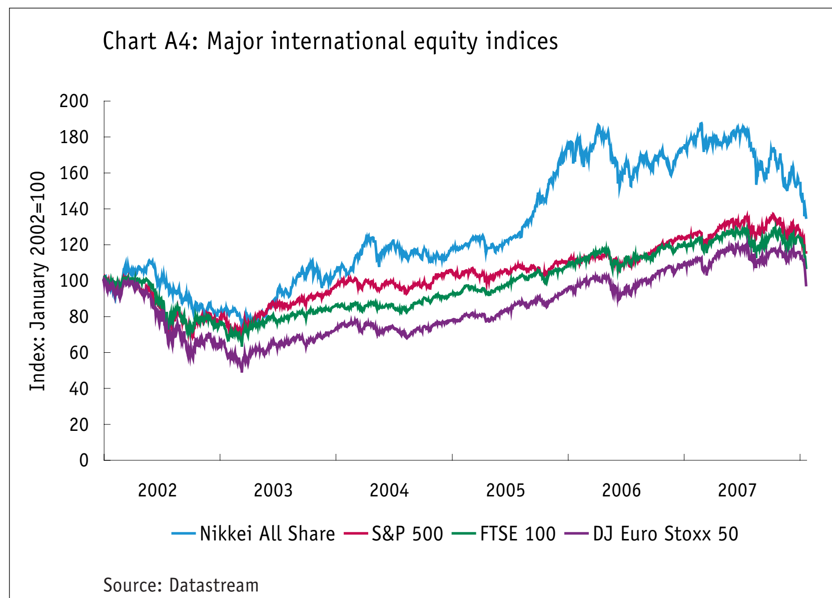
Developments in financial markets

Liquidity conditions in money markets deteriorated in August 2007 as banks began to store liquidity and became increasingly reluctant to lend to each other in light of concern over the extent of subprime exposures. Accordingly, term LIBORs rose quickly in both the dollar and the sterling markets to reflect tightening conditions. The three-month sterling LIBOR reached 6.90% on 11 September, its highest level since November 1998. The money market dislocation was reflected in the overnight index swap (OIS) spreads, which widened sharply in August and September 2007 – between late July and early September the three-month OIS-to-LIBOR spreads widened by 86bp in the dollar market and 102bp in the sterling market. Money market conditions appeared to improve in the first half of October 2007 in response to central bank liquidity injections and lower policy interest rates in the US. However, year-end funding pressures and concerns over US housing markets, economic growth and possible bank write downs resurfaced in late October. This led to a deterioration in money market rates and, in the sterling markets spreads widened to levels seen at the height of the dislocation in September.

Money market rates began to fall in December, in part assisted by coordinated central bank action to improve liquidity in the markets and OIS-to-LIBOR spreads more than halved from their peaks. On 12 December 2007, the Federal Reserve, the ECB, the Bank of England, the Swiss National Bank and the Bank of Canada announced a combination of measures to alleviate pressures in the money markets. These measures included increasing the amount of money available through planned open market operations, scheduling new operations and widening the range of eligible collateral. Although money market conditions have considerably improved, the outlook remains uncertain as the longer-term funding market remains less liquid.

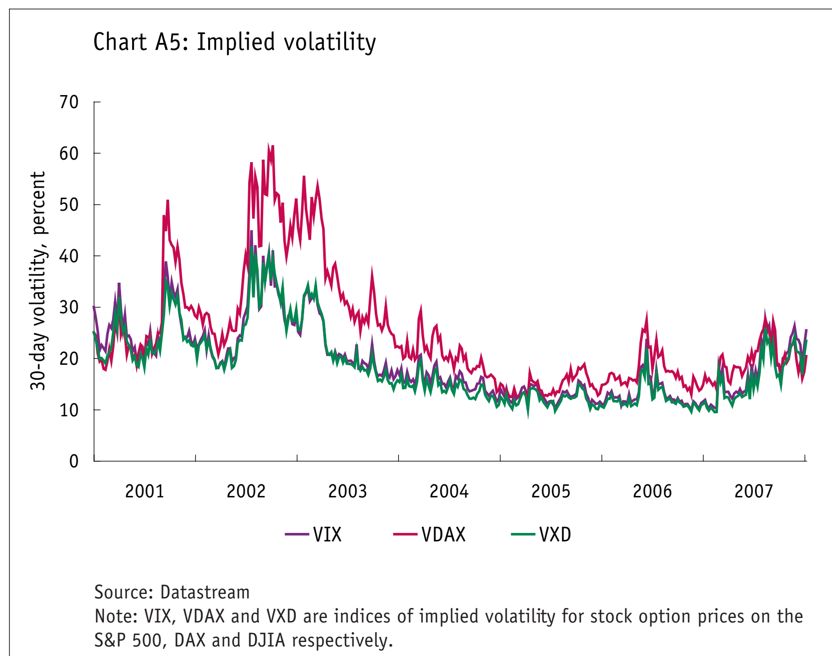
As money market conditions tightened and concern over credit quality of mortgage assets increased, credit spreads saw a similar tightening in conditions. Spreads widened dramatically at the early stages of the market dislocation in August and September 2007. The benchmark US credit default swap (CDS) index, CDX North America Crossover index (CDX NAXO), rose to 359bp in late July, while its European counterpart, the iTraxx Crossover index rose to 471bp. In line with an improvement in sentiment in the financial markets in late September and early October, spreads narrowed briefly before beginning to widen again. By January 2008, due to renewed concerns over the financial markets and the global outlook, the CDS spreads of some financial firms had widened to trade at the levels seen at the peak in late July and early August. Benchmark credit indices also rose to new records, with the iTraxx Crossover index rising to all-time highs. Credit markets remain volatile and could be vulnerable to a quick reversal of sentiment should further adverse shocks materialise.

Chart A4: Major international equity indices



Source: Datastream

Chart A5: Implied volatility

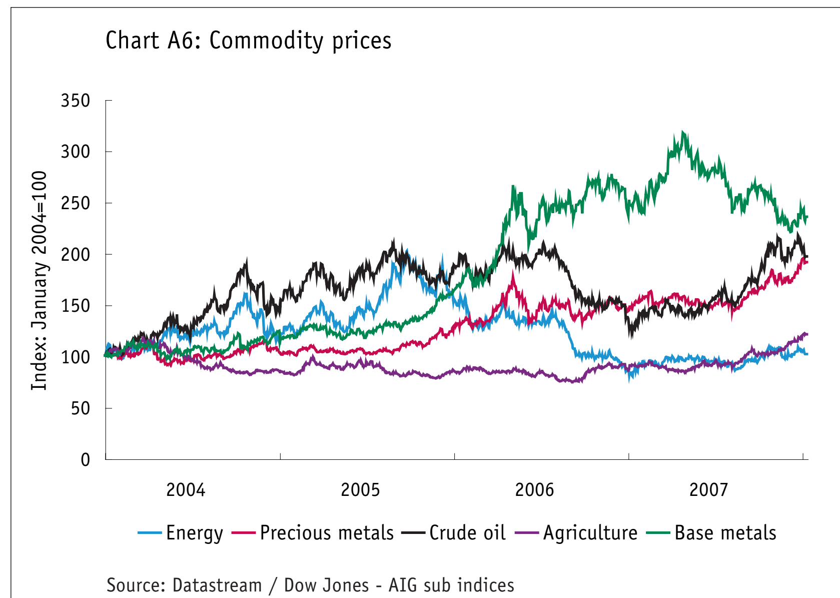


Source: Datastream
Note: VIX, VDAX and VXD are indices of implied volatility for stock option prices on the S&P 500, DAX and DJIA respectively.

The worsening outlook for corporate earnings and increased risk aversion were also reflected in elevated equity market volatility. Although equity market volatility is still below the record levels seen in 2001/2002, volatility began to edge higher in March 2007 and increased markedly in August during the beginning of the financial market dislocation and again in mid-November. Equity markets sold off in the second half of 2007, after having hit several records in the first half of the year, when they were partly supported by lower long-term interest rates. Higher oil prices and poor performance by financial stocks depressed overall stocks in the latter half of 2007. The FTSE 100 grew by 3.8% in 2007, the lowest growth rate since 2002 and well below the 10.7% achieved in 2006. The US markets also underperformed recent years, with the S&P 500 and Dow Jones gaining 3.5% and 6.4% respectively in 2007, in comparison with 13.6% and 16.3% in 2006.

Emerging market equities appeared to sustain momentum during the market dislocation after having seen record growth earlier in the year, with Asian markets continuing to trade at multi-year records. Investor sentiment remains negative and global equity markets sold off in the first few weeks of 2008, with the FTSE 100 seeing the largest daily falls since 11 September 2001. The tighter credit environment and worsening global economic outlook are likely to increase pressures on earnings and could bring equities under renewed pressure in 2008.

Volatility in the commodity markets increased during the course of 2007. Crude oil prices saw record increases in the second half of 2007, with the benchmark crudes nearly touching the psychologically important US$100 per barrel level before a single trade pushed through the US$100 per barrel level in intra-day trading in early 2008. Supply disruptions in the North Sea and in the Gulf of Mexico added to concerns over falling inventories and geopolitical tensions in the major oil-producing regions, which kept the supply pressures elevated. Energy prices are likely to remain high as demand from emerging market economies is expected to support global demand for energy even if economic growth in advanced economies slows. Supply is expected to remain under pressure due to capacity constraints and continuing geopolitical stresses.



Industrial metals continued to see record growth in the first half of 2007 as demand for raw materials from China and low inventories supported prices, leading to a 21% increase in industrial metals prices between the start of the year and early May. However, increasing uncertainty over the global economic outlook and the sustainability of demand for industrial metals put downward pressure on prices following the financial market dislocation that began in the summer of 2007, leaving prices down 14% over the year. Precious metals, in particular gold, benefited from flight-to-quality inflows during the financial market dislocation and gold nominal prices hit several 28-year record highs in the last months of 2007 before rising to trade above all-time record highs at over US$900/oz in January 2008. The weaker dollar, higher inflationary pressures and continuing concerns over the global economic outlook and financial markets are likely to keep demand for gold high as investors seek to protect their returns.

Alternative scenarios

In addition to our *Central economic scenario* we consider the likely impact of three plausible *Alternative scenarios* on firms, markets, consumers and us. These scenarios are plausible risks derived from underlying weaknesses or imbalances in the UK economy that increase the downside risks to our central projection.

The *Alternative scenarios* consider the implications of potential economic and financial developments that are not directly captured by our *Central economic scenario*. We explore the transmission mechanisms through which these scenarios can affect the economy and the financial services industry and highlight some of the likely implications. However, in designing our *Alternative scenarios* we do not assess how likely the scenarios are to occur or the possible triggers that could cause them to crystallise. The *Alternative scenarios* should not be interpreted as forecasts, but plausible prospects against which both financial firms and consumers should consider their future prospects.

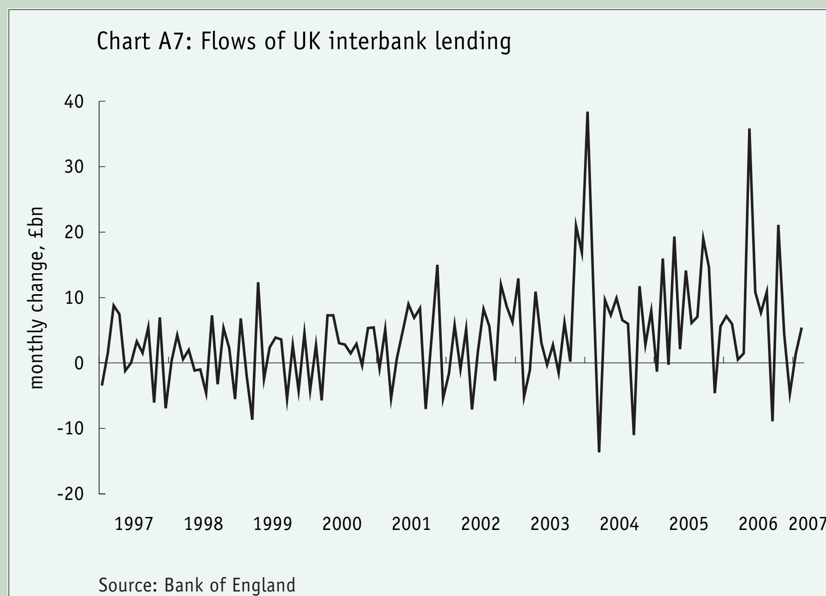
We use the *Alternative scenarios* as part of our process of identifying how our statutory objectives and strategic aims would be affected if certain shocks were to materialise. This enables us to better prioritise the risks that we face and, in turn, helps us develop our *Business Plan* for the year ahead. Firms should also use scenario planning as part of their stress testing and business-continuity planning. However, the scenarios that we consider here are not being advocated as the 'model' scenarios that all firms should use; rather, firms should use the scenarios that are most relevant to their own business model.

While there are a number of shocks that could lead to a deterioration in the *Central economic scenario*, we focus on three which we believe are particularly pertinent to the current environment in which we operate: a further reduction in the availability of credit; falls in property prices; and rising inflationary pressure. These three shocks are all interlinked and aspects of the three shocks are likely to reflect or partially reinforce one another. Some of the scenarios we considered in previous editions of the *Financial Risk Outlook*, such as *deterioration in personal credit quality (2007)* and *sustained and significant increases in oil prices (2006)*, are still relevant in the current economic and financial climate. Firms may therefore wish to refer back to them.

If any of the three shocks considered were to occur, the risks present in our operating environment would change and we would have to adjust accordingly. This would involve ensuring that the focus of our supervisory priorities reflects these changes and emerging areas of stress. We would also continue to work closely with the Treasury and the Bank of England to ensure that overall financial stability was not affected and that confidence in the financial services sector was maintained. With regard to our consumer objectives, we would change our consumer information priorities, targeting those groups of consumers most at risk and focusing on the issues of greatest concern. In stressed conditions, we would expect consumer complaints to increase and we might need to allocate more resources to ensuring that consumers had not been and would not be treated unfairly.

Availability of credit

Prior to the events of the second half of 2007, there was an abundant supply of cheap credit. There is now a risk that the tightening of liquidity conditions could lead to a long-term tightening of lending standards across assets and products. This could induce a fall in real economic activity due to a lack of finance.



The availability of credit to households and corporates appears to have been already affected by the recent financial market developments. According to the Bank of England's Credit Conditions Survey, the availability of secured lending to households and credit to corporates has been reduced.[7] The surveyed lenders also expected a further reduction in credit availability to both households and corporates in the months ahead. A reduction in secured residential lending could lead to a reduction in consumer spending and construction activity.

Risks for firms and markets

- As credit conditions tighten, the lending industry could become more concentrated. In particular, those who rely on wholesale funding could find it difficult to satisfy demand for loans given funding and pricing pressures. Finance for speculative projects or securitisation deals could also become more difficult to source and more expensive.
- Lenders could become increasingly selective about the risks they take on, which could also lead to a fall in business volumes. This could lead to a slowdown in corporate activity and consumer borrowing, and thus increase the risk of an economic slowdown.
- Higher funding costs could increase pressure on financial firms. This is likely to be reinforced by rising default rates as businesses and consumers face difficulty in meeting loan obligations due to higher interest rate costs and slowing economic activity.
- Related industries, such as mortgage intermediaries and packagers, could also face pressures on profitability due to declining business volumes and increased competition with direct delivery channels.
- Lenders might be less willing to compete aggressively to win intermediary business to maintain profitability. Financial intermediary networks would be likely to look at their cost structures as a result of falling commissions and would be likely only to want to work with the most productive and profitable firms.

Risks for consumers

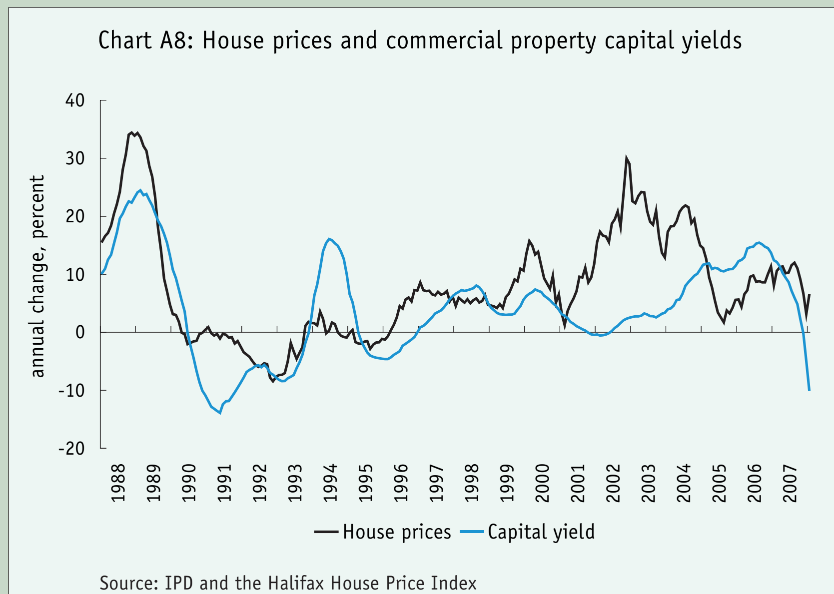
- If consumers found it increasingly difficult to obtain credit, the number of property transactions would be likely to fall and the market for mortgages for own-house purchase would therefore become smaller. However, the demand for re-mortgaging and second-charge lending could rise, particularly as consumers consolidate debt.
- If firms became more selective in their lending decisions, it would become increasingly difficult for those with poor credit histories to obtain finance. Interest rate increases for this type of consumer could lead to a further deterioration in affordability. In addition, those reverting to a higher standard variable-rate mortgage from a relatively low fixed-rate mortgage could find it difficult to manage these increased costs.
- Self-certification products could become even harder to find and, where available, could only apply to low loan-to-value mortgages. This, together with more stringent lending criteria and underwriting standards in terms of the affordability assessment, would be likely to further reduce the level of transactions as consumers might not have the required income to support their borrowings.

7 *Credit Conditions Survey Q4 2007*, Bank of England, January 2008.

Fall in property prices

Over the past few years, the performance of the commercial property sector has been driven primarily by yield compression caused by the large volume of capital entering the market and a shortage of marketable properties. Rental growth has been relatively subdued; overall rents grew by 3.5% in 2007. However, the gap between the all-property equivalent yield and the return on bonds has now turned negative. It is questionable if this is sustainable, particularly if borrowing is constrained or an economic slowdown causes rents to fall. A weakening of economic activity could reinforce the decline in commercial property prices as the amount of un-rented space rises, putting further pressure on yields. In these circumstances, commercial property prices could fall further. According to IPD, overall capital values have now fallen 11.7% from the peak in July 2007.

Chart A8: House prices and commercial property capital yields



Source: IPD and the Halifax House Price Index

We are also seeing a slower rate of house-price inflation. Housing assets constitute about 45% of personal wealth in the UK and household spending could be vulnerable to large corrections in house prices. Sharply falling house prices could encourage precautionary saving and also curtail individuals' ability to borrow against the value of their homes. In this scenario, the fall in commercial property prices, which will affect the construction sector, is therefore reinforced by a fall in house prices.

Risks for firms and markets

- A fall in commercial property prices could mean that finance for property developments or securitisation deals become more difficult to source and more expensive.
- As commercial and residential property prices fall, financial firms with high concentrations in this type of lending could face losses which require an increase in provisions on both the residential and commercial property books, thus reducing profitability. This could put firms' capital under pressure.
- The effects of a fall in property prices could be exacerbated by a fall in lending, which could be constrained by a lack of collateral to secure loans and a weaker economic environment.
- Equity markets could come under pressure as the economic outlook deteriorates and firms mark down asset values in property. If equity prices were to fall significantly, this could undermine the financial strength of the life-insurance industry and other financial services sectors.
- A loss in investor confidence as a result of a fall in commercial property prices could result in commercial property-backed investment funds being forced to sell properties to maintain liquidity. There could be further restrictions on withdrawals by consumers.

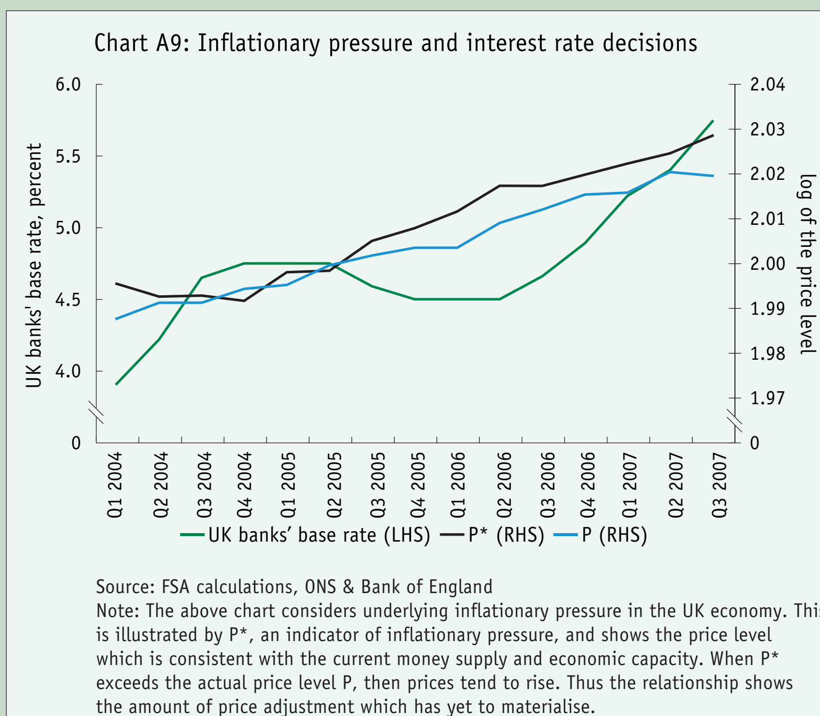
Risks for consumers

- Consumers could lose confidence and look to raise their savings rate, which while positive at the individual level, will, if it happens suddenly, lead to higher unemployment and a slowdown in the economy.
- In the event of a sharp fall in property prices, consumers' ability to borrow against the value of their homes would be reduced. In addition, lenders would be likely to reduce the percentage of the value that they are prepared to lend in order to mitigate this risk.
- Slower economic growth and a weaker labour market could increase the numbers of consumers facing financial hardship due to debt-servicing difficulties, particularly as the short-term solution of further borrowing against property to consolidate debts might not be available. This could result in a rise in personal bankruptcies or individual voluntary arrangements (IVAs) and increased mortgage repossessions.
- The yield on capital from highly geared buy-to-let investments could be negative, affecting confidence in this sector and leading to further price reductions. On the other hand, the demand for rental property could increase.
- Consumer confidence in mainstream investment products could also be affected if the equity market were to weaken. Funds based on commercial property could see further losses and withdrawals from funds could be restricted (as has already occurred in some instances).

Inflationary pressures

While inflation is still relatively low by historical terms, rising energy, raw material and basic food prices have increased inflationary pressures in a number of major economies. As a result, annual inflation in the euro area rose to its highest level in more than six years (3.1%) in late 2007, while in the US annual inflation increased 4.3% in November 2007. Annual inflation in China was 6.9% in November 2007, its highest level since 1996. In the UK, while factory-gate prices have risen sharply (4.5%) competitive pressures have meant that manufactures and retailers have tended to absorb these increases and consumer price inflation has only risen to 2.1%. Monetary growth, while slowing in the second half of 2007, has still been growing robustly (M4 lending grew at an annual rate of 12.9% in November 2007), and there is a risk that underlying inflationary pressures remain strong.

Chart A9: Inflationary pressure and interest rate decisions



Source: FSA calculations, ONS & Bank of England
Note: The above chart considers underlying inflationary pressure in the UK economy. This is illustrated by P*, an indicator of inflationary pressure, and shows the price level which is consistent with the current money supply and economic capacity. When P* exceeds the actual price level P, then prices tend to rise. Thus the relationship shows the amount of price adjustment which has yet to materialise.

There is a significant risk that cost pressures will increase sharply in the future – both from further rises in energy and commodity prices, as well as from an increase in wage demands – reflecting increased inflationary expectations.

Risks for firms and markets

- Higher production costs 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 could fall and some firms might default on their loan repayments. Falling equity markets could also reduce alternative funding sources available for various projects.
- Financial firms could see increasing losses as some businesses struggle to meet debt obligations. Firms exposed to businesses with significant investments in sectors particularly vulnerable to commodity-price pressures or rising interest rates such as airlines, car manufacturing and the retail and commercial property sectors, would be particularly affected.
- Banks and other lending institutions might need to increase their provisions to account for consumers having difficulties in repaying their mortgages and unsecured loans due to a fall in their disposable and real incomes. However, changes in interest rates would give financial firms greater opportunities to widen margins to maintain profitability.
- A significant commodity price shock could depress the currencies of commodity-importing nations and could also lead to sharp movements in the price of emerging market debt.
- The deteriorating economic environment could adversely affect life-insurers' balance sheets and the insurance industry would need to ensure their long-term liabilities would be met despite the short-term volatility.

Risks for consumers

- Higher prices would depress households' real and disposable incomes. This could lead to a fall in consumer spending and saving. Higher input prices could also increase unemployment, as firms seek to cut costs, putting further pressure on household finances. Despite posing higher costs, higher inflation could benefit some highly indebted consumers through eroding the real value of their debt.
- Mortgage payments could be put at risk as real interest rates increase. This could lead to increased mortgage and unsecured loan defaults.
- The value of long-term savings could decline as a result of increased equity market volatility. Buy-to-let property investments, particularly new-built flats, could fall significantly in value.
- Consumers could reprioritise pension planning, and today's consumption needs could take an increased priority over planning for future financial needs. This would exacerbate the savings gap which might further widen as a result of a loss in consumer confidence in investment vehicles after a period of volatility.

Priority Risks

Existing business models of some financial institutions are under strain as a result of adverse market conditions

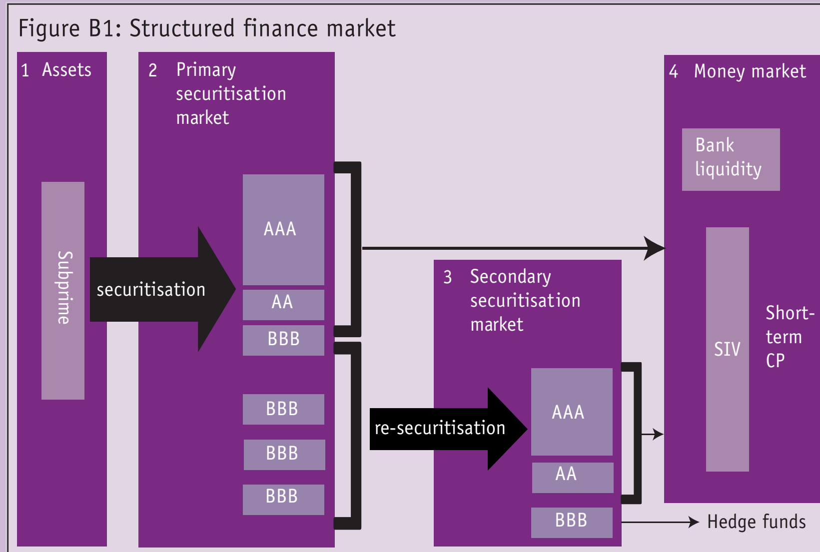
The structured finance vehicles that some firms have chosen to use over the last few years have had a material impact on their financial performance during stressed financial market conditions. In some extreme circumstances, this has put pressure on key measures of prudential risk, such as capital and liquidity. The disappearance of some funding vehicles from the market, such as SIVs and conduits, will increase firms' cost of funding and may also lead to a reduction in risk dispersal. It may force some lenders to reduce the size of their mortgage businesses, which would have direct consequences for consumers and the real economy.

Vulnerabilities arising from structured finance markets

Structured finance and the ways in which firms have used associated financing vehicles, such as SIVs and conduits are central to the instability that affected financial markets and financial institutions in the second half of 2007. Prudential risks for many firms are now greater than they were before market conditions became stressed in the second half of 2007, because of the way in which the structured finance markets have evolved (see box below).

The evolution of structured finance markets

Over the last few years, structural changes and financial innovation, in particular the development of the securitisation markets, have resulted in the creation of vehicles and products that allow banks to distribute risk off their balance sheets and increase the volumes of their business. This has led some banks to rely less on 'originate and hold' models and more on 'originate and distribute' models, though some originators kept the first-loss position. This shift has allowed some banks to focus on origination, which many see as their core strength, without tying up significant amounts of capital. However, the dispersal of risk has come at the expense of transparency, as the market cannot easily identify the ultimate carrier of the risk.



Both retail and wholesale banks use the 'originate and distribute' model for a wide range of lending and it has facilitated the increase in the supply of credit in the economy. The rise of the 'originate and distribute' model fostered a significant amount of financial innovation. Instruments such as SIVs, ABCP conduits, CDOs, and collateralised loan obligations (CLOs) raised capital from investors to purchase portfolios of assets; frequently, but not always, these assets have been structured finance instruments. Intermediaries have also dissected the risks contained in assets acquired from investors and repackaged these risks into instruments that conform to what investors want to buy.

The second half of 2007 was a testing time for the asset-backed finance markets. Liquidity more or less disappeared from the ABCP market after several years of unprecedented growth and most market commentators expect that it will be several years before liquidity and pricing return on a scale to that seen in the recent past. The lack of liquidity caused significant problems for many products, most notably SIVs, ABCP conduits, CDOs and CLOs, as summarised in the table below.

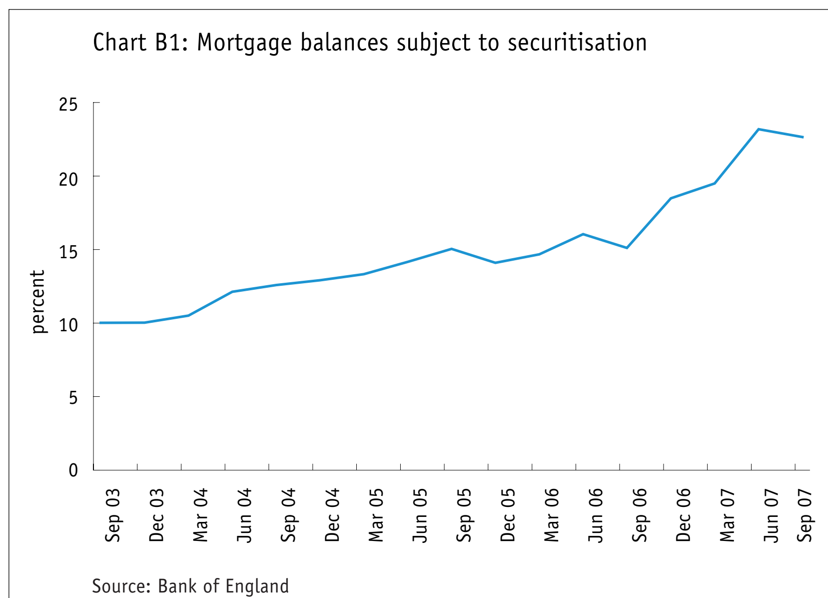
	Description of vehicle	Problems with vehicles
SIVs	Offshore funds that invest in highly rated long-term assets and fund themselves through short-term financing, resulting in a mismatch between assets and liabilities.	There was a lack of disclosure of the underlying assets which led to distrust of these vehicles. Once the SIVs began to experience difficulties, the existence of wind-down triggers made matters worse, as they had been designed to cover idiosyncratic risks, not general market-wide risks.
CDOs / CLOs	A series of bonds/loans that are packaged and sold on to investors. The issued bonds/loans are tranched, such that different investors take differing levels of credit risks and losses.	The rating agencies and investors had made poor correlation assumptions on the underlying assets which led to an underestimation of risk. In addition, there was a lack of true investors, meaning that liquidity was always light.
ABCP conduits	Primarily financing tools for vehicles for trade and consumer receivables. For example, credit cards and auto loans.	There was a lack of disclosure of the underlying assets which led to distrust of ABCP conduits. In addition, there was concern over whether liquidity providers could honour their commitments due to losses elsewhere or a general lack of liquidity.

The evolution of the structured finance markets has allowed risk to be dispersed more widely across a range of institutions and this was thought to have produced a more resilient financial system. However, the events of the second half of 2007 have revealed a number of problems caused by the way in which risk has been distributed and this has caused some firms' prudential risk profiles to deteriorate.

A number of structured finance vehicles left banks with liquidity risks that were not recognised until they were exposed by stressed market conditions. Firms with conduit businesses had not expected their liquidity lines to ever be drawn. Banks with SIV businesses have often decided to provide backstop funding for reputational reasons, which has unexpectedly increased the liquidity and capital needs of these organisations in ways that neither the financial markets nor regulatory models anticipated. The market will take a view on the extent to which this risk has been mitigated and understood in firms, and this will be reflected in future asset prices.

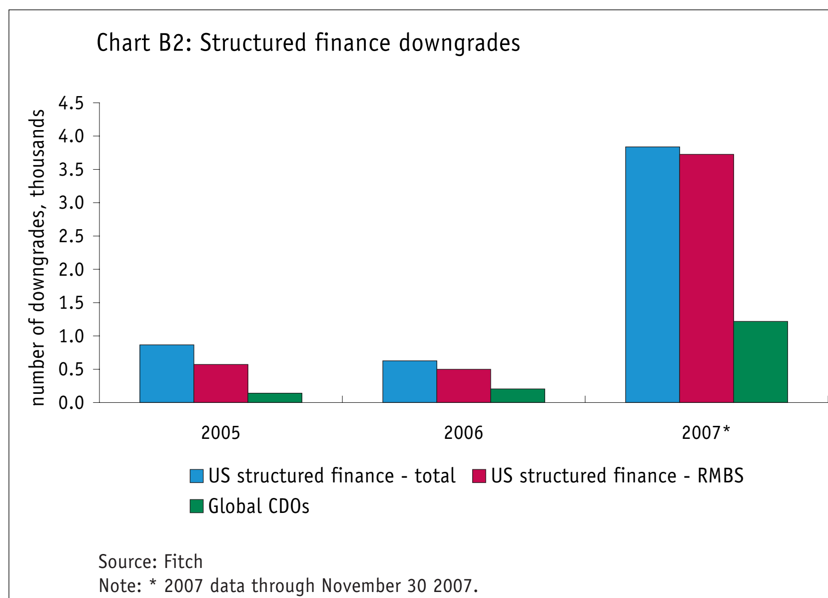
Vehicles such as SIVs and conduits have been important sources of demand for structured products; in recent years almost half of all triple-A rated mortgage-backed securities issued were purchased by ABCP conduits and SIVs. Similarly, an even larger proportion of the lower-rated securities were sold into CDOs. Therefore, the abrupt disappearance of ABCP conduits and SIVs from the market means that the availability of securitisation as a funding source has been severely curtailed. This will increase banks' cost of funding and could lead to a reduction in risk dispersal, with more held on banks' balance sheets, unless banks reduce their origination volumes.

Chart B1: Mortgage balances subject to securitisation



Source: Bank of England

Chart B2: Structured finance downgrades



Source: Fitch
Note: * 2007 data through November 30 2007.

Mortgage balances have been growing at faster rates than retail deposits. UK banks and building societies had been seeking to keep the ratio of mortgage balances to retail deposits relatively constant through the use of securitisation; over 20% of mortgages by value are currently subject to securitisation, a percentage that has increased steadily over the last seven years. A curtailed ability to securitise assets will therefore restrict lenders' ability to increase mortgage lending. Funding constraints could force some lenders to reduce the size of this side of their business. This will have direct consequences for the UK mortgage market and, consequently, UK consumers and the real economy (refer to *Economic and financial conditions* and the *Priority Risk* on *Consumer debt*).

The role of credit ratings agencies

Credit ratings have been important in supporting the growth in structured finance vehicles. They have also helped to lower the cost of capital and reduce information asymmetries between the sellers and buyers of

credit risk. Triple-A ratings have been key to the marketability of structured debt to institutional investors, to the extent that a triple-A senior tranche has been viewed as being vital to the issuance of structured debt. This has resulted in deals being structured so as to achieve a desired rating.

However, the large number of downgrades for US subprime retail mortgage backed securities (RMBS) and structured products exposed to subprime mortgages in the second half of 2007, led to a loss of confidence in structured finance ratings as a true reflection of credit risk. The high volume of downgrades and the speed and magnitude of ratings reductions in 2007 implies widespread failure across the main credit ratings agencies in providing accurate credit ratings for structured securities backed by US subprime mortgages. Ratings have failed to take account of loosening underwriting standards and may have been compromised by potential soft fraud by mortgage originators in disclosing misleading and inaccurate information to the agencies. In the future, ratings agencies will need to consider how their methodologies can be adapted to include these issues. If these issues are not addressed, there is a risk that a further loss of confidence in the ratings agencies could cause the markets to disregard a significant source of information on credit risk. This problem would be most significant in the structured finance markets, where, in spite of the problems described above, ratings are still the only widely available source of information for the investment community.

For their part, investors need to consider the appropriate use of rating opinions in their due diligence of investment opportunities. The financial market dislocation of the second half of 2007 revealed that some investors, including institutional investors, had assumed that a triple-A rating on a structured finance instrument meant not only an insignificant probability of default, but also deep market liquidity and low price volatility. This is not the case as ratings opinions comment solely on credit quality. If these investors do not refine their use of ratings, as one part of a robust risk-assessment process, then there is a risk that this will result in a further deterioration in market confidence. Ratings agencies will have an important role to play in working with the industry to promulgate a thorough understanding of the ratings and information they publish.

Valuations

Structured finance products have become increasingly complex, and tend to have limited liquidity. Before the second half of 2007, it was nonetheless generally possible to infer a mark-to-market value for a range of complex instruments via observable prices in primary and secondary markets. This tended to be the basis for valuation by investment banks for their own positions and the valuations provided to clients. One trigger for the market dislocation in the second half of 2007 was the realisation that certain structured finance instruments carried considerably more credit and liquidity risk than had been priced for. This led to a severe reduction in market liquidity for those products, and a lack of price discovery. Firms had to develop alternative mark-to-model valuation methods, which generally required at least some unobservable input parameters and assumptions. The effects of this were felt widely in the markets as is described throughout this document. Valuation issues also raise significant risks for the accounting and auditing profession. These are outlined in the box overleaf.

There is a risk that clients' interests may be harmed unless firms that are providing formal client valuations utilise appropriate controls to ensure that the valuations are fair, clear, and not misleading. The importance of seeking fair, independent valuations is highlighted by the recent changes in accounting standards, such as FAS 157 *Fair Value Measurement* and the IOSCO paper *Principles for the Valuation of Hedge Funds*. Many firms, at their clients' request, provide their clients with periodic formal valuations of their investment portfolios. In 2007, we published an outline of the better practices financial firms use to appropriately resource and control the integrity of all formal valuations which are distributed to clients.[1] Recent events highlight the importance of valuations for the maintenance of market stability and confidence and, if they are observed by the industry, these standards of good practice will help to bolster market confidence in published valuations.

Many of the events that we have seen in the financial markets over the last six months have not been observed for many years, and others are without precedent. Recent market events have put key measures of prudential soundness under pressure for some firms. We still expect all firms to remain vigilant in monitoring their own prudential soundness. They should apply rigorous stress tests so that they fully understand their vulnerability to some of the consequences of financial market disruption that we have discussed in this section.

1 *Capital Markets Bulletin Issue 1*, FSA, November 2007.

Accounting and auditing

High quality accounting standards and audit assurance are widely recognised as being important in maintaining confidence in, and the efficiency of, global capital markets. However, there is a risk that recent financial market conditions could result in fair-value accounting being called into question and global convergence of accounting and auditing standards being obstructed by the creation of variants of international standards. There is also a risk that audit assurance could be impaired should one of the 'big four' audit firms collapse.

Fair-value accounting

Both International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP) require the use of fair value in accounting for financial instruments. In most cases, fair value is the measurement most relevant to investors and other stakeholders as it seeks to capture the 'true' economic value of assets and liabilities. However, there is a risk that under fair-value accounting there may be difficulties in measuring the value of financial instruments where an active market currently does not exist. For a number of asset classes, notably ABS (especially those backed by US subprime mortgage positions), observable primary and secondary market prices disappeared quickly in the second half of 2007. Mark-to-model approaches had to be developed and deployed rapidly for some products of which valuations had previously been verified using observable prices.

The Financial Stability Forum's Working Group on Market and Institutional Resilience is coordinating international work on the implications of recent market conditions for valuing assets and liabilities. There is, nonetheless, a risk that bodies other than accounting standard setters might seek to set what would, in effect, be accounting rules, which could be inconsistent with sound accounting practice. This could lead to reduced market confidence in the accuracy of financial information. For example, some might favour applying valuation adjustments made for prudential purposes to financial reporting, or requiring firms' financial statements to value assets conservatively on the basis of an assumption of stressed, rather than normal, market conditions, or loan-loss provisions to be set significantly above losses actually incurred to provide a margin of prudence.

The market conditions of the second half of 2007 also highlighted the importance of companies making sufficient disclosures with regard to key judgments and uncertainties within accounts, off-balance sheet vehicles and structured products. The Financial Reporting Council (FRC) leads on the regulation of corporate reporting and its operating bodies have taken a number of initiatives on this subject. Auditors should understand firms' processes for developing their estimates, test those assertions as part of their audit of internal controls, and pay careful attention to the adequacy of disclosures. The FRC will pay particular attention to the way in which preparers of accounts and auditors have dealt with the risks arising from the recent market conditions. Meanwhile, we have emphasised that listed companies should appropriately use all relevant channels to supply information to stakeholders, including Preliminary Statements, management discussion in the Annual Report and press statements.

Convergence

A single set of accounting standards would enhance transparency and could lead to a lower cost of capital. However, there is a risk that the creation of jurisdiction-specific variants of IFRS will impede the progressive adoption of a single set of accounting standards around the world.

The EU has established an endorsement process before changes to IFRS (published by the International Accounting Standards Board) are adopted for use in Europe. This creates the possibility of divergence between IFRS and European-endorsed IFRS. While currently the difference relates only to one, technical part of the standard for financial instruments (IAS 39), it is conceivable that differences could grow over time.[2]

2 The difference in financial instrument accounting concerns certain rules relating to hedging relationships. The IASB believes that only 29 out of around 8,000 EU listed issuers take advantage of the different EU provisions.

The Securities and Exchange Commission (SEC) has removed the requirement for the reconciliation from IFRS to US GAAP for overseas SEC registrants that produce their accounts using IFRS. This is a large step towards global acceptance of IFRS. However, there is a risk that the EU will insist on recognition by the US (and other countries) of EU-endorsed IFRS. This could result in fragmentation of IFRS into locally-applied variants. It may also lead to the EU requiring reconciliation to EU IFRS for foreign issuers listing in the EU. In turn this could result in firms deciding not to list in the EU or to delist, in a manner previously seen in the US.

It is important for market confidence that financial reporting is supported by high-quality audits. One element which supports audit quality in an international context is appropriate international audit standards. However, there is a risk that the move towards common international standards in auditing will see similar challenges as those faced by accountancy. For example, the standards may become excessively rules based, thereby undermining audit quality and reducing market confidence.

Concentration of audit services

There is a risk that should one or more of the so called 'big four' accounting and auditing firms either collapse or otherwise withdraw from the market for the audit of public interest entities, the choice of auditors for the largest companies would be severely constrained. Various reports on the concentration of audit services have identified the 'big four' as being the only audit firms perceived by many market participants as equipped to perform the audit of the largest and most complex quoted companies. This includes almost all of the 'high-impact' firms that we regulate (both with domestic and overseas headquarters) and also most FTSE 100 firms.

We consider that a market with three or fewer major firms would be unsustainable in the medium term, and that the implications for audit quality would be sufficiently serious to pose a risk to the smooth functioning of the financial markets. The FRC is working with other regulators to create a continuity plan to reduce the risk of auditors leaving the market without good reason, and to reduce uncertainty and disruption costs in the event that an audit firm exits the market.

Increased financial pressures may lead to financial firms shifting their efforts away from focusing on conduct-of-business requirements and from maintaining and strengthening business-as-usual processes

The deterioration in economic and financial conditions in the second half of 2007 have placed increased financial pressures on firms. As financial conditions and the economy are likely to remain more difficult over the short term, these pressures will remain. This could lead to firms shifting their efforts away from focusing on conduct-of-business requirements, such as treating customers fairly, and from maintaining standards in business-as-usual processes, such as stress testing and credit derivative trade confirmations.

Conduct-of-business requirements

There is a risk that due to the increased financial pressures on firms, they may not make the same endeavours to comply with conduct-of-business requirements, such as treating customers fairly and quality of advice. Where firms are faced with financial difficulties, there could be a tendency to concentrate on immediate problems. However, firms must not lose sight of the need to continue to ensure that business-as-usual processes are still handled with due care. This will be particularly important for those tasks which, in a crisis, may be given lower priority, until the fact that they have not been addressed begins to affect the firm's performance, or means that the firm is not in compliance with regulatory requirements, including our high-level principles. Prudence will be needed to ensure that even in times of difficulty, adequate resource is devoted to the timely handling of conduct-of-business requirements and business-as-usual processes.

One aspect of this is treating customers fairly, where we have seen poor levels of progress in some financial sectors and there is a risk that this could become more widespread if economic and financial conditions were to become more difficult. By the end of March 2008 all firms should have management information in place to test whether they are treating their customers fairly, and by the end of December 2008 all firms must be able to demonstrate through this management information that they are consistently treating their customers fairly. Our assessment so far is that, while many firms have made progress on building the fair treatment of customers into their culture, there is little evidence that firms' work on treating customers fairly is translating into improved outcomes for retail consumers. This suggests a clear risk that many firms will not meet the December 2008 deadline.

Preparing for future shocks

Previous editions of the *Financial Risk Outlook* have urged firms to strengthen their risk-management practices so that they are well-placed to deal with economic or financial shocks. Although the industry is making progress in this area, many firms are still failing to consider sufficiently stressful and forward-looking scenarios in their stress-testing work. There is a risk that firms may dismiss the events of the second half of 2007 as having been unpredictable rather than using them to build internal support for the use of more extreme scenarios in their stress-testing programmes. We expect that industry practitioners will be learning lessons from the current episode of market instability to reassess the type of extreme events that might reasonably occur, assess the cumulative impact of stress events happening simultaneously, and to consider carefully whether they are underestimating the likelihood of severe events or overestimating their ability to take mitigating action in a timely and effective manner.

The financial market dislocation of the second half of 2007 highlighted the importance of robust business continuity plans to deal with liquidity crises and financial events that do not have their origin in physical infrastructure disruption. The market dislocation also demonstrably weakened consumers' confidence in the financial system

(please refer to *Priority Risk* on *Loss of confidence*). This could make some institutions more vulnerable to retail depositors seeking to withdraw their funds if the financial system or any institution is thought to be under a strain. It is important that firms have contingency plans in place to cope with heightened retail deposit outflows, as inability to meet this demand could further dampen consumer confidence and result in a prolonged period of stress.

Operational disruption, from widespread events or the failure of an infrastructure provider or a large market participant, remains a key risk for the financial services industry (see box below). Regardless of the other pressures that firms are facing, it is important that they continue to ensure that they have the appropriate business continuity arrangements in place to be able to respond to significant changes in their operating environment.

Back-office operations

In previous editions of the *Financial Risk Outlook* we have noted the pressures on firms' back-office and documentation procedures as a result of the rapid growth in the credit derivatives market. If firms are not able to keep up with this growth, they could face operational and legal risks. In general, credit derivative trade confirmation backlogs have been reduced while deal volume has grown rapidly

Operational disruption

Widespread operational disruption could be caused by a number of high-risk events. Natural disasters and climate change, for example, pose both operational, credit and insurance risks (the latter are discussed in more detail in the *Industry focus* on *General insurance*). A human influenza pandemic would present a particular challenge to business continuity planning; a prolonged pandemic could result in higher absenteeism rates, lower productivity and a general loss of consumer and business confidence due to fear of infection. Terrorist attacks also pose a key operational threat for the financial services industry and a significant attack could cause critical losses for the life, general and reinsurance industries.

Many firms, particularly medium-sized and smaller firms, outsource their disaster recovery arrangements and have the same recovery-service provider and recovery sites. This creates concentration risk and heightens the risk of a more protracted disruption across the sector in the face of a widespread event.

Firms should consider their external dependencies, such as key suppliers of goods and services and providers of critical infrastructure, for example water, telecoms and power, when developing their business continuity plans. Failure of key infrastructures that are relied upon within the financial services industry, or restriction of a firm's access to those infrastructures, could also cause significant disruption to financial services. Increasing automation, continuing growth in transaction volumes and greater reliance on straight-through processing expose financial markets to infrastructure failure as manual work-arounds become less feasible. Given their central role, infrastructure providers should ensure they have robust business continuity arrangements in place. Similarly, those using the financial infrastructure should also have in place clear procedures for dealing with the failure of, or a disruption in, their access to a key financial infrastructure.

Major operational disruptions and financial crises are rarely localised events, and often have cross-border impacts which require a coordinated response from the authorities in the affected jurisdictions. While cross-border crisis resolution issues were not tested during the events of the second half of 2007, cross-border communications were tested and were generally found to be good. However, there are potential risks if lines of communication between international regulators are not well-established and maintained and if the responses of the authorities in different jurisdictions are not seen to be consistent and mutually reinforcing. This could delay stabilisation and recovery and undermine market confidence in the capacity of the financial authorities' ability to deal effectively with financial crises.

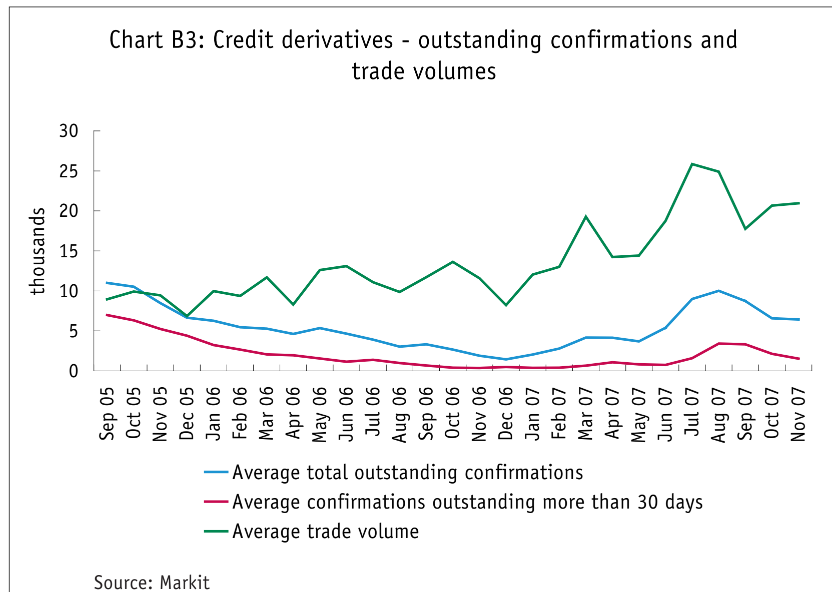
(credit derivatives were up 80% on average in the 12 months to November 2007) and progress towards improving back-office operations continues.

However, despite the improvements that firms have made to processes and the increased automation of credit derivative trade confirmations, back-office operations were unable to manage the increases in volumes during periods of heightened market volatility (March, July, and August 2007). This resulted in a sharp increase in backlogs.

Since then, firms have started to reduce their backlogs in spite of the historically high trade volumes. The industry continues to look at ways to make the credit derivative trade confirmation process more efficient by focusing on increasing straight-through processing and improving trade capture.

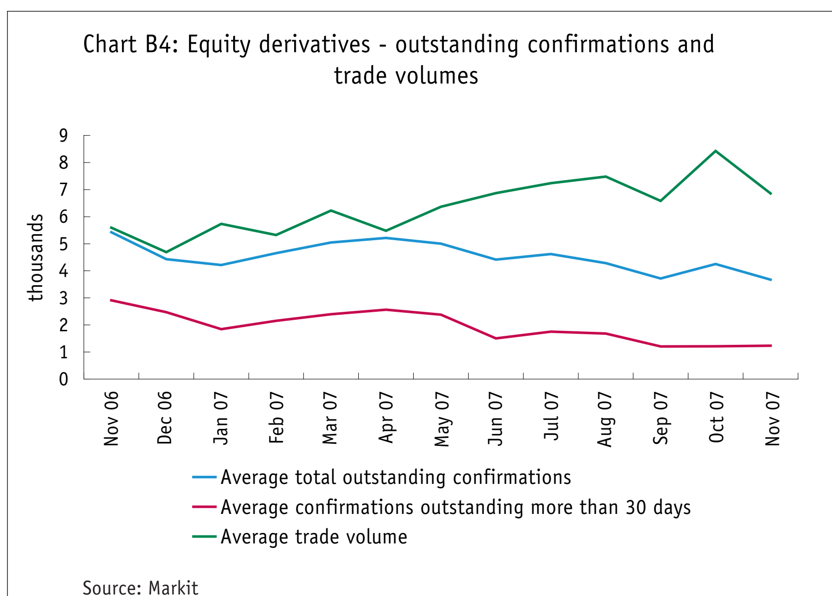
The equity derivatives market faces a different set of challenges compared with the credit derivatives market. These include a lack of standardised master confirmations, a more diverse client base with far fewer interbank trades and multiple electronic confirmation platform providers (which have been under utilised). The industry has made some progress in addressing these issues, but there is still much progress to be made before equity-derivative confirmation processes may be considered fully scalable. Currently less than 20% of equity derivative trades are electronically confirmed compared with 90% of credit derivatives.

Chart B3: Credit derivatives - outstanding confirmations and trade volumes



Source: Markit

Chart B4: Equity derivatives - outstanding confirmations and trade volumes



Source: Markit

Market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system

Maintaining market confidence is one of our statutory objectives, yet market confidence is difficult to measure and it is most visible at the extremes. Over the course of 2007 there was a transition from a situation where there was overconfidence in the market to the current situation where confidence is low. In particular, the events of the second half of 2007 revealed a marked decline in investor and consumer confidence in the markets, in some major financial institutions, and in the Tripartite authorities' ability to safeguard the financial system. This gives rise to a risk that should consumers lose confidence in some parts of the financial sector, in extreme circumstances they could disengage from those parts of the industry.

The events of the second half of 2007 raised questions about the effectiveness of the broader arrangements for regulation and the appropriateness of the Tripartite structure in the UK. These issues and proposed mitigations are discussed in the Tripartite banking reform consultation document, which is scheduled for release in early 2008.

Market confidence

Market participants' confidence in the financial system, and in the institutional arrangements to safeguard it, are central to maintaining financial stability. Adverse shocks, whether they are economic, market, or idiosyncratic events, are not necessarily financial stability risks, as long as the financial system is capable of absorbing those shocks and continuing to function effectively. However, if market confidence is weak, the probability of a financial stability risk crystallising rises.

In the previous edition of the *Financial Risk Outlook*, several of the risks we discussed related to underestimation and underpricing of risk. However, as has been discussed in Section A, *Economic and financial conditions*, market confidence became fragile in 2007, and all but disappeared in markets that were particularly exposed to problems in the US subprime mortgage market. The financial market dislocation that began as a deterioration in subprime mortgage credit quality in the US quickly spread first to other complex products referencing mortgages and then triggered a more general risk aversion in the markets worldwide. As has already been discussed in the *Priority Risk* on *Existing business models*, these events highlighted the importance of the accuracy and the clear understanding of credit ratings agencies' credit-risk assessments and the valuation of illiquid financial products to the maintenance of market confidence.

Under our *Central economic scenario*, there is a risk that, should market participants lose confidence, markets for certain retail and wholesale products could come under pressure, exacerbating already difficult circumstances for firms and consumers. Important market participants could also curtail or even stop trading in certain markets, which was the case in the European Covered Bond market when trading was suspended for two days in November 2007 amid concerns of market dislocation. There is also a risk that a lack of market confidence could result in investors not discriminating between different levels of risk with respect to different asset classes and institutions. This increases the risk of contagion spreading to markets whose fundamentals are otherwise sound.

Confidence in counterparties needs to be restored. This requires that investors judge that institutions have revealed their exposures, have confidence that recent capital injections into financial institutions are sufficient and will prove effective, and that the peak in future credit losses is manageable. Resolving some of the valuations issues raised in the *Priority Risk* on *Existing business models* is a key part of this process. If confidence fails to recover because these issues are not addressed and the business environment deteriorates further, this could magnify the transmission mechanisms of shocks to the markets and cause the repercussions of these shocks to be felt much more widely.

Consumer confidence

Consumer confidence in financial services is influenced by many different factors. Real or perceived failures in the retail financial market can reduce consumers' confidence in some parts of the financial services industry. For some consumers, it may be a reflection of their low financial capability in an environment where consumers bear an increasing responsibility for their own financial affairs.

In extreme circumstances, low consumer confidence in parts of the financial services industry could cause consumers to disengage with the industry. This did not happen in the case of Northern Rock, as consumer withdrawals from Northern Rock tended to flow into other deposit-taking institutions. However, a lack of confidence in long-term investments and pensions (following mis-selling cases of both personal pensions and mortgage endowments) at a time of rapidly rising house prices has caused some consumers to forego investment in a pension in favour of relying on the increase in equity in their homes for their long-term financial needs (refer also to the *Priority Risk* on *Consumer debt*). There is a risk that consumer confidence could fall if the general economic situation, particularly house-price inflation, deteriorates over the coming year.

The events surrounding Northern Rock demonstrated that consumers do not have confidence in the current framework for deposit protection. The Chancellor's guarantee of Northern Rock deposits is a short-term solution to this problem, and in the longer term, deposit compensation arrangements will be addressed through the Tripartite's work on banking reform.

However, even once consumers' confidence in the deposit protection scheme is reinforced, it is likely that the rise of electronic banking, more rapid communication of news and rumours over the internet will make retail deposits less 'sticky'. Firms should stress test their businesses (both their prudential soundness and their electronic infrastructure) accordingly.

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

Against the background of benign economic conditions in recent years, the stock of UK household debt has risen to record levels and there has been a sharp rise in defaults on unsecured credit. This largely predates any impact of tighter credit conditions and the interest rate increases of 2006 and the first seven months of 2007. Given the lags in the mortgage possessions process, it will take time for any problems to materialise. A growing number of consumers are likely to experience debt-repayment problems in 2008. This has implications, not only for consumers themselves, but also for the economy and credit providers.

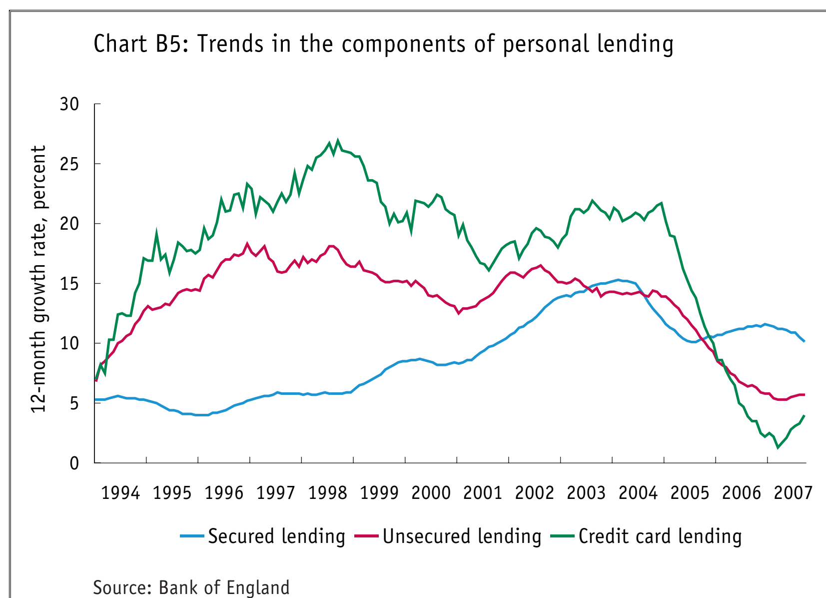
Economic conditions and borrowing

The UK economy has experienced a sustained period of economic stability, which has had a number of effects on consumer behaviour in retail financial markets. Continued house price appreciation, for example, has reinforced a strong belief in the value of investment in property to achieve both long- and short-term financial goals. Falls in house prices, and tighter lending standards would cause the number of customers in financial difficulty to rise (see the *Alternative scenario* on *Falling asset prices*).

At the same time, relatively low levels of unemployment and high levels of economic activity have boosted earnings, allowing many consumers to take on increased levels of personal debt. The period of relatively low interest rates has also led consumers to believe that the supply of cheap and readily available credit will continue. While this has helped to facilitate a maturing mortgage and consumer credit market, the savings ratio has declined sharply. We are concerned that many consumers are ill-prepared for a deterioration in economic conditions (refer to our *Central economic scenario*) and may have placed too much reliance on their ability to depend on cheap credit and housing wealth to sustain their consumption levels and investment plans.

Trends in secured and unsecured lending

Although current secured lending volumes remain robust (total secured borrowing stood at £1.18trn as of November 2007, an increase of 10.4% on the previous year), indicators of future secured lending, such as mortgage approvals, suggest that it is likely to slow sharply in the months to come. Due to the more restrictive market conditions, firms have now started to tighten lending standards on secured debt, which could result in some consumers seeking to substitute secured borrowing with unsecured borrowing (for example, personal loans and credit cards) to maintain expenditure. However, the growth in unsecured lending is also expected to moderate in the coming months.[3]



3 *Credit conditions survey 2007 Q4*, Bank of England, January 2008.

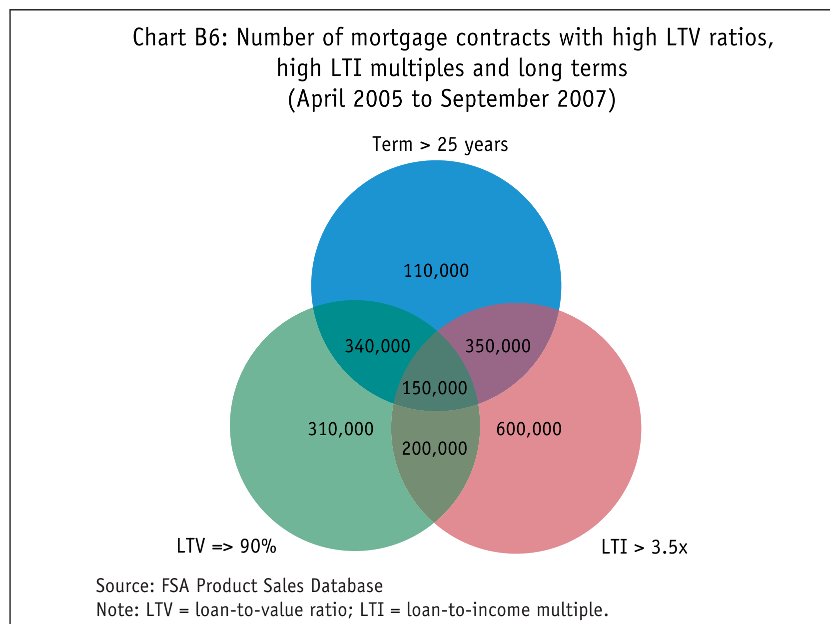
There is a risk that some consumers could find it difficult to meet their credit commitments due to tighter lending standards for both secured and unsecured credit. Moreover, there is an increased risk that consumers who cannot meet the revised lending criteria of either secured or unsecured lenders, or who have few remaining assets to secure further loans, could be forced to seek some form of debt resolution with their creditors. The numbers of mortgage repossessions, bankruptcies and IVAs could therefore rise further.

Trends in mortgage lending

In the last two to three years, the mortgage market in the UK has been characterised by rising sales overall, a greater appetite to meet the borrowing needs of a diverse customer base and increased product innovation. These factors and housing-market drivers have led to a rise in: average loan amounts; loan-to-income multiples (LTIs); and loan-to-value ratios (LTVs). The number of mortgages with these three characteristics has been increasing and there is also strong evidence that higher borrowing costs are being offset by increasing loan periods and a rise in interest-only mortgages.

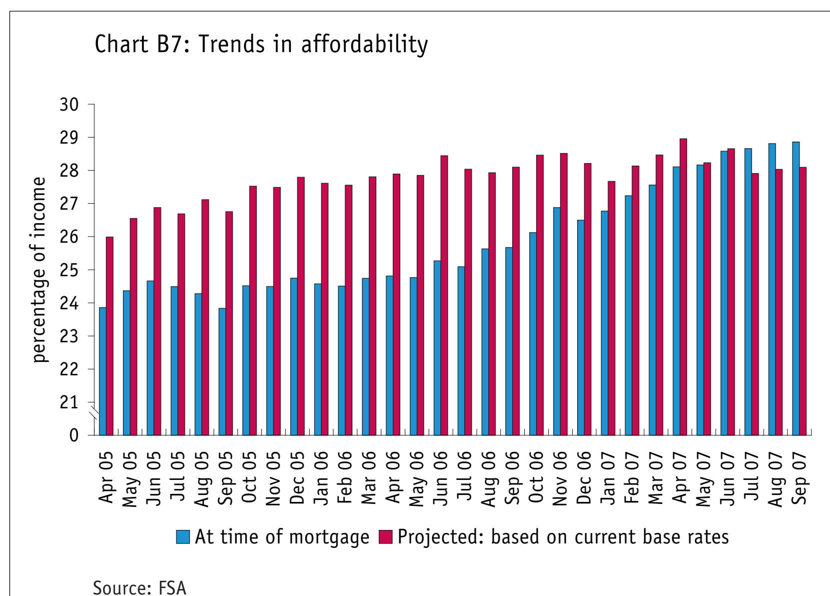
Taken in isolation each one of the three indicators may not represent significant consumer risks. However, where consumers exhibit two or more of these characteristics there is a greater cause for concern. The borrowers most likely to have all three of these characteristics are those that have the highest risks in terms of affordability and are most likely to default on loans. Collectively these indicators account for almost a third of new mortgage contracts written between the second quarter of 2005 and the third quarter of 2007.

Chart B6: Number of mortgage contracts with high LTV ratios, high LTI multiples and long terms (April 2005 to September 2007)



Source: FSA Product Sales Database
Note: LTV = loan-to-value ratio; LTI = loan-to-income multiple.

Chart B7: Trends in affordability



Source: FSA

The trends in new lending show that lending has been concentrated in groups which historically have not been homeowners with a mortgage.[4]

This increases the risk for firms that the default behaviour of new customers is not the same as traditional mortgage customers, and this may affect their assessment of risk and stress-testing results.

Changes in affordability

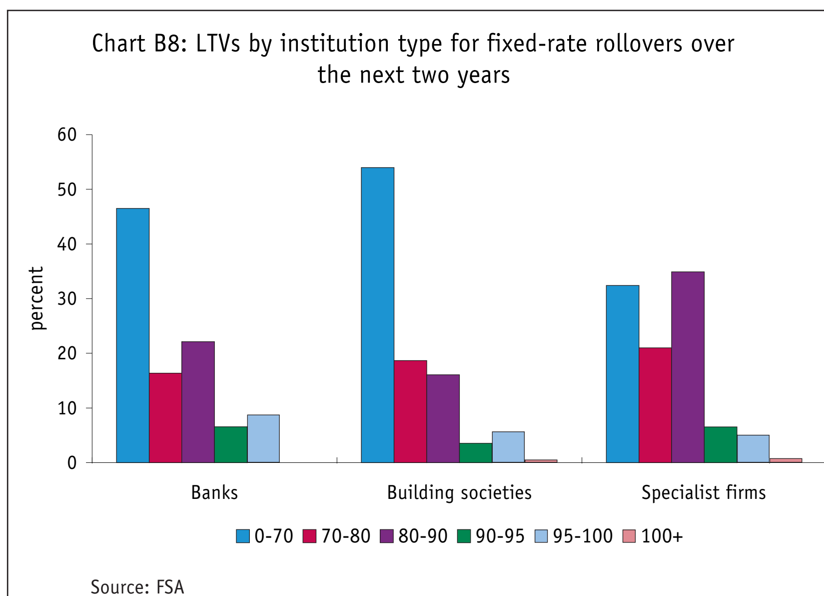
There is a risk that interest rates on mortgage loans could increase, reducing consumers' disposable income and increasing the pressures on affordability. Our analysis of the percentage of net income that consumers spend on their mortgage payments shows that, at the time a loan was taken out in 2005, the median repayment was around 24%

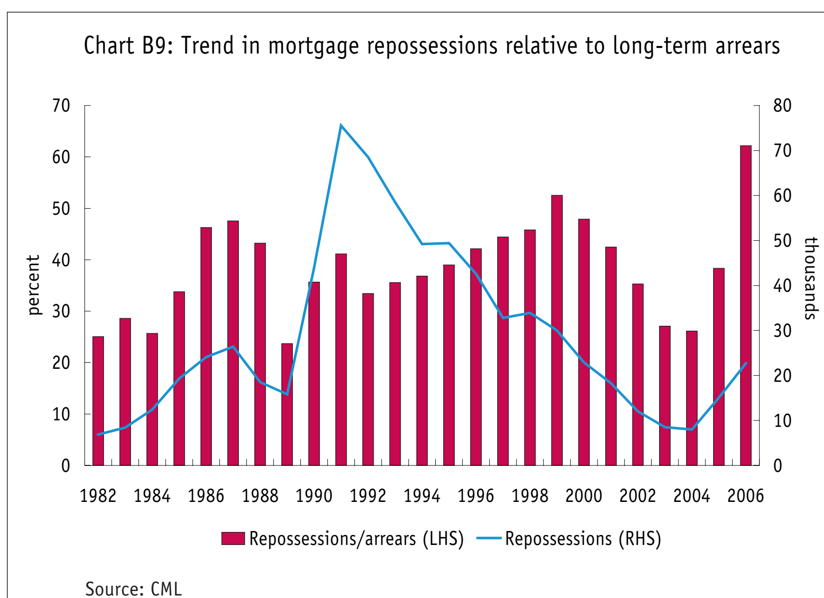
4 Our analysis of the types of borrowers that have taken out mortgage products is based on Experian Financial Strategy Segments, which categorises UK households according to their financial services behaviour, their income and their lifestyle.

of net income. For those on variable-rates, the interest rate increases in 2006 and 2007 have caused repayments to increase and mortgagors are paying around 27-29% of net income. An increase of a further 100bp would take the ratio to over 30%.[5]

An estimated 1.4mn short-term fixed-rate mortgages are due to mature in the next 12 months. We have estimated that mortgage payments would rise by approximately £210 per month as a result of the rise in market interest rates over the period since the consumer took out the fixed rate, were the fixed-rate mortgage to be replaced by a standard variable-rate mortgage. There is a risk that for some borrowers this will have a serious impact on the affordability of the loan for some time. Consumers near the end of a fixed rate (or other product with a fixed term) will need to start planning early to be able to cope with the potential increase in the cost of these products.

In addition to higher mortgage rates, many consumers are also faced with lenders lowering LTV ratios. There is a risk that some consumers could find it increasingly difficult to obtain funding given the tightening of lending criteria and the reduction in the LTV ratios. The cost of borrowing could rise significantly for this group, putting further pressure on affordability. The inability of firms to secure suitable funding to enable customers to roll over their fixed rates could also cause affordability concerns for these consumers.





Mortgage repossessions

While the level of repossessions is relatively low, there is evidence that the shift in mortgage lending has led to the sharp rise in mortgage repossessions seen since 2003. The Council of Mortgage Lenders (CML) reported that mortgage repossessions increased by 50% in 2006 and as a percentage of long-term arrears (arrears over six months) repossessions are now at their highest-ever level (approximately 60% of long-term arrears cases). This has occurred at a time when the economic environment has been relatively benign. As economic conditions deteriorate, we are likely to see an even greater increase in repossessions.

5 Around 40% of these mortgages currently enjoy a discount on the rate paid. When the discount period ends, the rate will be even higher.

Our analysis of individual repossessions cases shows that current consumer distress is focused on particular consumer groups rather than on particular types of lender. The characteristics of a bank or building society customer in distress are likely to be broadly similar to those of a customer of a specialist lender (although specialist lenders will have a greater concentration of those consumers most likely to be in distress). There is a risk that firms will not know the true financial position and credit profile of their customers as some consumers will have several loans with many different lenders. Our analysis shows that the repossession process can take a year, which means that a new lender may not be aware of a consumer's impending repossession order and their true credit profile when making a new loan. Lenders should make adjustments for this uncertainty in their stress testing.

There is a concern that not all lenders are treating their customers fairly when recovering bad debts (both secured and unsecured). Reports from various consumer groups suggest that some lenders' collection departments are not necessarily treating customers fairly in their efforts to secure payments on outstanding debts. This could lead to lenders being exposed to both reputational risk and possible breach of criminal laws and our rules.

Tighter economic conditions could increase the incidence or discovery of some types of financial crime or lead to firms' resources being diverted away from tackling financial crime

Increasing financial pressures on firms, employees and consumers could increase the motivation of some to commit financial crime, including market abuse and fraud. At the same time, the consequences of crimes committed under the more benign conditions in previous years may be more likely to come to light when firms are faced with more difficult economic conditions. There is a risk that resources may be diverted away from tackling financial crime given these pressures on firms. It is important that intelligence providers, policymakers and industry continue to work together to find ways of making the necessary intelligence available to the financial services industry, so that firms can make the best use of their resources to address financial crime.

Market abuse

There is a risk to wider market confidence if investors do not have confidence in the cleanliness of the markets. This risk is heightened when market volatility is high as both the opportunity for and harm caused by market abuse increase. While identifying and then successfully proving market abuse is difficult, we aim to achieve credible deterrence using all the options available to us. In this context, it is very important that firms have a strong focus on effective anti-market abuse systems and controls. Those firms that do not could face high legal, reputational and regulatory risk.

In the second half of 2007, we conducted a review of a cross section of hedge fund managers to assess their anti-market abuse systems and controls.[6] We found that the mitigation of market abuse was not sufficiently high on the list of priorities for senior management at some firms. The controls around inside information received by firms were also sometimes weak and the quality of training provided was at times lacking.

There is a particular need to strengthen the controls over inside information relating to public takeovers where the leakage of information is too prevalent. Many firms are complacent about the strength of their own controls in this area and may underestimate the threat from organised financial criminals who seek the information. Weaknesses in controls include the large number of insiders on deals, the ease of access to sensitive information on IT systems, insufficient training and a need to enhance personal-account dealing policies. All firms who are 'insiders' on such deals should undertake a detailed review of their systems and controls and compare them to the findings of our thematic work.[7] Firms also need to focus on ensuring that there is sufficient focus on training.

Given the more difficult market conditions, all listed issuers, in particular financial services firms, need to pay particular attention to ensuring they have appropriate systems and controls in place so that they meet their announcement obligations with respect to the disclosure of inside information. Regulated firms also need to be alert to the risk of a dissemination of false or misleading information or transactions undertaken that may be designed to give a false or misleading impression or distort the market in a security. Tackling market abuse is a collaborative effort between us and the market and firms need to ensure they are equipped to identify and report suspicious transactions to us.

Criminal financing and profits

The risk of UK financial services firms being used to launder the proceeds of crime remains very high. While it is difficult to determine trends in the total amount of money laundered in the UK, the major related offences

6 *Visits to Hedge Fund Managers*, FSA Market Watch Issue No. 24, October 2007.
7 *Thematic review of controls over inside information relating to public takeovers*, FSA Market Watch Issue No. 21, July 2007.

provide a guide to the scale of the problem; the direct losses from fraud in the UK are estimated to have been over £13bn in 2005,[8] while the size of the illicit drugs market is estimated to have been £5.3bn in 2003.[9] Money from crimes committed elsewhere in the world may also be laundered through the UK.

The Money Laundering Regulations 2007 should make it more difficult for criminals to launder funds through firms in the UK. However, as anti-money laundering (AML) controls improve, criminals will look to exploit the weakest points in the system and there is a risk of displacement to sectors that have previously been considered lower risk. Firms in all areas of financial services need to regularly reassess the risk to their business and ensure that they are effectively mitigating that risk. Trade-based money laundering (for example, the misrepresentation of the price, quantity or quality of imports or exports) could become increasingly attractive to criminals as other opportunities for money laundering diminish.[10]

The number of individuals in the UK believed by the Security Service to pose a direct threat to national security and public safety because of their support for terrorism increased from 1,600 in November 2006 to 2,000 in November 2007.[11] Firms face the continued risk that they may be used to transfer funds within the UK or internationally for terrorist activities and that they may be defrauded in order to finance terrorism. The amount of money needed can range from relatively small amounts for specific acts to larger sums for funding and maintaining terrorist infrastructure.

As understanding of financial crime risk evolves, the scope of the risks that firms are expected to assess and to mitigate has increased. While this increase in scope should facilitate a more comprehensive approach to combating financial crime it may also increase the challenges for firms. International efforts to combat corruption combined with the continuing development of the UK's legal framework on corruption may increase the level of interest in the financial services sector's efforts to combat corruption and bribery. There is a risk that firms could come under pressure to pay bribes, especially if they are operating in jurisdictions where paying bribes is widely expected. In addition, financial services firms may launder the proceeds of corruption or be used to transmit bribes.

The increasing emphasis on sanctions, both domestically and internationally, could lead to a renewed focus by governments on what financial services firms are doing to comply. The UK Government has increased the resources it allocates to this issue and created a dedicated Asset Freezing Unit. The number of individuals and entities on the UK's consolidated sanctions list increased from 1,642 to 1,738 during 2007 and is expected to increase further in 2008.[12]

We are seeing increasing evidence of attempts by firms and individuals of questionable integrity, often from jurisdictions for which it is difficult to undertake effective due diligence, either to take control of UK financial services firms or to list on the UK's markets. This could increase the risk of financial crime being committed in the UK and present a threat to the integrity of the UK's financial system.

Fraud

Increasing financial pressure arising from less benign market conditions may increase the motivation of some firms, employees and consumers to commit fraud and may increase the vulnerability of some consumers when targeted by fraudsters. Firms may also uncover and be more vulnerable to the consequences of fraud that has already been committed. We expect that the creation of the National Fraud Strategic Authority will improve the coordination of anti-fraud activity in the UK and that in time this will facilitate proportionate public and private sector investment in fraud prevention, detection and prosecution. However, fraud will remain a significant financial crime risk for the foreseeable future.

Personal data remains a high value commodity for criminals, with both the market in consumer details and the technology used by criminals continuing to evolve. It is estimated that identity fraud costs the UK economy £1.7bn per year.[13] Loss of customers' personal data can lead to significant distress for the

8 *The Nature, Extent and Economic Impact of Fraud in the UK*, Michael Levi, John Burrows, Matthew H. Fleming and Matthew Hopkins, Report for the Association of Chief Police Officers' Economic Crime Portfolio, February 2007.
9 Home Office analysis.
10 *Trade Based Money Laundering*, Financial Action Task Force, 23 June 2006.
11 *Intelligence, counter-terrorism and trust*, address to the Society of Editors by Jonathan Evans, Director General of the Security Service, 5 November 2007.
12 HM Treasury data.
13 *Updated estimate of the cost of identity fraud to the UK economy*, Home Office Identity Fraud Steering Committee, February 2006.

customers involved and may also affect their willingness to use alternative delivery channels for financial services; almost one in three internet users say they have not done their banking online due to their fears about safety and security.[14] There is a risk that consumers do not have sufficient understanding of how to prevent their data being used for criminal purposes; the growth of online social networking, for example, is leading to consumers putting more of their personal data in the public domain.

Data loss can also lead to financial loss and reputational damage for the firm involved. Although firms are becoming more aware of the risks associated with data loss, all but the largest firms are failing to anticipate innovations by criminals committing identity fraud. There is also a risk that financial services firms do not have sufficient controls to authenticate the identity of their customers in order to prevent criminals making use of stolen data. In this context, consumer data lost by non-financial organisations also presents a threat to financial services firms.

In 2007, we received approximately 6,500 consumer enquiries on the subject of 'boiler room fraud', in which high-pressure sales techniques are used by unauthorised entities to persuade consumers to invest in shares that have little or no value. Victims of boiler room fraud can lose their life savings and, because boiler rooms are unregulated, the victims are not eligible for compensation from the Financial Services Compensation Scheme (FSCS). Moreover, there is a risk that awareness of boiler room fraud may discourage consumers from investing in legitimate shares.

Organised property fraud is an area where we are seeing increased activity (see box below). The potential for criminal gain from this type of crime suggests that it is likely to increase unless coordinated action is taken by public and private sector agencies, and unless the adequacy of systems and controls in financial services firms is ensured. We are working in partnership with a wide range of private and public sector bodies to increase the level of coordination in tackling organised property fraud and to improve the effectiveness of our joint response.

Organised property fraud

Our analysis of mortgage repossessions (discussed in more detail in the *Priority Risk* on *Consumer debt*) has revealed instances of organised property fraud. There is a risk that this criminal gain may be used to fund other criminal activity. Organised property fraud is most common in new-build and purpose-built flats in major towns and cities and where renting is the main form of tenure. We have found that losses on this type of property tend to be higher than for other types of property. We estimate that average losses for purpose-built flats are around £45,000 on the sale of the property alone and this loss has been rising over time.

Since April 2005, we have required mortgage lenders to provide data on individual mortgages (excluding buy-to-let). Using this, together with data from the Land Registry, we have been able to look at purchasing behaviour in blocks of flats with high concentrations of repossessions. Analysis of the data shows that particular introducers are often sourcing multiple mortgage applications for residential mortgages in the same building. This behaviour is suspicious because these mortgages are often taken out on the same day, on the same properties, but in very different parts of the country from the introducer's and buyer's base. The mortgages tend to be first-time buyer, interest-only mortgages.

In some cases, Land Registry data shows two property transactions on the same day, at substantially different amounts for the same property, with the mortgage being arranged for the higher of these amounts. The mortgages appear to be issued to individuals who provide false information to the lenders on their status and income. Our own investigations suggest that in a number of instances these individuals do not actually exist.

The size of the problem is difficult to quantify, but we anticipate that the criminals' gain from this type of fraud is very significant. The cost to the financial services industry could be even greater after taking account of lost interest and other costs.

14 *Get Safe Online Report 2007*, Get Safe Online, November 2007.

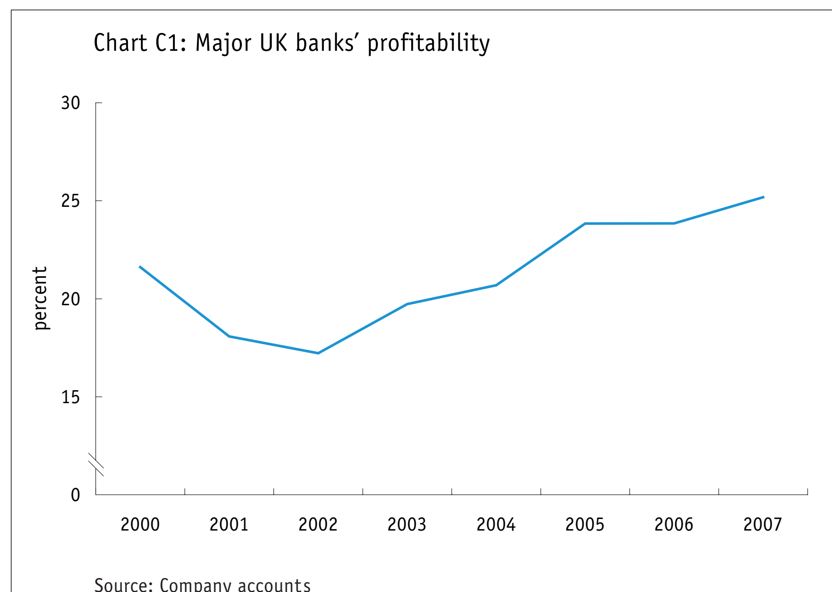
Industry focus

Banks and building societies

Following one of the most prolonged positive markets for banking, the events of the second half of 2007 led to an abrupt deterioration in the business environment for both retail and investment banks. The industry now faces the most difficult conditions seen since the early 1990s and it would be prudent for banks and building societies to assume that the business environment will remain difficult for a sustained period. The market events have raised fundamental questions about some banks' and building societies' business models, and presented senior management and the Boards of financial firms with new challenges in managing liquidity, capital and asset quality.

Profitability, capital and gearing

The profitability of the major UK banks, as measured by pre-tax return on equity, continued to rise, reaching 25.2% in the first half of 2007. However, the market dislocation of the second half of 2007 will have put pressure on profitability for many institutions, as a result of higher funding costs and higher asset writedowns, the latter mainly in the area of structured credit. Growth in retail lending and investment banking activities also slowed sharply towards the end of 2007 as credit conditions tightened. Although there may be some recovery in net interest margins (which continued to decline for the major UK banks during the first half of 2007), the benefits may be more than offset by falling volumes.



Pressures on profitability are likely to continue in 2008. Under our *Central economic scenario* we expect a continuing slowdown in the rate of growth of lending in the UK and a marked decrease in fee income. If market conditions remain difficult for a prolonged period, the downside risks to this scenario will increase. Higher funding costs are already undermining the profitability of lending activities that have tight margins, such as mortgages. The more cautious approach to risk may lead to an increase in margins and improve profitability on individual transactions but may not suffice to offset the slowdown in loan volume. Banks are likely to respond by cutting costs, but scope may be limited by the extent of previous cost cutting and by the pressures on staff dealing with the other issues faced by the industry.

Banks face a challenge in adapting to this changed operating environment, and in managing the expectations of shareholders and other stakeholders. There is a risk that banks may attempt to maintain profits and returns to shareholders by undertaking high-risk activities without full risk assessments and without having the appropriate systems and controls in place.

Under Basel I measures, the major UK banks' total capital ratios remained stable at 12.4% as at June 2007; the tier 1 ratio also remained steady at 8.0%. Loan losses and the move to more risk-sensitive approaches to capital calculation in the Capital Requirements Directive/Basel II will, however, lead to a decline in some banks' ratios. Concerns have also been expressed that the measures of risk used by companies and regulators to determine banks' capital requirements under Basel II could be pro-cyclical. We will continue to monitor the situation with the Bank of England.

Banks will need to pay close attention to the management of their capital to ensure that they meet both economic and regulatory capital requirements over the longer term, particularly if the speed of recovery from the market dislocation is slower than expected. Senior management need to ensure that they fully understand the impact of Basel II and have a robust capital plan in place. The robustness of banks' capital will largely determine their scope to extend credit to the household and corporate sectors. Some of the larger global firms have already taken steps to raise capital to maintain desired capital cushions. Senior management should also ensure that their firms maintain an appropriate mix of capital so as to avoid becoming over-reliant on hybrid capital and other forms of innovative financing, which are less able to absorb shocks compared with core equity capital.

Banks' and building societies' business models

The *Priority Risk* on *Existing business models* discussed the uncertain outlook for some of the banks' business models, notably the 'originate and distribute' model employed in structured finance and across a range of lending activities. Meanwhile, the building societies' business model has provided some benefits in the more difficult operating conditions. Building societies are required by statute to take the majority of funding from retail sources, and some may therefore be less exposed to higher wholesale funding costs. As mutual institutions they may find it easier to withstand a period of low returns by curtailing growth, as long as costs are similarly controlled. However, given their focus on mortgage lending, they are exposed to any cooling of the UK mortgage market, as well as to increasing competition for retail deposits and savings. To offset diminishing returns from their traditional markets, some building societies have increased their business in higher-risk areas, such as buy-to-let or commercial property lending, although from a low base. These exposures could be costly in impairment charges should there be a sustained property market downturn.

Another business line for banks and building societies, the distribution of retail investment products, is covered by our Retail Distribution Review. This is discussed in the *Industry focus* on *Retail intermediaries* and many of the issues which it is considering, such as the pressure on profitability and low levels of trust in advice among consumers, are also relevant to banks and building societies. We hope that our Review will act as a catalyst for the generation of market solutions to these issues by the banks and building societies as well as by other retail intermediaries, although we recognise that regulation may have to change to facilitate this.

Retail banks are also facing uncertainty about the outlook for the so-called 'free banking' model. Under this model banks have packaged a set of services into a single current account designed to handle customers' cash-management needs, including payment transactions (for example, cheques, ATM withdrawals, direct debits and standing orders) and an agreed overdraft. Most elements of the current account are 'free' in the sense that they do not carry an explicit charge. Banks do not explicitly charge for account maintenance or for payment transactions, nor do they charge a commitment fee for the overdraft line provided. Equally, customers receive no or very little

interest on the average balance held in the current account. Explicit charges are used for overdrafts when drawn and other items such as stopped cheques.

This model relies on cross-subsidisation, with income from charges allowing banks to provide the majority of transactional banking services at no explicit cost to the customer. However, there is growing pressure on retail banks to unwind cross-subsidies between customers in response to action by regulatory bodies and some resistance from consumers and consumer groups. The Office of Fair Trading (OFT), for example, has taken action on credit card charges and has launched a test case into the fairness of unauthorised overdraft charges under the Unfair Terms in Consumer Contract Regulations (UTCCR). If the court rules against the banks in the test case and banks can no longer levy these charges, they will need to replace this lost income stream. Banks will need to plan and stress test for all possible outcomes of the court case.

In addition to the UTCCR investigation, the OFT is conducting a market study into pricing by banks. While the study is focused on personal current accounts, it is also likely to include an examination of the links between personal current accounts and other retail banking products. This is to ensure the competitive dynamics of UK retail banking and the impact of the current ‘free banking’ model on competition and consumers are included in the study.

Banks will need to adjust their business models to take these changes into account. One option could be to introduce fees for personal current accounts, either across the board or for customers that do not maintain a certain credit balance. This is not without risks for the banks, since consumers would be likely to switch from fee-charging banks to non-fee-charging banks and the timing of any changes will be important. The introduction of charges for personal current accounts could also have implications for financial inclusion as some customers may not be able to afford to pay for banking services. Whatever strategy is adopted, banks will need to be mindful of their obligations to treat customers fairly and the OFT’s requirements for a competitive market.

Liquidity and funding

The availability of wholesale funding became severely restricted and the cost of funding rose significantly for many banks as a result of the liquidity crisis in the second half of 2007. There is a risk that this market dislocation could continue to pose difficulties for banks in securing funding from the interbank or other wholesale markets, including the markets for the securitisation of RMBS and commercial mortgage backed securities (CMBS). The cost of funds raised is also likely to be significantly higher than was originally estimated. It is important that banks have in place funding plans for both the short and medium term and mitigate market-wide liquidity risk in the future. In the longer term, banks need to ensure diverse funding sources and may need to rebalance their business model accordingly (refer to the *Priority Risk* on *Existing business models*).

There is a need for both banks and the authorities to review liquidity management.[1] For their part, banks will need to consider issues such as the appropriate balance between wholesale and retail funding, and consider how their funding policies might be improved in order to provide greater resilience to shocks. They will need to strengthen their stress-testing practices in this area, and translate them into detailed contingency funding plans in order for them to be effective. Stress testing is discussed in more detail in the *Priority Risk* on *Increased financial pressures*.

The liquidity crisis has highlighted the importance of maintaining the confidence both of counterparties in the wholesale markets, and of savers and customers in the retail deposit market, as discussed in the *Priority Risk* on *Loss of confidence*. Confidence in the banking system of both investors and depositors has been severely reduced by the problems at Northern Rock.

Lending and asset quality

The volume of lending to the personal sector remained broadly stable in the first three quarters of 2007, with a small decline in secured lending and a recovery in unsecured lending. However, surveys show that a slowdown in secured lending began with the arrival of the market dislocation, particularly in personal lending but also in areas such as leveraged lending for private equity buyouts. This is a reflection partly of tightening lending standards and higher margins as a result of the reappraisal of risk taking place in the market, as well as anxiety about future funding conditions.

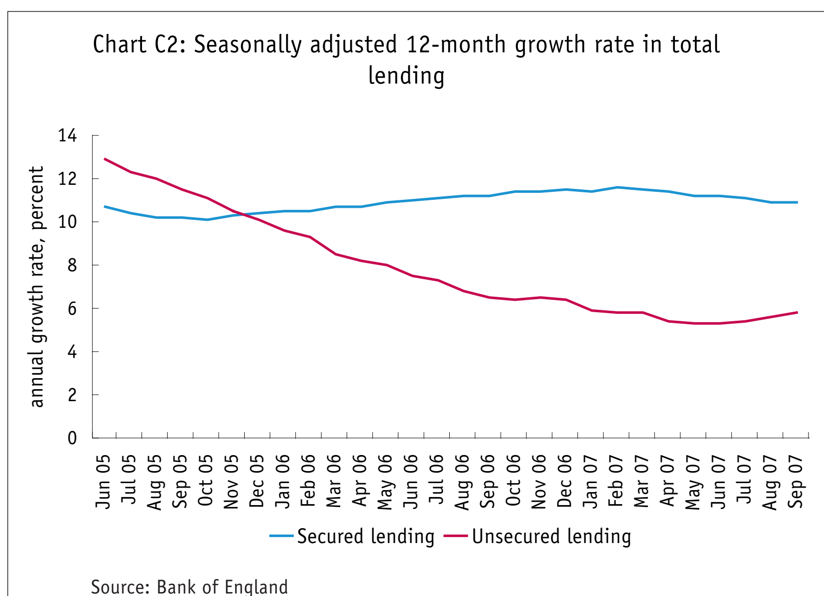
1 *Review of the liquidity requirements for banks and building societies*, FSA Discussion Paper 07/7, December 2007.

Even allowing for the limited exposures of UK banks to the US subprime market, the asset quality of UK banks remained generally strong throughout 2007. However, there is increasing evidence that asset quality, most notably mortgage arrears, began to deteriorate in the last quarter of 2007 and this trend is likely to continue in 2008. It is also likely that corporate default rates, which are still near historic lows, will increase as distressed credits find it harder to obtain rescue financing given the reduced availability of credit. The combination of a deterioration in asset quality and a slowdown in lending volumes poses a significant earnings risk for firms. To a limited extent, this will be offset by an improvement in margins as a result of the repricing of risk, which in turn will help to improve asset quality over time.

The asset quality of secured lending remained strong in the UK housing market for most of 2007. However, worries about affordability are rising, as discussed in the *Priority Risk* on *Consumer debt*. Market expectations of further interest rate cuts by the Bank of England are partly offset by the forthcoming repricing of many fixed-rate mortgages. Furthermore, many variable-rate mortgages are priced off LIBOR (as opposed to the base rate) and this remains at an elevated level in the current market.

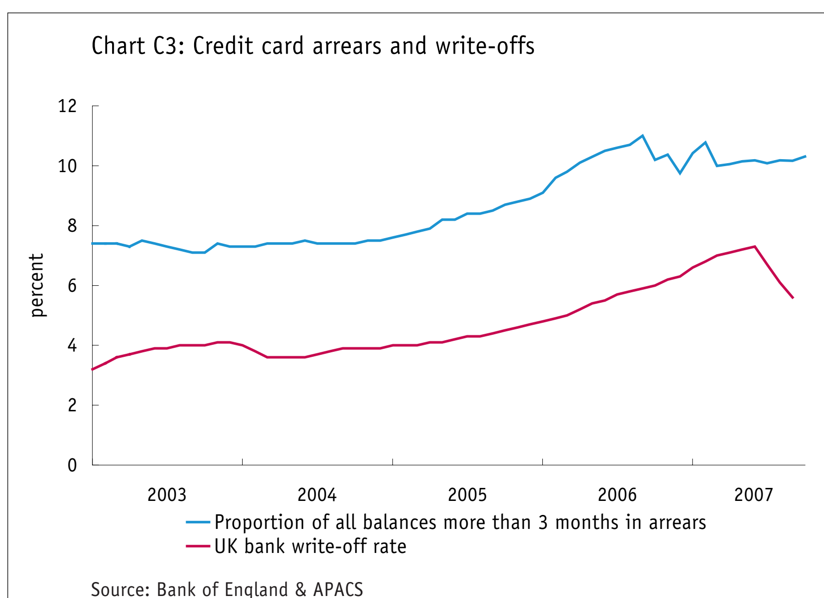
Over the past four years, asset quality has deteriorated sharply in unsecured lending. Although credit card write-offs fell in the third quarter of 2007, they still remain at high levels. This could be due to a number of factors which have stretched consumers' ability to repay credit, such as the rising interest rate environment and rising fuel and utility bills.

Chart C2: Seasonally adjusted 12-month growth rate in total lending



Source: Bank of England

Chart C3: Credit card arrears and write-offs

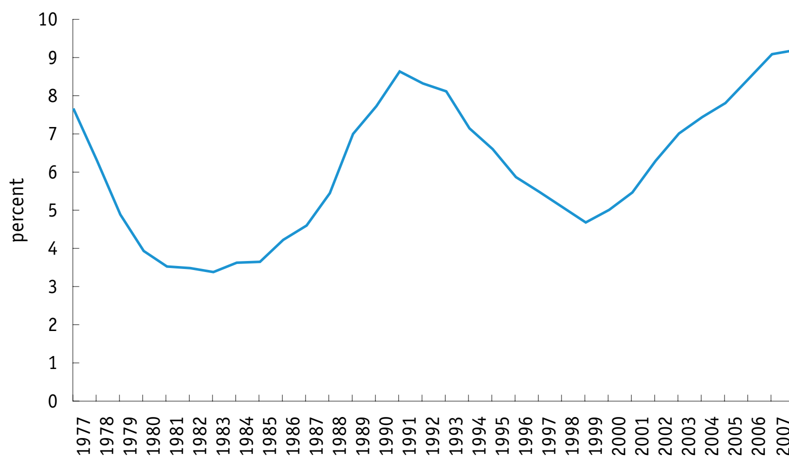


Source: Bank of England & APACS

UK commercial property lending by banks has increased rapidly over recent years and as a percentage of total UK lending it is now over its 1990 peak. After slowing slightly, the rate of growth of lending by the major UK banks rose again, to reach 15.5% in the third quarter of 2007. However, commercial property prices have now begun to fall. In November 2007, commercial property prices fell by 4%, the largest monthly fall on record.[2]

The impact of a property downturn on banks could be exacerbated by the fact that the proportion of speculative lending (for unlet properties) has been rising, although it is still below the proportion seen in the early 1990s. Arrears rose in 2007 and there is a risk that banks will face increased impairment charges in 2008. Commercial property companies are likely to experience weaker rental income, mainly through a rise in vacancies, leaving them less able to service

2 Investment Property Databank.



their borrowings. This could further increase UK banks' exposures to commercial property if outstanding credit back-up facilities to UK property companies are drawn down. The impact of falling commercial property prices on CMBS could also affect banks' profitability. This could lead to similar problems for securitisation and CDOs of CMBS to those that we have recently experienced in the RMBS market.

Corporate lending growth (excluding lending to other financial companies) has fallen from an annual rate of around 20% three years ago to 11.4% in the year to August 2007. This was partly the result of the slowdown in commercial property lending, but also the consequence of an abrupt slowing in lending for leveraged finance. Rising concern about the prices being paid for leveraged buyout (LBO) loans and also about the level of leverage used in many deals led to an abrupt collapse of investor interest in this product in June/July 2007. Globally, the banks active in this market have been left with a stock of leveraged loans to which they were committed, but now face difficulties in selling. There has been only limited progress in selling this stock of 'pipeline' loans, which some estimates put at almost US$170bn (at end November 2007). As yields on high yield bonds have risen, banks may have to cut prices to deal with this stock, or keep them on their balance sheets. The latter course of action would limit banks' capacity to take on new business.

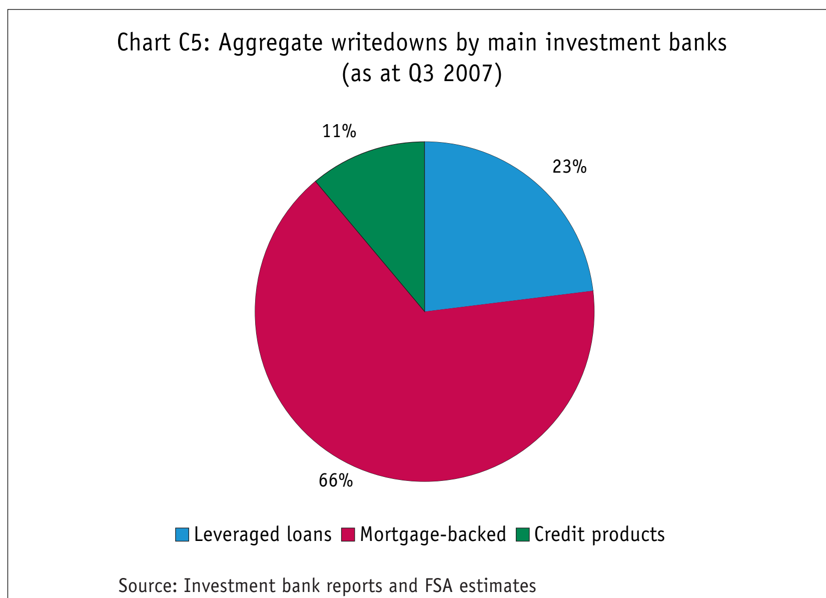
There is strong anecdotal evidence that firms are becoming more selective about the risks that they take on, and are endeavouring to ensure that the pricing and terms of loans reflect the underlying risks more accurately than has generally been the case in the recent past. As discussed in the *Alternative scenario*, *Availability of credit*, this tightening of credit could lead to a slowdown in corporate and consumer borrowing, thus increasing the risk of an economic slowdown. It is important that, in responding to the changed financial environment, firms do not switch from relatively slack lending standards to overly cautious lending standards. However, a more careful approach to risk assessment is a necessary condition for an improvement in the quality of balance sheets and the restoration of confidence in the banking industry more generally.

Investment banking

Investment banking faced an increasingly difficult operating environment in the second half of 2007 as the shocks from the subprime crisis spread and demand for structured products and LBO loans diminished. Some of the leading global investment banks were obliged to take losses of some US$28bn in the third quarter of 2007, principally on structured products and leveraged loans. Since then, further significant losses have been announced by some firms, and more are likely to follow. Investment banks will also be affected by reduced transaction volumes; most investment banking business models (for example, 'originate and distribute') rely on a sustained deal flow and a rapid turnaround of deals which are warehoused on their balance sheets prior to sale.

Indications of rising risk in the business environment can be seen in an increasing ratio of net Value-at-Risk (VaR) to tangible equity after the second half of 2006. This was mostly due to increased interest rate, exchange rate, and equity volatility. Unlike in previous years, the rate of increase of VaR exceeded the increase in investment banks' tangible equity. By August 2007 the net VaR/tangible equity ratio had risen to the level last seen in early 2002. Since market volatility is a major component of VaR models, it is likely that VaR will increase further as the impact of current conditions feeds through.

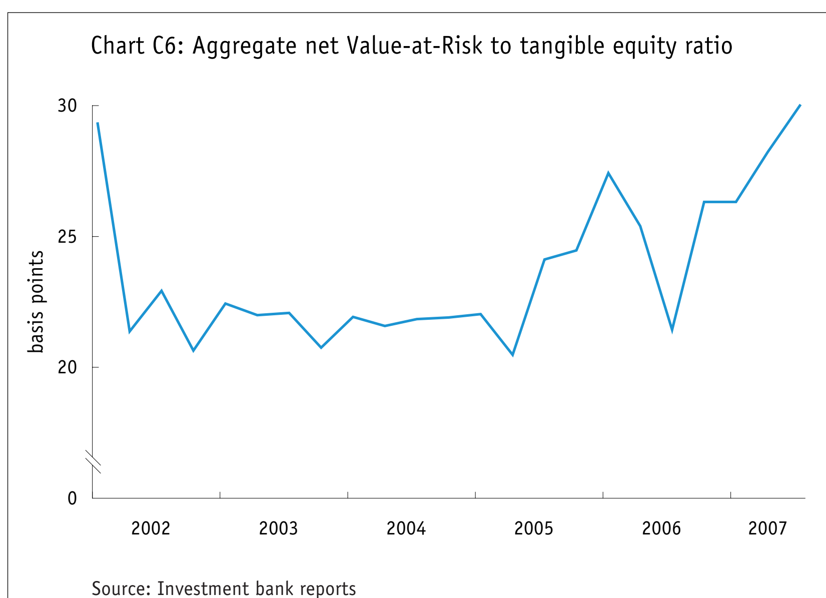
Chart C5: Aggregate writedowns by main investment banks (as at Q3 2007)



Source: Investment bank reports and FSA estimates

Investment banking faces an uncertain environment and a number of significant risks over the next 18 months. Macroeconomic risks, such as a severe downturn in the US with spillovers to other markets, could cause both a reduction in demand for banks' services worldwide and losses in their portfolio holdings. A downturn in the US could further exacerbate strains on the US housing market and also lead to a downward adjustment of the US commercial property market, with consequent downgrades and falls in values of CMBS. The problems in the US housing and commercial property markets have already spilled over to Europe and affected investment banking activities here.

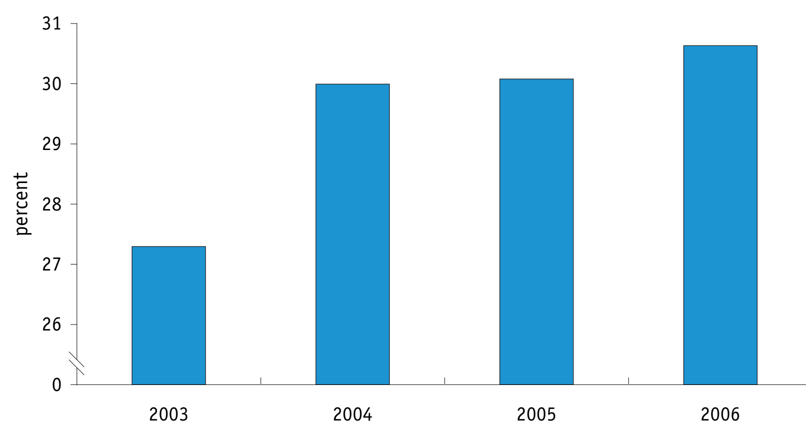
Chart C6: Aggregate net Value-at-Risk to tangible equity ratio



Source: Investment bank reports

While capital positions of many investment banks remain sound, a key balance sheet risk is that if the problems related to the subprime crisis and structured products are not resolved quickly, further writedowns will be needed. The difficulties that investment banks face may also lead to de-leveraging. Investment banks are now operating with an increased leverage compared with the beginning of the decade.

Investment banking earnings have tended to be more volatile than those of commercial banking operations, and it is argued that the remuneration policies of investment banking firms, or units within firms, are designed to make costs similarly flexible. There are indications, however, that remuneration charges are not necessarily adjusting commensurately with falls in earnings. More fundamentally, there is a concern over whether investment banking remuneration policies provide the right incentives for risk assessment. Bonus awards typically reflect performance during the year in question and, in the absence of a short-term indicator which can reflect quality, are often based on business volumes. The size of bonuses can be a powerful incentive for staff to focus on the quantity of business that they may undertake during a year, and pay less attention to its quality. There is a concern that in some cases remuneration policies can work against the systems and controls that have been put in place in order to control risk.



Key messages for banks and building societies

- Banks should assume that the operating environment will remain difficult for a sustained period and therefore plan accordingly. Some may find that the cumulative effect of the deterioration in the business environment requires them to raise capital. Firms need to be prepared to take the decisions necessary to deliver the capital required to support sound future business strategies.
- Banks need to have funding plans in place for both the short and medium term which have been stress tested against the risk that the availability of funding remains restricted and more costly than before the onset of the market dislocation. In the longer term, banks need to ensure diverse funding sources and may need to rebalance their business models accordingly.
- A more careful approach to risk assessment and management than has been evident in the recent past is a necessary condition for an improvement in the quality of balance sheets and the restoration of confidence in the banking sector more generally.
- Firms need to maintain the momentum in improving their stress and scenario testing. In particular, many firms are still failing to consider sufficiently stressful and forward-looking scenarios in their stress-testing work.
- Treating customers fairly should continue to be a key priority for banks and building societies. A reappraisal of risk and a tightening of lending criteria will need to be applied in parallel with sensitive handling of customers who may now be facing repayment difficulties as a result of lending by banks and building societies in previous years, sometimes on terms which they may now recognise to have been inappropriate.
- Like their counterparts in commercial banking, investment banks should work on the assumption that their business environment will remain difficult for a sustained period. They must address important questions about the future of the investment banking business model and adjust their strategies accordingly.
- Investment banking businesses should look afresh at their remuneration policies, partly to consider whether they provide the right incentives for risk assessment and partly to reflect the need for their cost base to adapt to earnings volatility.
- Banks should continue to seek fair and independent valuations for structured finance and other illiquid products, and ensure that controls are in place to provide clients with valuations that are fair, clear and not misleading.
- Banks need to ensure that they continue to focus on improving anti-market abuse systems and control inside information.

Retail intermediaries

Many financial products are complex and consumers can often find it difficult to choose, negotiate or 'shop around' for suitable financial products. Consumers can also be disadvantaged by information asymmetries that exist between themselves and financial providers and distributors. The retail intermediary industry therefore plays an important role in helping consumers to meet their financial needs. However, the industry faces a number of issues, for example adapting business models to the less benign financial conditions, improving management and oversight and improving the quality of advice. The pervasiveness of small firms in the retail intermediary sector makes it particularly susceptible to these issues, especially in the context of recent market conditions.

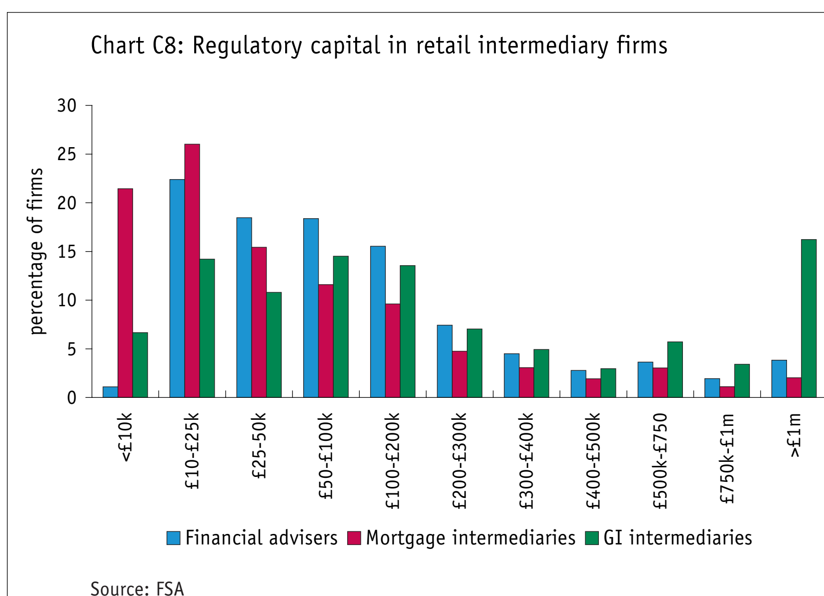
Sustainability and resources

A strong, well-functioning retail distribution market is important in ensuring that consumers can access high-quality financial products that meet their needs, with retail intermediaries playing a crucial role in the success of this market. However there are some widely recognised risks to the sustainability of the industry, some of which we have previously highlighted. For example, the lack of persistency of pensions and long-term investment policies, the impact of competition from comparison websites in the general insurance market, and pressure on profitability for both financial advisers and general insurance brokers.

Many firms pay insufficient attention to the sustainability of their business model, particularly in terms of ensuring that it is capable of surviving changes in the economic environment, or other factors that might lead to a downturn in profitability. To some extent this problem has been hidden in recent years, as benign economic conditions have meant that consumer confidence has been high, bolstered by a greater propensity to take on increased amounts of debt to support higher levels of expenditure (this is discussed in more detail in our *Priority Risk* on *Consumer debt*). With a less benign economic outlook (see *Economic and financial conditions*), there is an increased likelihood of this risk crystallising, making it more difficult for firms to sustain a profitable and compliant business. The mortgage intermediary industry will be particularly at risk if a combination of pressure on house prices, tighter credit conditions, lower consumer confidence and high levels of personal debt means that both demand and supply of mortgages decline in 2008.

Regulatory reporting data shows that, while most firms hold capital in excess of requirements, few have the buffer of capital that might be required in the event of a more difficult economic environment. Firms might need to use capital reserves to meet ongoing expenses in the event of a reduction in business activity, or need resources to meet the increased complaints and subsequent claims which often arise when economic conditions deteriorate. Of general insurance intermediary firms, 32% have regulatory capital of less than £50,000. This rises to 42% for financial advice firms and 63% for

Chart C8: Regulatory capital in retail intermediary firms



Source: FSA

mortgage intermediaries. There is a risk that as firms use their capital to meet the needs of their business, they will move closer to the minimum requirement and could be poorly equipped to deal with future capital needs.

Firms also need to ensure they have the right business strategy to maintain income and control expenditure should a more difficult economic outlook lead to a fall in business volumes. While rising incomes and wealth have supported demand for financial advice and low interest rates have contributed to strong demand for mortgages, a deterioration in economic conditions could see consumer demand for financial products contract sharply. This would particularly affect the large number of firms who receive most of their income from up-front commission (for example, 75% of financial advisers receive at least half of their income through initial commission).[3] Furthermore, the supply of some products could fall if the increased costs and risks associated with the deteriorating economic conditions feed through to higher prices for consumers. Firms need to consider the possible consequences of these risks and actively build them into their management procedures.

The existing pressure on financial resources combined with a less benign economic outlook means that there is a heightened risk of firm failure and increased pressure to sell products inappropriately, increasing the potential for consumer detriment.

Management and control

The management and oversight within some retail intermediary firms remains inadequate. This can result in a weak control environment and misaligned incentives under which consumer detriment can occur. Specifically, firms need to ensure that they have good risk-management, monitoring and audit functions in place, and that technology is used appropriately.

We remain concerned that wrap platforms may be used inappropriately. While we recognise the benefits to firms and to some clients, firms must still ensure that wrap platforms are used appropriately; that they are used to the benefit of the consumer; and that advisers have the appropriate level of knowledge.

Firms with appointed representatives need to have suitable levels of controls and monitoring in place to ensure that customers are being provided with good quality advice and are treated fairly. Recent work has shown that there is a risk that firms over-rely on remote monitoring with inadequate consideration given to their monitoring procedures. Firms need to have rigorous management information in place to allow close and continuous supervision and to support a risk-based approach to monitoring their appointed representatives, including being able to ensure their financial strength.

Retail intermediary firms employ a variety of third parties, such as compliance consultants, software houses and packagers, to help them run their business efficiently, and to assist them in meeting their regulatory obligations. There is a risk that firms could place undue reliance on these third parties. However, the ultimate responsibility for compliance cannot be outsourced. Firms continue to have responsibility for the regulatory standards of any third party they employ, with their senior management remaining central to ensuring that necessary systems and controls are in place.

Quality of advice

The previous edition of the *Financial Risk Outlook* highlighted the low levels of trust in financial advisers, which has been partly driven by concerns over the quality of the advice and service given to customers in the past. Lack of confidence in the market could deter consumers from seeking advice, resulting in inadequate provision for their needs and reducing potential business levels. Many firms still do not adequately assess the suitability of the advice they give. They do not always collect sufficient information from customers or use it appropriately, leading to advisers not properly assessing or understanding the suitability of the products they recommend.

In the mortgage sector, our thematic work shows that an unacceptable number of mortgage brokers continue to operate below the standards we expect. For example, there is evidence of inadequate collection of customer information to establish clients' needs, with senior management failing to ensure that customers are being treated fairly. We are also concerned that some advisers and lenders may not adequately consider affordability, particularly when the mortgage term runs into retirement, where there is irregular income and where interest-only mortgages are recommended without a plan for repayment. Our work has shown that the recommendation of self-certification mortgages also poses risks. Too few firms are able to demonstrate that customers' needs are being met and that a self-certification product rather than a full-status product is appropriate.

3 NMG IFA Census, All respondents, 2007.

In the general insurance sector we are particularly concerned about poor advice given to customers where sales of insurance products such as payment protection insurance (PPI) are supplementary to the primary business of the firm.

Communications with customers should be complete, accurate and carried out in a way that facilitates consumers' understanding. However, we still see problems with communications including financial promotions, disclosure documentation, statements of demands and needs, and suitability reports. As a result, some customers are misled and not given a clear explanation of the risks, charges and implications of the product they are being sold.

Advisers are required to act in the best interests of their customers, but the remuneration structure does not necessarily encourage this. Across the advice sectors the most common method of remuneration continues to be by way of commission from providers to intermediaries. While paying for advice through commission is popular with consumers, it can also lead to a perception that advisers might not always recommend the best products for their customers and encourage the misconception that their advice is provided for free.

Finally, there are questions over the standards of professionalism and competence in firms, with some advisers having inadequate levels of training, qualifications and experience, partly due to the low barriers to entry. A lack of professionalism in the sector can lead to the provision of poor advice and low levels of service quality.

We are aiming to address these concerns through our Retail Distribution Review, which applies to all those involved in the distribution of investment products, whether life insurers, banks, asset managers or financial advisers. We hope that our Review will act as a catalyst for the generation of market solutions to these problems in the first instance. However, we recognise that regulation may have to change to facilitate solutions.

A similar situation exists in the mortgage advice industry, where current minimum entry levels are lower than for the investment market. This is not necessarily a risk in itself, as mainstream market products are generally more simple than those in the investment market and the advice process is more straightforward. However, our review of training and competence in mortgage advice firms continues to yield poor results, with two thirds of firms still at risk of failing to treat their customers fairly by implementing adequate arrangements.

Key messages for retail intermediaries

- Retail intermediaries need to pay close attention to the sustainability of their business model, particularly in terms of ensuring that they have the strategy and financial resources that will enable them to withstand changes in the economic environment, or other factors that might put pressure on their income and profitability.
- Retail intermediaries should ensure they have robust management and systems and controls in place. Specifically, firms need to ensure that they have good risk-management, monitoring and audit functions, especially where a firm has appointed representatives. Firms must recognise that while the use of third-party services can help them run a strong and efficient business, the ultimate responsibility for compliance cannot be outsourced and remains with their own senior management.
- Treating customers fairly is a key priority for retail intermediaries. Firms need to do more to ensure the quality of the advice they give, collecting sufficient information from customers so that advisers can properly assess their needs and recommend suitable products. Furthermore, communications with customers need to be complete, accurate and carried out in a way that facilitates consumers' understanding.

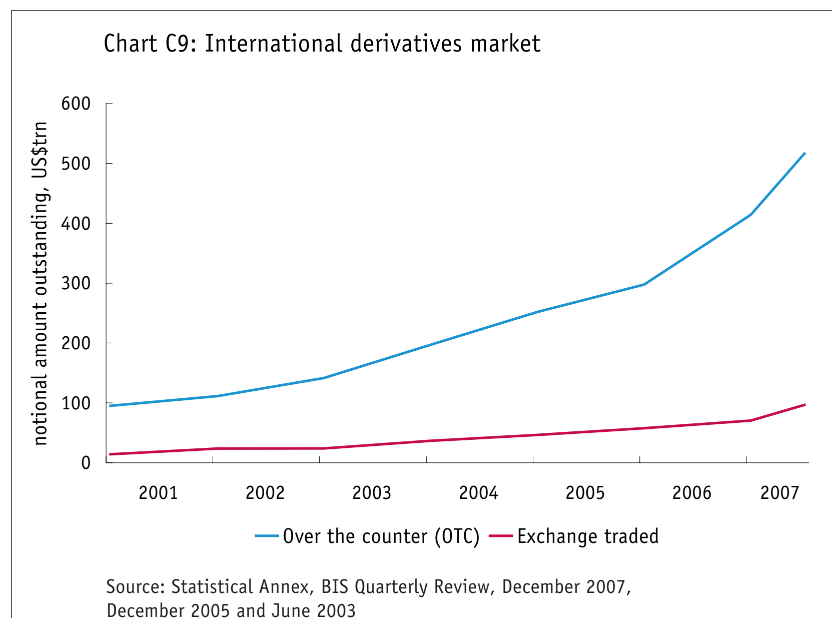
Asset management

Recent financial market events have focused attention on asset managers' resources to value and trade the increasingly complex range of instruments in use, as well as the back- and middle-office support available to process them. The market dislocation of the second half of 2007 also highlighted the importance of asset managers understanding how their portfolios could behave under stressed scenarios. We remain concerned about consumers' ability to understand increasingly complex products.

Trends in asset management

Over the past year, the asset management industry has seen continued evolution and innovation in products across both retail and institutional markets. A trend has emerged of traditional asset managers introducing alternative investment products into their offerings. Some alternative managers have also sought to emulate the traditional business model through actions such as listing their management company on global exchanges. Asset managers have continued to face tough competition for high-quality staff from other market participants, including hedge funds and investment banks. These trends highlight a range of risks in the industry related to existing and new products.

Chart C9: International derivatives market



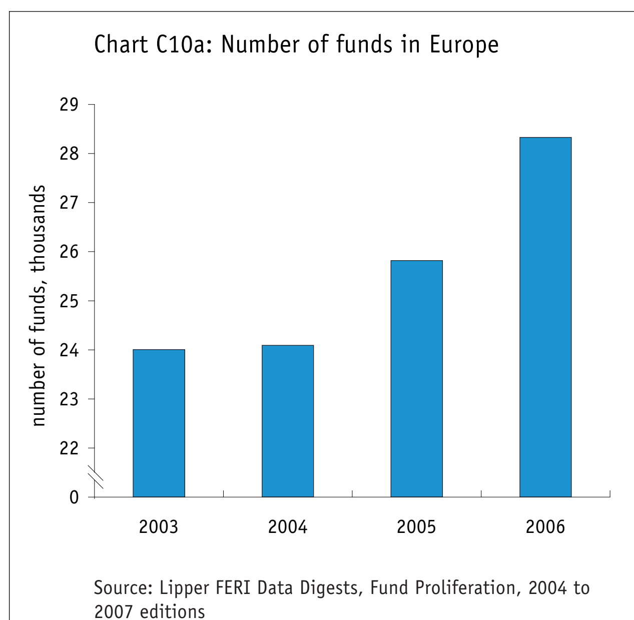
Source: Statistical Annex, BIS Quarterly Review, December 2007, December 2005 and June 2003

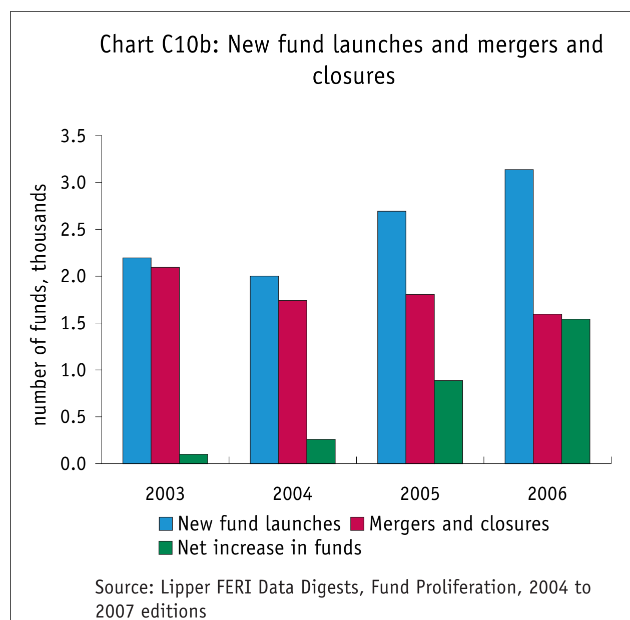
Existing product issues

As noted in the *Priority Risks*, recent market events have highlighted the shortcomings of many investment banks' ability to value illiquid and complex instruments such as ABS. Asset managers have relatively fewer resources to value these instruments in-house and could be over-reliant on third-party or counterparty valuations. In such cases, there is a risk that they do not have the ability to value and trade a portfolio, which could result in the unfair treatment of consumers, and reduced consumer confidence. While recent market events have highlighted the ABS sector, other assets such as property, private equity and venture capital trusts could pose similar illiquidity and complexity issues.

The increasing use of derivatives by asset managers poses a range of risks. There is a risk that managers could start using derivatives before appropriate middle- and back-office systems and controls for the risk-management and compliance monitoring of these are developed. An increasing number of fixed-income managers, for example, are using credit default swaps in corporate bond-style strategies, but the systems and controls needed to trade, value and book credit default swaps can be very different from those used for corporate bonds and managers therefore need to be adequately resourced. There is also a risk of asset managers and clients not being sufficiently aware of how using derivatives changes the risk characteristics of their portfolios. For example, derivatives introduce implicit leverage into portfolios, something which needs to be monitored against mandate restrictions (such as client risk tolerance). Using over-the-counter (OTC) derivatives also introduces the need to manage counterparty risk through suitable collateralisation arrangements.

Some asset managers continue to face challenges in administration (in-house and third-party), operations and IT systems. These include risks





such as the possibility of incorrect trades, mandate breaches or valuation errors. In part, this may result from inadequate systems and controls in middle- and back-office areas and insufficiently trained staff. There continues to be a high demand for risk and compliance staff with specialist skills such as derivatives knowledge. In trying to deal with these problems some fund managers may outsource an increasing range of functions, which could reduce the amount of oversight that they have (especially if they offshore to jurisdictions with lower or different standards).

While much regulatory attention has been given to stress testing balance sheets and capital levels of financial services providers, relatively less has been given to portfolio- and product-level stress testing. Changes at the portfolio and product level can have a significant impact on the business through the loss of revenue and reputational risk from sudden unexpected redemptions or forced sales. Managers should be prepared for this by stress testing their portfolios and products where appropriate. These stress tests could include examining the liquidity of underlying securities, the impact of sudden redemptions and the impact of market movements on potential mandate breaches, as well as examining the efficiency of collateralisation processes during times of stress.

New product developments

The asset management industry continues to see new products emerging. Specific country emerging-market mandates, especially focused on China, India and Russia, have increased significantly in number and by assets under management. New styles of investing in familiar markets – such as '130/30'[4] or unconstrained equity funds[5] – have also increased in popularity. These trends are visible in both retail and institutional markets. Some of these products are entering the retail market after having been established for some time in the institutional market.

It is questionable whether all asset managers have the appropriate systems and skills to manage and control the wide range of new products available to a consistently high standard. The rapid pace of change has resulted in managers expanding their offerings from traditional to alternative asset management, from developed to emerging markets and from long-only to long/short investment-management styles. These new areas involve the use of skills that are in short supply and require asset managers to compete with banks, hedge funds and each other for talent.

The rapid rate of change requires a commensurate adjustment in middle- and back-office expertise, enhanced risk-management systems, controls and processes. Where

4 A 130/30 fund is a type of 'long-short' equity fund which takes both long and short positions at the same time. The '130' refers to a 130% long exposure to equities while the '30' refers to a 30% short exposure.
5 An unconstrained equity fund is characterised by fewer limits on portfolio construction than a fund constrained to having exposures in a narrow band relative to an index.

managers have not developed these organically they have been acquiring specialist firms or teams. There are considerable risks in amalgamating often very different cultures and systems into traditional businesses as well as risk in new start-ups prematurely entering to market. One example of this is traditional managers buying hedge fund teams but failing to provide the appropriate information barriers to manage non-public information flow.

Lack of consumer understanding of the risks posed by new and potentially complex products could result in consumers buying inappropriate products or paying higher-than-expected charges because they were not set out clearly in the product documentation. There is also the possibility of market disruption from potential mass exit from products during less benign financial market conditions. This was recently seen in redemption deferrals due to high volumes of withdrawals from property funds. This could have resulted from consumers not understanding, or providers not adequately communicating, the characteristics of products. In particular, characteristics such as potentially volatile performance or illiquidity in the underlying assets need to be clearly communicated.

Performance fees, a common feature of hedge fund products, are beginning to find their way into traditional mandates. Consumers unfamiliar with this charging structure may not be able to make appropriate comparisons or understand their impact on net returns in the absence of a significant improvement in standards of disclosure or literature.

Consumers may also be confused by competing products, which could result in them buying inappropriate products and paying more than they would for similar products. This could potentially reduce confidence in the financial system due to inadequate standards of clear and transparent disclosure. Structured products offering market exposure and guarantees are types of products where consumers may not be aware of the relative risks of these products compared with more 'traditional' asset management products because of a lack of information transparency. These issues of confusion and reduced confidence echo the observation of low levels of trust in advice among consumers noted in the *Industry focus* on *Retail Intermediaries*. We hope that our Retail Distribution Review, which covers distribution of retail investment products by all types of regulated firm, will act as a catalyst for the generation of market solutions to these issues. However, we recognise that regulation may have to change to facilitate this.

Key messages for asset managers

- Managers need to ensure that they have robust systems and controls in place to enable them to accurately value illiquid and complex instruments (such as ABS) in-house before they start using them.
- Money market and other funds which have relied heavily on credit ratings for security selection will need to improve their credit due diligence and selection processes. While many asset managers already use robust credit analysis in security selection, some may have suffered large losses due to over-reliance on credit ratings agencies.
- Some asset managers continue to face challenges in administration, operations and IT systems. There continues to be high demand for risk and compliance staff with specialist skills and there is a risk that oversight may be reduced if fund managers outsource an increasing range of functions. Managers need to satisfy themselves that their in-house and third-party services providers have the appropriate systems, controls and staff to ensure these risks are robustly managed.
- Changes at the portfolio and product level can have a significant impact on asset managers' business. Managers should be prepared for this by stress testing their portfolios and products where appropriate.
- Managers need to ensure they are retaining or employing staff of sufficient experience and expertise to understand and manage the increasingly complex range of products that are entering the market. They also need to implement effective systems and controls to monitor and control the risks associated with these products before the products are launched, as well as maintaining them on an ongoing basis.
- Asset managers should ensure that they treat customers fairly and provide clear, fair and not misleading communications.
- Anti-market abuse systems and controls at some hedge fund managers need to be improved. The mitigation of market abuse needs to be a priority for senior management, the controls around inside information need to be strengthened and the quality of training improved.

Capital markets and financial exchanges

Market events in the second half of 2007 have had a significant impact across capital markets in general. Tighter credit conditions have led to a decline in some areas of business, such as the volume of private-equity-led LBOs, and heightened the potential for an increase in corporate restructurings and defaults. Other rapidly growing areas, such as commodity markets, have benefited from an increased appetite for risk diversification. The implementation of MiFID has increased the scope for competition between a variety of infrastructure providers which will impact market users and the regulatory community. Capital market participants will need to understand how these changes may impact their own business models.

Consolidation and fragmentation

The financial market infrastructure continues to be subject to considerable change and the consolidation of infrastructure presents a number of regulatory challenges. Most UK Recognised Bodies are now part of large multi-jurisdictional groups and this increases the difficulty of regulating these groups. Issues for consideration include: the gravitation of decision making to non-regulated holding companies; outsourcing of functions; and greater integration, which can pose difficulties due to the need to achieve a common set of rules across regulated entities. There is a risk that the close cooperation required between regulators in this new environment is not sufficiently robust, and it is important that consistency of regulation across jurisdictions is ensured where possible. There is also a risk of extra-territorial application of laws, which legislation such as the Investment Exchanges and Clearing Houses Act 2006 has been brought in to mitigate.

Facilitated by the Markets in Financial Instruments Directive (MiFID), competition is increasing between established infrastructure providers and new entrants, in particular Multi-lateral Trading Facilities.[6] However, there is a risk that fragmentation of trading and, most significantly, of trading data may result in a reduction in market transparency for both regulators and market participants. There is evidence of some shift of off-book reporting away from traditional exchanges. This increases the need to ensure that market data is published in accordance with MiFID and consolidated so that the price-formation process remains effective. In addition, there is a risk of detriment to market confidence if market conduct in this new environment is not effectively monitored and enforced. We have taken steps to mitigate the effects of data fragmentation through helping to form the Trade Data Monitor regime to improve the integrity of OTC trade data and the development of enhanced market surveillance systems. Increasing commercial pressures from competition could also result in a greater potential for conflict between commercial and regulatory objectives.

Commodity markets

Financial commodity markets continue to grow (refer to *Economic and financial conditions*) stimulated by persistently strong demand for the underlying physical commodities, easier market access and the demand from an increasing range of investors to achieve returns from this sector. However, commodity markets are characterised by volatility that can be difficult to predict. There is a risk that new investors to the market may not fully understand the nature of commodity markets. Excessive volatility could also be a risk to orderly functioning of markets. There are indications that the Exchange Traded Fund (ETF) market in commodities may be attracting more significant retail participation. This raises a risk that retail investors may not have adequate information and protection.

Corporate workouts

Tighter credit conditions across the marketplace could increase the number of corporates experiencing financial distress. This risk may be magnified by the high levels of corporate debt and the conditions on which such debt has been raised by some firms during the relatively benign credit conditions of the past few years.

6 Multilateral systems, operated by an investment firm or a market operator, bring together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract in accordance with the provisions of Title II of MiFID.

Growth in the number of participants investing in credit instruments, and the growth of credit-risk-transfer techniques such as credit derivatives and sub-participation,[7] have the potential to make corporate restructuring and workouts more complex than in the past. The weaker covenants under which some firms have financed themselves in recent years may leave creditors unable to assert control over a firm until there has been a significant deterioration in a firm's financial position. This could leave the creditors with limited options when the covenants are triggered and deliver lower recovery values to creditors.

The increase in the use of the 'originate and distribute' model among banks means that it may no longer be feasible for a creditor, traditionally the bank with the largest exposure or with the closest relationship to the debtor, to take the 'lead' in restructuring negotiations. The wide variety of market participants who may have either net long or short credit exposure to the distressed firm means that any restructuring will necessarily be more complex and involve a much greater number of parties than in previous default cycles. There is a risk that the greater complexity facing creditors could, in the immediate aftermath of a credit event on a heavily traded security or multiple concurrent defaults, lead to disorderly markets for related securities.

The increasing use of credit derivatives and sub-participation will also alter aspects of the restructuring environment. The existence of default swaps on a distressed firm's debt may affect the interests and behaviour of stakeholders during negotiations. The ability of default swaps to be cash settled within a month of a credit event may bring a further round of changes to the composition of the creditors group. Sub-participation may mean that some of the parties involved in the restructuring negotiations may not have any exposure to the company but remain as the official creditors on the company's books.

Private equity

2007 began strongly for the private equity sector with strong fund raising following on from record years in 2005 and 2006 when over £31bn was raised by UK-based funds.[8] By June 2007 announcements had been made of the largest-ever LBO transactions in both the US (the US$45bn acquisition of TXU by a consortium led by Kohlberg, Kravis, Roberts & Co (KKR) and Texas Pacific Group[9]) and the UK (the £11.1bn acquisition of Alliance Boots by a KKR-led consortium).[10] However, as credit conditions deteriorated in the second half of 2007, the market for both the origination and distribution of leveraged loans slowed significantly with potentially negative consequences for stakeholders in the market.

Leveraged finance providers have encountered difficulties in distributing loans underwritten before credit conditions deteriorated. While estimates of the size of the deals being warehoused vary significantly, if these difficulties persist it could result in substantial capital and risk-management constraints for the firms concerned. In the absence of a liquid secondary market, difficulties in valuing loans have been encountered and the profit and loss impact of market conditions on underperforming loans may not be fully realised until liquidity is restored.

Deals that were in progress when market conditions deteriorated have been subject to significant restructuring (where terms have allowed). This has had major implications for the profitability of the transactions and returns for the private equity sponsors and investors.

In the second half of 2007, new public-to-private and LBO deals virtually dried up as the increased yields being demanded by lenders were seen to be unsustainable at the prevailing price levels. If sustained into 2008, this will compress returns for the pool of committed capital awaiting suitable LBO investment opportunities. It is anticipated that a loosening in credit conditions, or reductions in price expectations of prospective sellers, will be needed for transactions to resume. The latter could potentially have negative consequences for current public investors in firms considered to be likely LBO targets.

Refinancing has also become difficult for firms. In particular, private equity portfolio firms, which typically have greater leverage within their capital structures than public or other privately-owned firms, have been affected. The chance of financial distress and failure has therefore been accentuated by deteriorating credit conditions. The associated corporate restructurings and insolvencies could have a negative impact on wider market efficiency given the enhanced complexity of economic exposure to these entities and the wide and unclear ownership of this risk.

7 Sub-participation is the process wherein a lender of record contractually agrees to give a third party rights relating to the debt but the third party acquires no contractual right against the debtor.
8 Private Equity Intelligence, 2007.
9 TXU press release, April 2007.
10 Alliance Boots press release, April 2007.

The growing impact of Sovereign Wealth Funds

Although Sovereign Wealth Funds (SWFs)[11] are not new, the assets controlled by these entities have increased rapidly in recent years, with most reports suggesting that their combined size is in excess of US$2trn.[12] Although this is small in comparison to the amount under management of mature-market institutional investors (US$53trn), it is higher than the amount managed by hedge funds.[13] Many of the home countries of SWFs have become significantly wealthier because of rising commodity prices or strong export growth, and as long as this continues it is likely that the funds will continue to increase in size. It has been suggested that SWFs could grow to as much as US$12trn by 2015 and surpass the total sum of the world's official reserves within the next five years.[14]

The growth in SWFs means that the official sector has become an important active investor group. However, the objectives of this investor group can be quite heterogeneous. They include: to insulate the budgets and economies of natural-resource producers from volatile commodity prices; to spread wealth across generations; and to achieve higher returns on foreign exchange reserves. These different objectives will drive different asset-allocation strategies.

With large sums available for investment there exists the potential for SWFs to have significant effects, good and bad, on the efficient operation of global capital markets. The issues include:

- In searching for greater yield, the diversification of SWF's portfolios from traditional low-risk and highly-liquid assets (for example, government bonds) to other securities and derivatives could increase liquidity in formerly illiquid corners of the markets.
- SWFs currently have minimal obligations with respect to transparency about their size, portfolio composition or investment strategies. There is a potential risk that their actions, or rumours of potential actions, could increase volatility in capital markets. However, this could be countered by the stabilising impact that these institutions could have by acting as a long term source of investment capital.
- Concerns have been publicly voiced by various market participants that some SWFs could potentially take stakes in important overseas companies for political, rather than economic, reasons. This has prompted some jurisdictions to set up processes to vet (and potentially veto) any foreign ownership of strategically important firms (whether or not it is linked to a SWF); in some cases, this could be viewed as a protectionist measure. This may prove disruptive to other participants trading in the same markets.

Key messages for market participants

- Market participants should be prepared for a prolonged period in which conditions for capital raising are more difficult. Firms must also be prepared for new and innovative funding models to continue to prove difficult to use and ensure their business model accounts for this.
- Investors should ensure they are confident that their risk-assessment processes are effective and that they take account of all asset-risk characteristics as part of their investment decisions. Firms should ensure they have adequate information to make appropriate assessments on the complete range of inherent risks when considering investments.
- Market participants should continue to ensure that operational and compliance areas are sufficiently resourced to cope effectively with business volumes and market volatility. In a more difficult environment, it is vital that firms continue to meet their regulatory requirements and maintain their improved performance in operational areas.
- Firms should continue to stress test their business models to improve their ability to deal with economic or financial shocks. The type, severity and likelihood of events that firms may need to react to should be a central component of this process, taking into account lessons that have been learned over the second half of 2007. Business continuity planning should also continue to be a key area of focus for firms.
- Firms must ensure that they maintain effective anti-market abuse systems and control inside information. Given current operational and financial pressures on firms are likely to be greater in the coming year, they will need to ensure they retain sufficient focus on preventing market abuse and meeting their information disclosure duties.

11 Sovereign Wealth Funds can be broadly defined as state-owned entities that manage national savings for investment.
12 *A Scoreboard for Sovereign Wealth Funds*, Truman E., 2007.
13 *Global Financial Stability Report*, International Monetary Fund, October 2007.
14 *How big could Sovereign Wealth Funds be by 2015?*, Morgan Stanley, 2007.

Life insurance

While current data suggests that life insurers do not have material exposures to structured finance instruments, they may be affected by the wider market consequences of the recent financial market dislocation, such as wider corporate bond spreads and higher equity market volatility. Insurance companies invested in these assets are exposed to falls in asset value when marking them to market. Meanwhile, legacy issues and structural changes continue to give rise to the risk that life insurers are not delivering the target outcomes that we have set out for the fair treatment of consumers.[15] In particular, there is a risk that consumers do not have the information they need to make informed decisions about their policies and that structural changes pose a threat to the level of new and existing business for life insurers. The improvements to life expectancy have potential implications for the profitability of annuity business and at the same time create a need for consumers to save more to avoid a shortfall in their income in retirement.

Transfer of funds between providers

Life insurers have reported a significant increase in pension sales; total premiums increased by 21%, from £29.1bn in 2005 to £35.8bn in 2006.[16] This is mostly due to an increase in reported single premiums from £16.8bn to £22.9bn; regular premiums have only risen slightly, by £0.6bn to £12.9bn. A significant proportion of the reported increase in pension sales growth appears to be due to an increase in transfers of existing business. Taking this into account, the net flow of funds into the pensions industry was negligible, with new regular and single premium income almost exactly matched by outflows.

There was an increase in transfers following the changes to the pension legislation in April 2006, which enhanced the range of assets available for investment through self-invested personal pension schemes (SIPPs). However, there is a risk that among such high volumes of transfers there will be customers for whom these transfers do not provide any advantage and only result in additional costs. Transfers may also move policyholders out of policies that have guarantees or smoothed investment returns (such as with-profits policies), exposing them to increased volatility in investment returns.

Even where transfers are cost neutral to the policyholder, there are costs to the insurer which are only recouped if the new business stays with them. If the trend of low persistency levels continues, this could affect insurers' profitability, leading to future increases in costs for policyholders.

We hope that our Retail Distribution Review, which covers distribution by all types of regulated firm, will act as a catalyst for the generation of market solutions to low persistency and other issues. We recognise that regulation may have to change to facilitate solutions.

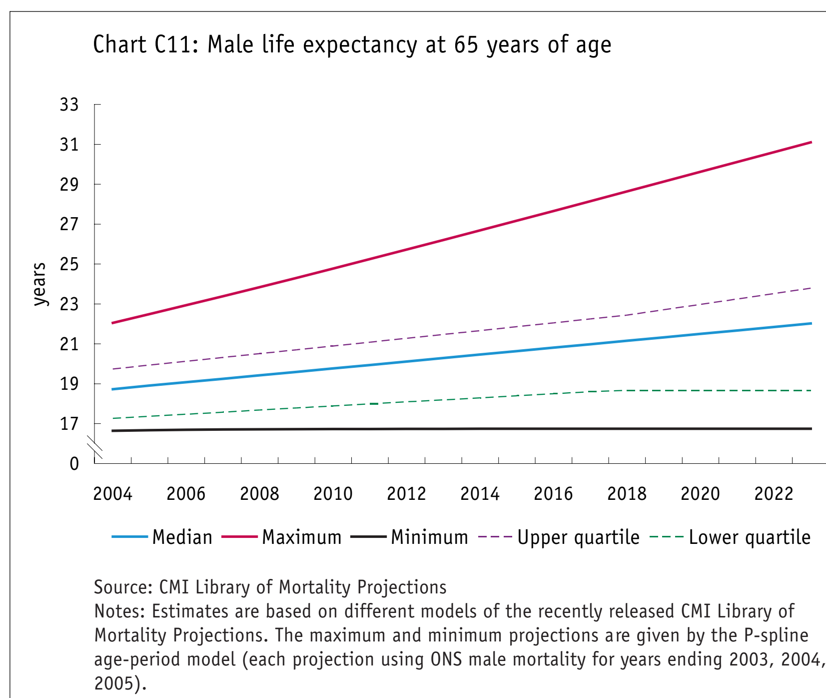
Lack of planning for retirement

Our financial capability work has shown that there is a lack of planning for retirement.[17] This is also evidenced by the negligible flow of new business into the pension savings industry. This risk may decline over the longer term with the introduction of the Government's Personal Account proposals, which mean that from 2012 all employers will have to provide a workplace pension and automatically enrol all of their employees who meet the required criteria. However, until the proposals are finalised, there is a risk that increased uncertainty around pension planning will result in consumers or employers delaying decisions about retirement saving. Delaying pension planning can make it harder for consumers to 'catch up' in later years and achieve a sufficient income in retirement.

15 The six target outcomes are described in *Treating customers fairly: measuring outcomes*, FSA, November 2007.
16 Analysis of FSA returns.
17 *Financial Capability in the UK: Establishing a Baseline*, FSA, March 2006.

The decline in traditional retirement savings and competition from alternative suppliers such as fund supermarkets and wrap providers, and other alternative methods of providing a retirement income, pose a threat to the levels of new and existing business for life insurers. This is a particular challenge for firms with shrinking with-profits funds, where pressures to reduce costs may affect standards of customer service. Insurers seeking alternative sources of new business, while continuing to manage their existing business, need to ensure they do so in a way that treats their existing customers fairly.

Chart C11: Male life expectancy at 65 years of age



Source: CMI Library of Mortality Projections
Notes: Estimates are based on different models of the recently released CMI Library of Mortality Projections. The maximum and minimum projections are given by the P-spline age-period model (each projection using ONS male mortality for years ending 2003, 2004, 2005).

Longevity risk

Ageing population and improving life expectancy give rise to longevity risk, as consumers are living longer on average than they themselves or life insurers had initially expected. Annuity providers in particular are exposed to this risk as pricing and reserving for annuities involves estimating mortality rates 35 years or more into the future. The risk is magnified in the current economic climate of relatively low interest rates, as future payments to annuity policyholders are not as heavily discounted. In 2004, the Continuous Mortality Investigation (CMI) estimated a loss on the sale of joint life annuities to males aged 65 of 3.42% as a percentage of premiums charged in 1997. These are substantial margins and large enough to potentially eliminate any contingency margins firms have allowed for.

Uncertainty over future longevity projections can also have significant implications for firms' pricing of annuities. Several models already exist that estimate future mortality, but the projections produce significantly different results to one another. By not allowing for adequate improvements in mortality for older ages, firms could be under-pricing their annuity products. Firms also need to ensure they reserve enough capital to reflect the true extent of the uncertainty behind future longevity estimates.

Further research by annuity providers may add to the industry's understanding of longevity risk, such as the differences in mortality improvement rates between socio-economic classes and the impact of lifestyle factors on life expectancy. However, this may be constrained by a lack of good quality historical experience data, especially in the case of bulk annuity providers which obtain their experience data from pension schemes. Again, this increases the risk that firms may be under-pricing their annuity business.

Longevity risk affects consumers through the inherent uncertainty it imposes on financial planning for later life as well as through higher annuity costs. Lower annuity rates mean that people need to save more today unless they are to face a lower standard of living in retirement. Current trends in lower saving rates combined with increasing life expectancy indicate that some consumers may be worse off in the future.

Consumer communications

Clear information is important in ensuring consumers are treated fairly. Information provided on investment products at the point of sale has at times been below the standard required.[18] The main areas of concern are poor explanations of risk and charges, and the quality of information about the product and its aims. Jargon is also a significant problem, and key information is often not prominently communicated. This increases the risk that consumers choose products not suitable for their needs or not consistent with their risk appetite.

18 *Good and Poor Practices in Key Features Documents*, FSA, September 2007.

Policyholders rely on being kept informed of their investment through post-sale communications from insurers, or through ongoing contact with a financial adviser. There are too many instances of poor quality post-sale communications in which valuable product features, such as market value reduction free-dates and guaranteed annuity rates, are not always mentioned or clearly explained. This is a particular issue for complex policies and with-profits policies, where changes in the asset mix of the fund may have a significant impact on whether the policy continues to meet policyholders' needs and expectations.

Insurers' communications also play an important role in informing policyholders about their retirement options. The decision on whether to buy an annuity from the host insurer or to purchase an annuity on the open market is important, as it influences an individual's lifetime income. Despite the significant variation between annuity rates, only around 40% of policyholders exercise the option to buy their pension on the open market.[19] There is a risk that if insurers' communications around selecting retirement options are insufficient or unclear, policyholders may make poor decisions or fail to take active steps to maximise their retirement income.

A significant number of with-profits policyholders are not getting ongoing advice on their policies. In part this has come about through structural changes in the industry as many of the direct sales forces that sold these policies no longer exist.

Some financial advisers are reluctant to give advice on with-profits policies, because of concerns over their complexity, the level of support and information available from providers, and the risk of mis-selling claims.[20]

The combination of these factors gives rise to a risk that some policyholders are not in a position to make informed decisions about their policy. One possible outcome is that they might cancel a policy when they should keep it or keep a policy which does not continue to meet their needs or expectations. With-profits funds also continue to be the focus of negative media coverage, particularly closed funds. This increases the risk that policyholders will cancel policies which may contain valuable options or guarantees.

Key messages for life insurers

- A number of factors (including the decline in traditional pensions saving, uncertainty around pension planning, and tax changes) pose a threat to the levels of new and existing business for life insurers. Insurers need to seek alternative sources of new business, or implement a plan for orderly run-off, while continuing to manage their existing business in a way that treats their customers fairly. Moreover, a loss of confidence in the market could exacerbate the already low levels of new business by deterring consumers from investing in new products. This could also encourage existing customers to surrender their policies.
- Treating customers fairly is a key area where life insurers need to make improvements. In order to meet our December 2008 treating customers fairly deadlines, life insurers need to significantly improve the quality of their consumer communications, during the sales process and throughout the life of the policy. This includes informing policyholders of their retirement options. Insurers also need to ensure they manage their with-profits funds in a way that treats customers fairly.
- Insurers need to maintain the momentum in improving their stress and scenario testing. Firms should think carefully about the correlation between risks in stress and scenario tests. For example, in the event of adverse market conditions a firm may need to improve its liquidity by securing funding via the capital markets. However, if other firms in the sector are facing similar issues the risk of funding being unavailable is much greater or it may only be available at a higher cost. The same applies to firms reliant on reinsurance programmes to absorb claims. If firms fail to recognise the capital and financial implications of not appropriately assessing all the risks they are exposed to, this could lead to financial losses.

19 Research from the FSA's *Consumer Purchasing Outcome Survey* (to be published later in 2008).
20 *Insurance Sector Briefing: Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders*, FSA, May 2007.

General insurance

The recent adverse market conditions have had a significant impact on monoline financial guarantee firms. The downgrading of credit ratings of monolines can affect their ability to continue to write business and have wider market implications. Some actions by ratings agencies have already taken place. For more traditional general insurers the softening underwriting cycle continues to pose difficulties. However, a year of manageable claims and abundant capital has helped the industry to build up capital levels. Growth in alternative reinsurance solutions could have implications on the length and depth of the underwriting cycle over the longer term. In the meantime firms need to ensure they pursue underwriting strategies in line with their articulated risk appetite. In the retail general insurance industry, crystallised conduct-of-business issues relating to distribution persist, including inappropriate sales of protection products and misleading financial promotions.

Monolines

Financial Guarantee Insurers (or monolines) are firms that provide credit insurance to lenders or bondholders. The continued deterioration in structured credit markets and, in particular, in securities related to US subprime mortgages, has increased the potential for higher than expected claims to emerge. Recently monolines have established reserves in addition to substantial mark-to-market losses. Monolines do not generally need to post collateral or accelerate payment, so mark-to-market losses do not raise immediate liquidity issues as is the case for many other financial institutions. Nonetheless, they are required to report mark-to-market results for derivative exposures and if the results are unfavourable, market reaction can be adverse.

Downgrading of the ratings of the monolines can occur when the actual or potential for claims reduces a monoline's capital buffer to below the minimum required to maintain its rating (typically triple-A), or where adverse market sentiment affects a firm's franchise, impairing its ability to write new business. Although a downgrade would affect a firm's ability to continue writing business, it would not necessarily mean that there is concern about the ability of the monoline to perform on its existing liabilities.

If a monoline is downgraded, the ratings of the securities insured by the monoline would also be at significant risk of downgrade. This could have wider market consequences and potentially result in the reduction in the credit quality of portfolios, and where portfolios are required to have minimum credit quality, forced selling. There is also a risk that this could result in a reduction in the credit quality of bespoke non-traded wraps provided to financial institutions. Counterparty exposures to monolines have become material for certain banks and investment firms that have bought credit derivative protection for some of their ABS and CDO positions. Credit ratings downgrades could also add to pressures on confidence in structured credit markets and lead to higher costs of raising finance.

Underwriting cycle

Premiums in most general insurance lines have been falling since 2003. However, in 2007 the rate environment for some personal lines appeared to change. Consumers in flood-prone areas, for example, have seen higher premiums as a result of the summer 2007 floods. The environment for catastrophe risk was relatively benign in 2007, with the North Atlantic hurricane season remaining relatively subdued. There is a risk that this benign environment combined with new capital may lead to reduced discipline in underwriting and pricing.

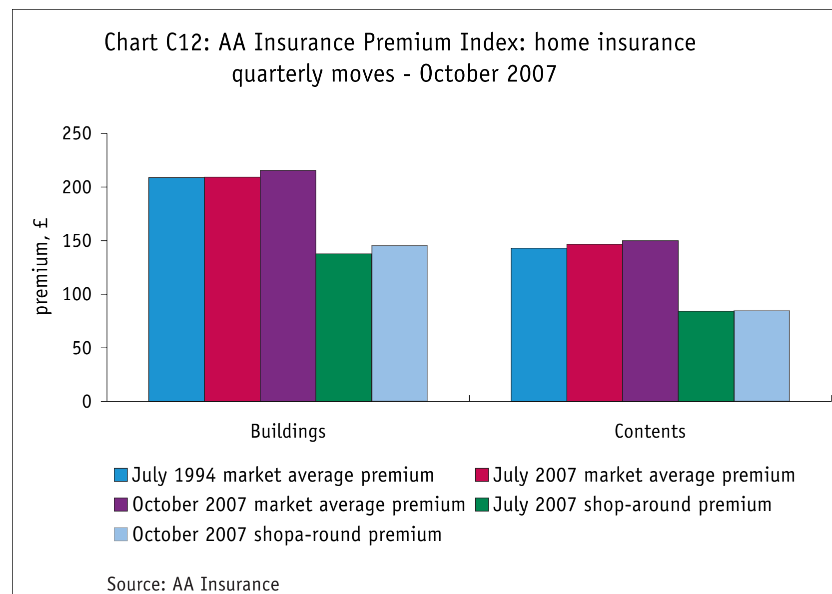
There has been continued pressure on premium rates in almost all lines of business for commercial lines and the London market, with no significant deterioration in terms and conditions. While in 2006 profitability in several lines of business was supported by year-end reserve releases, this may not be sustainable in the longer term, particularly if rates continue to fall. There is a risk that inadequate premiums could lead to losses and strain on capital resources.

Access to capital

Following the 2005 hurricane season there has been an increase in the use of alternative forms of reinsurance capital, primarily catastrophe bonds and sidecars. In the 15 months to January 2007, sidecars raised US$6.5bn, compared with US$2-3bn in the preceding decade.[21] Presently, these alternative reinsurance solutions complement traditional reinsurance arrangements. However, should the growth of these new instruments be sustained, there could be longer-term implications for the length and depth of the underwriting cycle. Firstly, the ability of alternative forms of capital to absorb losses could be different to more traditional capital. Secondly, the permanence of new capital could be limited, particularly if expected returns do not materialise. In the current environment it is not clear how much of this alternative capital would be made available should there be significant losses in subsequent windstorm seasons.

Climate change

Climate change poses direct risks to the financial services industry through physical damage to assets, potential changes in asset values and business continuity disruption. The insurance industry is aware of the challenges posed to their risk-management systems by climate change, which could result in higher and more frequent claims through flooding, windstorms or forest fires. However, the 2004 and 2005 hurricane seasons revealed weaknesses in some wholesale firms' assessments of their exposures to natural catastrophes. Although the models were subsequently scrutinised by regulators and credit ratings agencies and revised, these models remain essentially untested.



From a retail perspective, the UK floods in summer 2007 may also have revealed weaknesses in firms' models for personal lines business. Although the risk of river flooding may have been adequately captured, risks from inadequate storm drainage and hillside run-off could increase the level of exposure. Failure to properly assess risk exposures or to recognise the capital and financial implications of them could lead to significant financial losses.

The summer 2007 floods resulted in an increase in insurance premiums; on average premiums rose by 3% for buildings insurance and by 2.3% for contents insurance. There is also a possibility that cover, particularly household policies, may become more expensive or may not be available in some areas for certain types of risk.

Terrorism

London and other major financial centres continue to be high-profile targets for direct terrorist attacks. This remains a key operational threat for firms and is a potential source of market disruption. Terrorist attacks also pose risks to firms and consumers in the UK insurance industry. Insurers need to ensure that significant or unusual exclusions are adequately disclosed so that consumers are able to make informed decisions about the cover they are buying. Firms should also focus on aggregate management to identify and monitor any potential aggregate exposures to terrorist attacks.

Wholesale brokers

Achieving a balance between fulfilling regulatory obligations and pursuing commercial objectives remains a challenge for the wholesale market, particularly among brokers. A notable example of shortcomings uncovered through our supervision of this sector is a lack of engagement from senior management in identifying and managing conflicts of interest. Making improvements in the basic standards of management, governance and culture therefore remains a regulatory priority for wholesale brokers.

21 *Of sidecars and such*, Morton N Lane, President Lane Financial L.L.C., 2007.

Brokers play an important part in commercial lines, both in the London and regional markets, accounting for 82% of sales.[22] Nonetheless, the validity of the brokers' business model has been questioned frequently in the past few years because of several factors. These include the loss of income owing to the decline in contingent commissions, a complex processing model, and the commoditisation of insurance. These concerns could accelerate broker consolidation and insurer acquisition of brokers, increasing regulatory concerns over conflicts of interest and how they are managed.

Distribution

In the retail market, distribution has continued to shift towards direct sales and sales through affinity groups. Together with bank and building society sales, these account for 60% of sales, up from 31% in 1999.[23] In addition, price-comparison websites have increased competitiveness in an already competitive market, bringing benefits to consumers but presenting firms with a more difficult environment. In the wholesale market, the increasing trend in insurers acquiring brokers creates challenges for firms in managing their conflicts in a way that treats their customers fairly.

Conduct-of-business issues related to distribution and, in particular, inappropriate sales of PPI and misleading financial promotions are the most significant crystallised risks in retail general insurance. When sold appropriately, PPI can provide valuable protection against changes in personal circumstances – particularly in an economic environment of rising consumer debt and an increase in the cost of debt. However, poor standards in the sale of these policies have given rise to the risk that consumers are unable to make an informed decision about the cost and appropriateness of cover, and are unaware of limitations and exclusions.

Despite increased regulatory intervention, some firms are making little progress in improving their sales practices. We are now seeking to impose more punitive regulatory measures where standards fall below the required level and consumers are not being treated fairly. This increases the reputational and financial risks for firms with poor selling practices.

General insurance financial promotions that do not provide clear and adequate information about the nature and extent of the cover provided may encourage consumers to enter into a contract with a firm on a misleading basis. There is also a risk of misleading promotions distorting the market because it becomes harder for consumers to compare products.

22 FSA calculation based on industry returns.
23 FSA calculation based on industry returns.

Key messages for general insurers

- The validity of the wholesale brokers' business model has been questioned frequently in the past few years. These concerns could accelerate broker consolidation and insurer acquisition of brokers, increasing regulatory concerns over conflicts of interest and how they are managed. We expect brokers to implement necessary culture change and improve their systems and controls.
- Given expectations of a less benign global economy over the coming year, it is vital that insurers have robust controls around their underwriting strategy. To minimise the risk of writing business below cost, firms need to have a clear strategy for setting and monitoring premium rates and have the controls in place to capture the impact of changing terms and conditions.
- Treating customers fairly remains an important issue, particularly in relation to sales of PPI. A lack of engagement in improving selling practices by some firms is impeding the fair treatment of customers and, unless substantial improvements are made, they will not meet our December 2008 treating customers fairly deadline.
- Insurers need to maintain the momentum in improving their stress and scenario testing. Firms should think carefully about the correlation between risks in stress and scenario tests. For example, in the event of market turbulence a firm may need to improve its liquidity by securing funding via the capital markets. However, if other firms in the sector are facing similar issues the risk of funding being unavailable is much greater or it may only be available at a higher price. The same applies to firms reliant on reinsurance programmes to absorb claims. If firms fail to recognise the capital and financial implications of not appropriately assessing all the risks they are exposed to, this could lead to significant financial losses.

Index of charts, tables and figures

Section A: Economic and financial conditions

Charts

A1 Real effective exchange rates 6

A2 3-month LIBOR spreads over Overnight Index Swaps (OIS) 10

A3 Credit Default Swap Indices 10

A4 Major international equity indices 11

A5 Implied volatility 11

A6 Commodity prices 12

A7 Flows of UK interbank lending 14

A8 House prices and commercial property capital yields 15

A9 Inflationary pressure and interest rate decisions 16

Tables

A1 World output growth 7

A2 Selected forecasts for the UK economy 8

Section B: Priority Risks

Charts

B1 Mortgage balances subject to securitisation 21

B2 Structured finance downgrades 21

B3 Credit derivatives – outstanding confirmations and trade volumes 27

B4 Equity derivatives – outstanding confirmations and trade volumes 27

B5 Trends in components of personal lending 31

B6 Number of mortgage contracts with high LTV ratios, high LTI multiples and long terms 31

B7 Trends in affordability 32

B8 LTVs by institution type for fixed-rate rollovers over the next two years 32

B9 Trends in mortgage repossessions relative to long-term arrears 33

Figures

B1 Structured finance market 20

Section C: Industry focus

Charts

C1 Major UK banks' profitability 39

C2 Seasonally adjusted 12-month growth rate in total lending 42

C3 Credit card arrears and write-offs 42

C4 Commercial property share of UK banks' lending 43

C5 Aggregate writedowns by main investment banks 44

C6 Aggregate net Value-at-Risk to tangible equity ratio 44

C7 Major investment banks – average asset / average equity ratio 45

C8 Regulatory capital in retail intermediary firms 46

C9 International derivatives market 49

C10a Number of funds in Europe 50

C10b New fund launches and mergers and closures 50

C11 Male life expectancy at 65 years of age 56

C12 AA Insurance Premium Index: home insurance quarterly moves – October 2007 59

Glossary

ABCP – asset-backed commercial paper

ABS – asset-backed security

AML – anti-money laundering

bn – billion

bp – basis point

CDO – collateralised debt obligation

CDS – credit default swap

CDX NAXO index – an index offering credit default protection against North American companies of sub-investment grade

CLO – collateralised loan obligations

CMBS – commercial mortgage backed securities

CMI – Continuous Mortality Investigation

CML – Council of Mortgage Lenders

CPI – consumer price index

GDP – gross domestic product

ECB – European Central Bank

ETF – exchange-traded fund

FRC – Financial Reporting Council

FSCS – Financial Services Compensation Scheme

FSMA – Financial Services and Markets Act

GAAP – Generally Accepted Accounting Principles

IAS – International Accounting Standards

IASB – International Accounting Standards Board

IFRS – International Financial Reporting Standards

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

IMF – International Monetary Fund

IPD – Investment Property Databank

IVA – individual voluntary arrangement

LBO – leveraged buyout

LIBOR – London interbank offered rate

LTI – loan-to-income

LTV – loan-to-value

MiFID – Markets in Financial Instruments Directive

mn – million

OIS – overnight index swap

OFT – Office of Fair Trading

OTC – over the counter

PPI – payment protection insurance

PSD – Product Sales Database

RMBS – residential mortgage backed securities

SEC – Securities and Exchange Commission

SIPPs – self-invested personal pension scheme

SIV – structured investment vehicle

SWF – sovereign wealth fund

trn – trillion

UTCCR – Unfair Terms in Consumer Contract Regulations

VaR – Value-at-Risk

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