Financial Risk Outlook 2007

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
2007

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Foreword

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

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

The Financial Services and Markets Act 2000 (FSMA) sets out 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 the external environment. These include changes in economic conditions, the performance of financial markets, the behaviour of firms and consumers, social and demographic change, and legal and regulatory developments. The *Financial Risk Outlook* describes the key developments over the past year and highlights the main risks to our statutory objectives that we have identified in these areas. We refer to these as our *Priority Risks*. The *Priority Risks* are the issues that we think pose the most significant risks to our statutory objectives and strategic aims in the next 18 months. However, we also look at issues of a more slow-burning nature that affect us and our stakeholders over a number of years.

A number of the *Priority Risks* are medium to long term in nature and we expect to see them appear in our analysis over a number of years. Our related regulatory work is structured in response to both our desired outcomes and any changes during the intervening period. In this context we provide an indication of our views on the direction of the *Priority Risks* since the previous *Financial Risk Outlook*.

The *Priority Risks*, by their nature, often arise from things that we cannot directly control. Nevertheless, we aim to reduce the likelihood of crystallisation and the extent of any adverse effects they may have. We do this by taking new initiatives and by focusing our existing risk-based activities on areas where the *Priority Risks* have the most impact. Our *Business Plan*, which will be published in February 2007, sets out how we propose to pursue our strategic aims in the context of the *Priority Risks* and describes our other priorities for the year ahead.

Our Central economic scenario *and our three* Alternative scenarios *are presented in Section B*

The *Executive summary* and the *Priority Risks* are presented in Section A. In Section B, *Economic and financial conditions*, we describe and analyse the current global economic and financial conditions in the UK and elsewhere. We also look at the prospects for the global economy and set out both our *Central economic scenario* and three plausible *Alternative scenarios* that could have major implications for us and our stakeholders. Over the coming months we will monitor the likelihood of these other scenarios materialising, and assess whether there is any related need to adjust our *Business Plan* and *Central economic scenario* accordingly.

We discuss risks identified in the banking, capital markets, asset management, and insurance sectors in Section C, *Developments in industry*. Section D looks at *Consumers' engagement with industry*, Section E considers *Financial crime* issues and Section F presents the *Legal and regulatory framework*. Regulatory change continues to be a key challenge for us, firms and consumers. Our *International Regulatory Outlook 2007*, published in December 2006, offers a more extensive analysis of regulatory change being driven by international developments.

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

Executive summary and Priority Risks

Executive summary

Our *Central economic scenario* is one of relatively benign economic conditions and financial stability, a view which is in line with consensus forecasts. However, we also believe there is an increasing risk that the business operating environment we will face over the next 18 months, both in the UK and abroad, could be more challenging than in recent years. While global economic and financial conditions remained mostly favourable in 2006, a set of conditions has developed in economies and markets that could become unsustainable. Furthermore, the probability of these conditions unwinding in a disorderly fashion may rise over time.

Economic and financial conditions

Central economic scenario, *Section B*

Global economic conditions are benign at present, but, as we highlight in our *Central economic scenario*, there are considerable challenges ahead. The range and magnitude of significant downside risks appear to be growing, and there is an increasing risk that the operating environment could become more demanding for firms and consumers. While the risks to financial stability are relatively low at present, if economic conditions were to deteriorate rapidly and significantly, financial stability could be tested.

Alternative scenarios *and* Risks to financial stability, *Section B*

In our three *Alternative scenarios* we consider the possible transmission mechanisms, including their potential impact on financial stability, of a sudden turn in economic conditions and other disruptive events. Although the financial services industry is making good progress in strengthening its risk-management practices, it is important that firms' stress-testing programmes continue to analyse and test alternative assumptions that may not be captured by past events in current pricing assumptions for risk. Firms should also ensure that their business-continuity and disaster-recovery arrangements provide resilience in the event of a range of different types of major operational disruption.

Developments in industry

Banks and building societies, *Section C*

Banks are expected to remain both profitable and highly capitalised in 2007, despite some deterioration in the business operating environment in 2006. However, within this broadly benign scenario banks will face a number of risks, especially if the business operating environment weakens. In the retail market, these include dealing with increasing arrears on unsecured lending and preparing for a possible weakening in the housing market. In the wholesale markets, banks' risk appetite has risen in a low-volatility and spread-compressed market. This has increased the potential risks that could arise should business operating conditions reverse. Building societies continue to face an increasingly competitive operating environment within their core markets, and have adapted in a number of ways, such as reducing costs and moving into new, higher-risk areas of business.

Capital markets and financial exchanges, *Section C*

Competition among financial exchanges and market infrastructure providers, together with the proposed or potential consolidation of such entities (often on a cross-border basis), gives rise to a number of risks including heightened conflicts of interest and reduced transparency. It also poses various regulatory challenges, for example with respect to governance. Maintaining the integrity of financial markets remains of paramount importance, as some market participants continue to face high legal, reputational and regulatory risks from not having appropriate systems and controls in place to prevent market abuse. The private equity market is continuing to grow, competing with public markets and adding to overall capital market efficiency. However, a number of risks exist in the private equity market that merit careful consideration, for example, instances of excessive leverage. There have also been difficulties in establishing ownership of economic risk. This last point would be particularly critical following a credit event, as any confusion over the ownership of economic risk could potentially damage the timeliness and effectiveness of a workout. As product innovation and investment in alternative asset classes continues, issues have arisen with respect to the valuation of illiquid and complex assets. Volatility in such instruments may be high and can give rise to substantial losses.

Asset management, *Section C*

Traditional asset managers are facing increasing levels of competitive pressure from alternative providers such as hedge funds and private equity managers. Regulatory reform and rising demand from retail and institutional clients for products with more complex features also pose varying degrees of difficulty for sector participants. Hedge fund performance remains broadly positive across the vast majority of strategies, but there is a continuing debate as to whether hedge funds are truly providing 'alpha' to their investors; this is difficult to determine in a bull market, but the issue is critical because it is the justification given for the fees that they charge their clients.

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

Life insurers reported robust sales in 2006. Although headline new business sales have surged, it is not clear how much of the new business written is actually new money coming into the market. The outlook for life insurers in 2007 is mixed, particularly given the significant strategic challenges for which firms need to prepare. For example, pension reforms are expected to continue in the years ahead and will be demanding for both the industry and consumers, not least because of longevity risk. Given the absence of large catastrophe losses, 2006 was also a good year for general insurers. However,

the sector faces a number of significant risks from the external environment, such as climate change and terrorism. Although general insurance firms and reinsurers have been able to attract additional capital (after the catastrophic losses caused by the 2005 hurricane season), our concern remains that these capital flows could reverse should expected levels of return fail to materialise.

Consumers' engagement with industry

Consumers face a more demanding environment *and* Consumer borrowing is high, *Section D*

High employment and rising house prices have enabled many consumers to expand their credit commitments. However, there is a risk that they could be unprepared and ill-equipped for a weaker economic environment and hold an overconfident view about the future. In particular, while most consumers appear to be managing their current levels of secured and unsecured debt, rising interest rates have heightened concerns that some consumers may have unsustainable levels of debt. This could lead to an increase in the number of consumers facing debt-repayment problems. We have already seen sharp increases in bankruptcies, Individual Voluntary Arrangements (IVAs) and mortgage repossessions.

Financial capability *and* Retail intermediaries, *Section D*

While some consumers appear to be adapting well to new financial responsibilities, many consumers lack financial capability in key areas and do not feel confident in making financial decisions. In particular, many do not plan ahead for their future financial needs and therefore may face financial difficulties if their circumstances change or if the economic environment deteriorates. Many consumers also have difficulties choosing the appropriate financial products to meet their investment and savings needs, and some do not understand the risks related to products that they already own. Retail intermediaries play an important role in helping consumers meet their financial needs. However, it is clear that many consumers have low levels of trust in this sector. The sector will continue to face change in 2007 and beyond from demographic trends, competition, technological advances, and regulatory and legislative pressures.

Financial crime

Financial crime, *Section E*

Many of the qualities of our financial system, such as openness, transparency, and accessibility, are exploited by criminals planning to commit financial crime. In an environment of greater technological complexity and growing cross-border transactions, financial fraud is increasing. This problem is compounded by the fact that, as firms and law enforcement agencies find new ways to tackle financial crime, fraudsters develop new ways to commit financial crime.

Legal and regulatory framework

The international dimension to regulation, *Section F*

The relatively high level of regulatory change, brought about in large part by the implementation of the Financial Services Action Plan (FSAP) and other major EU legislative measures, will continue in 2007. Although these initiatives are designed to reduce risk and improve efficiency in the long run, the sheer volume of change heightens compliance risk for firms and puts pressure on scarce resources, potentially with high opportunity cost and increased operational risk. We expect 2008 and beyond to be generally less demanding from an implementation perspective, though significant measures, such as Solvency 2, will remain on the horizon for some firms.

Accounting and auditing, *Section F*

EU Directives have also brought about great change in financial reporting, as all EU-listed groups are now required to report using International Financial Reporting Standards (IFRS). IFRS has been successfully implemented in the UK, but there are two major risks to the continued success of IFRS: inconsistency across national economies and how the framework adapts in the future.

Long-term issues

A number of longer-term issues in the business operating environment has arisen that will affect risk across a wide range of industries. Volatility in financial markets has remained at recent historic lows while investors' risk appetite has continued to increase and new innovative products have been developed to take advantage of these conditions. The benign economic environment and the availability of low-cost funding have also given rise to increasing correlations between asset class returns and investment strategies. Instruments that have historically been used to diversify portfolios due to their low or negative correlation with other components of the portfolio may no longer necessarily fulfil this role as effectively. If the conditions that have fostered these developments were to reverse, or there was a specific market event that precipitated the unwinding of investor positions, there would be a risk that previously established relationships between asset prices could break down. This could potentially cause distress in the more highly leveraged parts of the financial system and have disorderly consequences for market stability.

Risks arising from an ageing population have been discussed for many years and will remain a vitally important issue for years to come. An ageing population gives rise to longevity risk, which we have also highlighted in previous editions of the *Financial Risk Outlook*. Longevity risk has particular implications for the life insurance industry and consumers for their own retirement planning. Evidence to date suggests that actual improvements in life expectancy may soon exceed the assumptions used in mortality tables produced by actuaries, and there is not yet a way to hedge comprehensively against this uncertainty. This will pose significant challenges for the financial-services industry, consumers and us.

Priority Risks

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

In the next section of this document, *Economic and financial conditions*, we set out in more detail our *Central economic scenario*, outline recent developments in the global economy and also consider how three *Alternative scenarios* could affect the *Priority Risks*.

Promoting efficient, orderly and fair markets

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

The global economy and financial markets have performed well for a number of years: growth has been robust, inflation has been subdued and volatility has remained low. Although our *Central economic scenario* is one of continued stability, there is a growing risk that the operating environment for firms and consumers could become more demanding over the next 18 months. With geopolitical risks increasing in light of continuing risk of conflict in the Middle East and northeast Asia (notably North Korea) and protectionist pressures mounting in G7 economies, the probability of an 'event risk' crystallising is growing.

Moreover, this recent period of economic and market stability does not mean the financial system is necessarily in a position to withstand the impact of a significant event. Financial markets have become increasingly complex in recent years, which implies that transmission mechanisms for shocks have also become more complicated. Correlations between asset-price movements and investment strategies have risen, which may increase the inaccuracy of risk-management models and change the valuation of some financial instruments that factor correlation risk into their pricing models.

The combination of low volatility, high correlation and a historically low level of risk premia brings with it an inherently high likelihood of a major shock, especially if an event were to occur that triggered a significant deterioration in market sentiment.

The previous edition of the *Financial Risk Outlook* urged firms to strengthen their risk-management practices in order to deal with these challenges. Our recent thematic review of stress testing found that overall the industry is making good progress in this area. However, we also think that many firms still need to make further progress to attain the standards of the Comprehensive Approach – a view of good practice in stress testing that was developed in cooperation with the industry. In particular, we were struck by

the relative weakness of the firm-wide stress events at some of the firms we visited. While the current level of profitability and capitalisation in many firms may provide part of the explanation, additional reasons could be that some firms underestimate the likelihood of severe events or, where mitigating action is envisaged, they overestimate their ability to take action in an effective and timely manner.

We recognise that there are significant hurdles to overcome, such as the inherent limitations of any mathematical model, designing a suitably stressed scenario that can also achieve senior management buy-in, and in stress testing severe (or so-called ‘tail’) events. Nevertheless, we believe that stress tests of this nature benefit individual firms in that they identify the underlying key assumptions in firms’ trading and investing strategies and enable senior management and boards to review and engage in a proper oversight of their firm’s risk appetite. They also enhance the resilience of the financial system as a whole.

Terrorism poses a range of financial crime, operational and insurance threats

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.

The 7 July 2005 terrorist attacks in London demonstrated the strengths and limitations of the Counter Terrorist Financing regime. The small amount of money needed to perpetrate the attack and the lack of unusual bank-account activity meant that identifying an imminent plot would have been virtually impossible. However, the cooperation and information yielded from firms after the attack was vital for the investigations. We expect terrorist financing to remain a major source of reputational risk for the financial services industry, particularly given the fact that terrorist threats to the UK emanate not only from abroad but are also present in the domestic environment.

The UK insurance industry, both life and general insurers, continues to be financially exposed to domestic and overseas terrorist events. The events of recent years have demonstrated that firms are able to withstand significant shocks, but the potential losses from a single terrorist event could be larger than the private sector is prepared to finance. Government-backed schemes, such as Pool Re in the UK and the Terrorism Risk Insurance Act in the US, are important for ensuring that direct commercial cover is available for all who wish to purchase it.

Illiquid financial instruments are difficult to value, which raises, for example, conflict-of-interest risks

The appetite for alternative, often complex and illiquid, financial instruments continues to increase. These investments, which include assets such as private equity, complex derivatives, structured products and distressed debt, can play an important role in diversifying investors’ portfolios and they help to increase the depth and breadth of the capital markets. However, they are less

liquid than many exchange-traded securities and are generally more difficult to price and trade. This can lead to a wide dispersion in opinion among market participants as to the price at which the products should be fairly marked for valuation purposes. Although specialist third-party pricing services have expanded their coverage and helped to mitigate this risk, many complex instruments are not yet covered.

There is a requirement for many parties involved in trading and pricing complex and illiquid assets to consider their inherent conflicts of interest. These arise when the same party makes investment decisions and also plays a key role in pricing the same instruments. In particular, this is important for those professionals whose remuneration is directly linked via an incentive arrangement to the declared investment performance of a portfolio containing investments for which the professional has assigned prices.

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

The previous edition of the *Financial Risk Outlook* cited problems of backlogs in outstanding trade confirmations for credit derivatives as one of our *Priority Risks*. The industry, together with regulators, has made significant progress in dealing with this problem in spite of credit-derivative trade volume growth continuing to increase in 2006.

However, at the same time we have observed a general deterioration in equity-derivative outstanding confirmations over the last year as trading volume has grown. A significant backlog has emerged, though it is not yet on the same scale as the credit-derivative backlog. The equity-derivative and credit-derivative markets have different characteristics, and these two problems may require different solutions. Nevertheless, it is important for firms to address these operational shortcomings so they have a complete picture of the risks they are running.

The risk of financial crime is increasing

Methods of carrying out financial crime are currently evolving more rapidly than firms' and the authorities' responses. The previous edition of the *Financial Risk Outlook* highlighted that the risk of financial fraud was increasing and this continues to be the case. Organised criminals have been highly dynamic in reacting to changes in firms' anti-fraud systems. This has involved seeking to exploit 'weak links', for example by recruiting insiders, or carrying out fraud at levels that fall below a firm's 'fraud appetite'. Criminals are also quick to adapt old techniques to take advantage of new technologies, such as Chip and PIN.

The public sector's response to fraud has continued to be hindered by the fragmented structure of the UK's anti-fraud frameworks and the lack of a coordinated strategy for dealing with fraud. The government's Fraud Review has recommended a more coordinated approach to dealing with this risk, a conclusion that is also endorsed by us and industry.

By definition, if crimes committed for financial gain are on the rise then money laundering will also be increasing as there are more proceeds to launder. There will be substantial systemic change to the anti-money laundering (AML) environment in 2007. There is a risk that firms' implementation of a more risk-based approach to financial crime may be undermined if the processes they put in place to adapt to our new rules and Joint Money Laundering Steering Group (JMLSG) Guidance are not sufficiently dynamic and flexible. The implementation of the Third EU Money Laundering Directive in December 2007 also presents both opportunities and risks for our risk-based AML regime.

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

The volume of regulatory reform and the need to contain the regulatory burden on firms has been highlighted in previous editions of the *Financial Risk Outlook*. This will continue to be a challenge for firms until at least 2008, and they should not underestimate the continuing challenge of implementing EU legislation. Two of the highest-profile measures, the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD), come into force in 2007. Firms need to have the systems in place to meet the new or revised prudential, organisational and conduct of business requirements. Firms that underestimate or postpone the implementation are likely to incur significant last-minute costs and may face additional compliance risk. Firms with international operations also face additional demands arising out of the cross-border application of the CRD and the Basel 2 framework.

We are now in what the European Commission has termed a 'consolidation phase'. Nevertheless, there are still a number of evolving regulatory initiatives that will continue to demand our attention, the most prominent of which is Solvency 2, which aims to create a system of risk-based prudential regulation in the insurance sector. However, the adoption of the CRD has also renewed interest in measures concerning the composition of capital, the large-exposures regime and liquidity-risk management.

Helping retail consumers achieve a fair deal

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

Total UK personal debt has continued to grow and stood at around £1.3 trillion as at November 2006. In early 2006, the consumer-credit cycle appeared to be turning as the growth rate in consumer lending slowed for both mortgages and unsecured lending. However, as the year progressed, growth in consumer lending picked up and registered 10.4% for the year to November 2006. Aggregate household debt has risen dramatically in recent years, and the level of secured debt as a percentage of disposable income reached 126% in the third quarter of 2006, while unsecured debt amounted to 26%. Although the relative stability of aggregate net wealth would appear to present a more benign picture, this may be misleading because the distribution of net wealth across households in the UK is highly skewed.

High levels of employment and low interest rates have enabled most consumers to continue to service their debt, but any significant deterioration in these variables has the potential to expose those households which have taken on too much debt. In spite of the benign environment, we have seen growing signs of consumer distress, such as record levels of insolvencies, late payments on credit cards and a rise in mortgage-possession orders. Debt-repayment difficulties have so far been concentrated among those who rent their homes, perhaps because, at a time of rising property prices, homeowners have had access to mortgage equity to enable refinancing of unsecured debts. However, should house prices fall, the scope for this form of low-cost refinancing would diminish, and we could see a greater number of consumers struggling to meet their financial obligations due to the higher interest cost of unsecured lending.

If a larger number of households began to experience debt-repayment problems, this would have serious consequences for providers of credit. However, it is highly unlikely that consumer-indebtedness problems would lead to a financial stability problem. Regulated firms' profitability and capital levels indicate that they are well placed to absorb the adverse effects of lower lending growth and increased bad debts. However, profit levels could be eroded by such adverse events, and firms could experience significant reputational damage if they were seen (in retrospect) to have given credit to large numbers of consumers who were unable to afford it.

Consumer needs remain complex, but many consumers lack the capability to make effective financial decisions

Consumers' financial needs have continued to become increasingly complex, and a wide range of financial products has been launched to help meet these changing needs. While some consumers appear to be adapting well to these new responsibilities, our financial capability baseline survey shows that many consumers lack financial capability in key areas (not just financial planning and product selection) and do not feel confident in making financial decisions.

Consumers' difficulties in planning ahead have led to some consumers being under-provisioned for their retirement. This will leave them more reliant on the state pension; this reliance could further increase if their circumstances were to change or if the economic conditions were to deteriorate.

Many consumers also have difficulties choosing the right financial products to meet their needs. While increased product choice for consumers is generally positive, some consumers do not understand the risks related to the products they are being offered and therefore may not be able to make a confident choice. Not surprisingly, the lack of understanding may be even greater where products are more complex. As well as not being able to choose the most suitable product, consumers may not be advised to buy the most appropriate product, as we highlight in the next *Priority Risk*. Many consumers purchase products without receiving any form of regulated advice, which may reflect an unmet need for some form of generic advice, a lack of trust in financial advisers, or difficulties in accessing advice.

The level of financial capability changes very slowly and is influenced by a wide range of variables. These include the UK financial capability strategy, government policy, changes in the wider economy, and firms' response to a more principles-based regulatory environment. In the meantime, firms should continue to recognise and respond to the underlying problems posed by the lack of financial capability, and ensure that their customers are treated fairly.

The distribution of retail investment products and the reputation of the distribution market raise concerns about the sustainability of the sector and the fair treatment of customers

The current business model for the distribution of retail investment products may be unsustainable in the longer term, and does not adequately benefit product providers, retail intermediaries or consumers. The financial advice sector is experiencing downward pressure on its profitability, and concerns about the lack of persistency of pensions and long-term investment policies also cast doubt on the future profitability of life and pensions business. The failure of two large financial advisory firms in the last 18 months further illustrates this point. Should the current model of retail distribution prove to be economically unviable, this could reduce the availability of financial advice and affect the extent to which consumers access investment products. This would happen at a time when a significant minority of consumers lack the financial capability to make financial decisions and when long-term investment products are needed to meet the financial needs of consumers.

The remuneration structures between product providers and distributors are largely commission-based, leading to potentially adverse incentives and a related bias in the way that products are recommended and sold. This can lead to consumers not being sold the most suitable product for their needs and firms focusing on short-term business planning, both of which could result in increased claims on the Financial Services Compensation Scheme (FSCS).

The reputation of retail financial advisers and other distributors has suffered in recent years due to incidences of mis-selling and the inability of the sector to attract new talent. Low levels of financial capability and consumers' lack of confidence in the market could deter them from seeking financial advice and purchasing investment products, leaving these consumers with inadequate provision for their financial needs. Alternatively, low financial capability can lead to a situation where investment products are actively sold rather than bought, and in which industry competition is for distributors who can sell those products rather than for the consumer.

The sale of retail investment products has been subject to regulation for more than two decades with a considerable impact on the processes and costs of the industry, yet shortcomings continue to emerge in the way that retail investment products are sold and the quality of advice given. This could mean that changes in regulation have failed to address the root causes of the problems in this area; the combination of industry-based solutions and our move to principles-based regulation should provide a more satisfactory outcome.

Economic and financial conditions

Central economic scenario

Our central scenario for the global economy is still benign, but is more challenging than in recent years. In spite of recent falls energy prices remain high, and inflation indicators have increased across the major economies. Financial conditions are now tighter than they were 12 months ago, although interest rates are still low in recent historical terms. There is some uncertainty over the US economic outlook and how it will affect the rest of the world over the next 18 months. Growth in all the major economies is expected to slow in 2007, and the risks to global economic growth remain on the downside. The financial operating environment for firms and consumers could weaken if there was a deterioration in global economic conditions or if volatility were to increase from its recent historically low levels. In addition, global imbalances have continued to widen while investors' willingness to take risks has increased. This means that even a modest deterioration in the economic environment could lead to an increase in risk premia, and have disproportionate effects on financial markets.

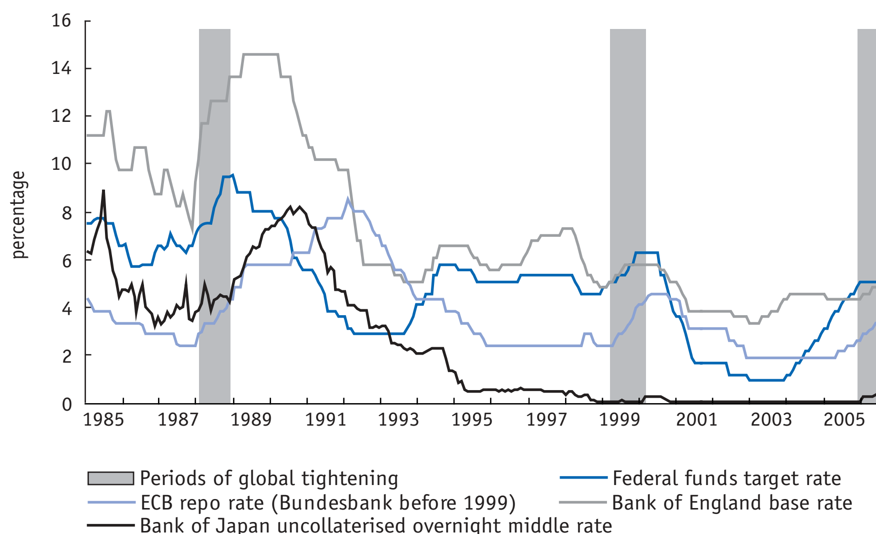
Global economic conditions

Global economic conditions remained benign in 2006, but there are challenges ahead

The global economy grew by 5.1% in 2006, moderately higher than the 4.9% growth rate recorded in 2005.[1] Most regions grew at, or above, expectations throughout 2006, with the expansion being particularly strong in emerging Asia and Latin America. However, the US economy began to look less robust towards the end of the year, which also dampened growth forecasts for 2007. While global growth is expected to remain strong, the peak of the global economic expansion during the present cycle may already have passed. The IMF expects global GDP growth to moderate somewhat to 4.9% in 2007.

1 *World Economic Outlook*, International Monetary Fund, September 2006.

Chart B1: Global interest rate cycle



Source: Datastream

A strong global economy, high energy prices and falling levels of spare capacity have contributed to the build up of inflationary pressures in many countries. The central banks of the US, UK and the Euro area continued to tighten monetary policy and raise interest rates in 2006. Many emerging-market central banks also tightened monetary policy to deter exchange-rate depreciation. The Bank of Japan ended five years of its zero interest-rate policy by raising rates to 0.25% in July 2006, but the weaker yen more than offset the restrictive impact of higher interest rates on monetary conditions in the country. The pace of interest-rate tightening slowed towards the end of 2006 as many central banks judged rates to be approaching their neutral levels, and inflationary pressures across the major economies appeared to be moderating. However, the Bank of England resumed interest-rate tightening in January 2007 after CPI inflation reached an 11-year high.

The US economy slowed towards the end of 2006…

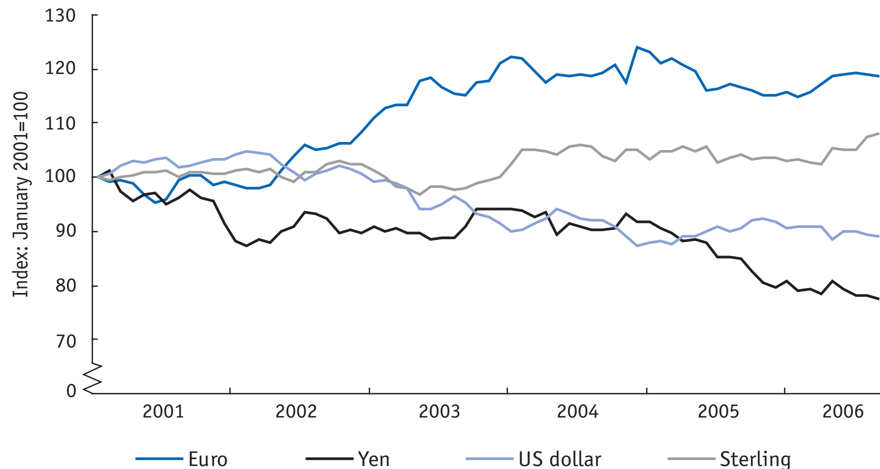
The US economy slowed considerably in 2006 due to a weaker domestic housing market and high energy prices, which slowed US growth to below its potential rate. Strong corporate balance sheets and tight labour markets were able to partly offset the impact of the housing slowdown on the economy. However, the effects of the housing downturn are expected to continue to affect the economy in the first half of 2007, especially if US consumer spending slows due to a fall in mortgage equity withdrawal or increased job losses in sectors of the labour market exposed to housing. A slowdown in the US, even if only moderate, would have negative repercussions for worldwide economic growth in 2007. Slower GDP growth, combined with considerable inflationary pressures, led to an increase in uncertainty surrounding the future direction of monetary policy when the Federal Reserve left interest rates on hold at 5.25% in August 2006. Both the two-to-ten-year and three-month-to-ten-year sections of the yield curve remained inverted for most of 2006, pointing to the bond market's more pessimistic outlook on the economy.

…and the dollar depreciated against the euro and sterling

The Federal Reserve's decision to leave interest rates on hold removed some support from the US dollar, which depreciated towards the end of the year against other major currencies, particularly the euro and sterling, as the positive interest-rate differential was eroded. In December 2006 the US dollar reached a two-year low against the euro and a 14-year low against sterling,

having depreciated by 11.8% and 13.3% against the currencies over the year respectively. The US dollar weakness was compounded by investors' concern over the continuance of the external financing of the US current-account deficit.

Chart B2: Real effective exchange rates



Source: Datastream

The Euro area grew by an estimated 2.7% in 2006, driven by a recovery in domestic demand on the back of improving labour markets and strong business confidence. The ECB continued to gradually raise interest rates over the course of the year in response to increasing inflationary pressures. Monetary tightening and stronger growth helped to strengthen the euro on a trade-weighted basis and against both the US dollar and the yen. The rate of economic growth in the Euro area is expected to moderate in 2007 as higher interest rates, the stronger exchange rate, fiscal tightening (notably in Germany), and the slower-growing US economy begin to affect the economies of the region.

The Japanese economy outperformed expectations in the first half of 2006, continuing to benefit from stronger regional and domestic demand. However, the economy grew by 2.4% in 2006, moderately slower than in 2005. There were indications that the output gap turned positive in July and several inflation indicators turned mildly positive during the year, indicating that Japan was moving away from the deflationary pressures that have depressed the economy for more than a decade. However, deflation still remains a risk to Japanese economic recovery, especially if global economic conditions were to deteriorate. Economic growth moderated towards the end of 2006, partly due to weaker private consumption, and is expected to slow further in 2007. On a trade-weighted basis the yen weakened over the course of 2006, largely due to continuing yen carry trades.

China continued to expand robustly, driving the demand for commodities

The rest of Asia continued its robust expansion in 2006, despite tightening financial conditions and concerns over a US slowdown. China grew by 10.5% on the back of increasing net exports and accelerating investment growth in the first half of 2006. While the Chinese economy is expected to continue its robust growth in 2007, there are considerable downside risks to the economy. The main risks are lower investment growth and higher renminbi, which could put pressure on export growth. A slowdown in the US economy could pose risks to the continued expansion of export-dependent Asian economies, as a significant share of their growth is either directly or indirectly dependent

on export demand from the US. In particular, a slowdown in China could have implications for the rest of the region, as it is a major hub for global manufacturing supply chains. The outlook for China's economy could also have implications for the commodities market, as the demand for energy and base metals has been heavily influenced by robust growth in China.

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

	IMF			Consensus Forecast		
				Average		Range
	2005	2006e	2007f	2006	2007f	2007f
World	4.9	5.1	4.9			
Advanced economies	2.6	3.1	2.7			
UK	1.9	2.7	2.7	2.6	2.4	0.8 - 2.9
US	3.2	3.4	2.9	3.3	2.3	1.7 - 2.7
Euro area	1.3	2.4	2.0	2.7	2.0	1.7 - 2.3
Japan	2.6	2.7	2.1	2.4	2.0	1.4 - 2.7
Developing countries	7.4	7.3	7.2			
China	10.2	10.0	10.0	10.5	9.5	9.0 - 10.3
India	8.5	8.3	7.3	8.4	7.7	6.9 - 8.5

Note: Figures for India are percentage changes from previous fiscal year.
Source: *World Economic Outlook*, IMF, September 2006
Consensus Economics, Consensus Forecasts, December 2006
Asia-Pacific Consensus Economics, Consensus Forecasts, December 2006

Domestic economic performance

UK growth remained above its long-term trend in 2006

Economic activity in the UK has proved robust, with growth remaining above its long-term average trend rate in 2006. Activity also proved more balanced, with solid gains in consumer spending being complemented by strengthening business investment and faster export growth, aided by the recovery in demand from the Euro area. While the growth in personal unsecured borrowing slowed during 2006, a re-acceleration of house price inflation provided scope for a renewed surge in secured borrowing, pushing personal-debt levels as a proportion of income to a record high. Interest rates were raised by 25 basis points in August and November 2006 and again in January 2007 to 5.25%, reflecting persistent above-target inflation.

According to Consensus Forecasts, UK economic growth is expected to ease only moderately to a rate of 2.4% on average in 2007. Consumer-spending growth is likely to remain relatively modest, weighed down by high debt levels and a gradual rise in unemployment. Business investment should continue to grow relatively strongly, although this will in part be offset by the planned slowdown in public-sector investment. Net exports are likely to have a neutral impact on GDP growth next year, although the risks to global trade are weighted to the downside due to the risk of a hard landing in the US.

Table B2: Selected forecasts for the UK economy

	2004	2005	2006e	2007f
Real GDP growth (%)	3.3	1.9	2.6	2.4
Consumer spending growth (%)	3.4	1.4	2.1	2.3
Current-account balance (£ billions)	-19.3	-29.5	-31.3	-33.6
Unemployment (%)	4.8	4.8	5.5	5.6
Inflation CPI Q4 (%)	1.4	2.1	2.6	2.0
Bank of England Repo rate Q4 (%)	4.75	4.50	4.96	4.89
House-price inflation annual average (%)	11.9	5.5	5.4	5.6

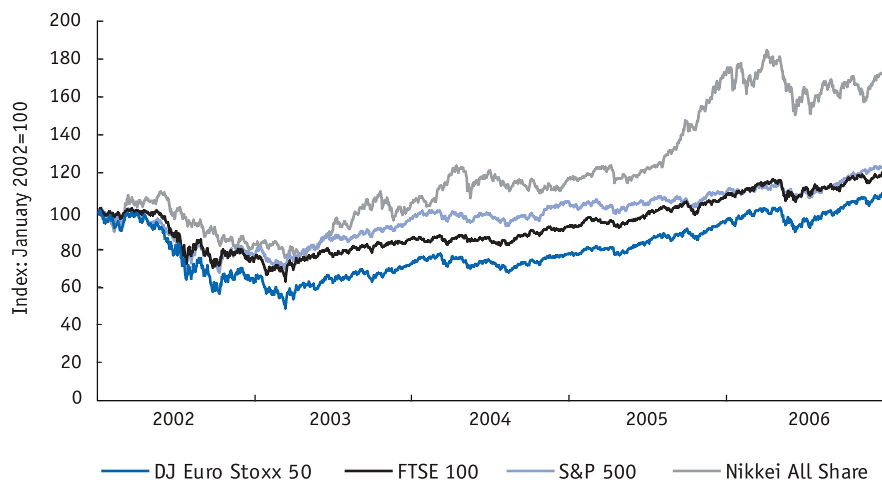
Note: House prices are all-lenders mix adjusted series, Department for Communities and Local Government.
Source: House price inflation and unemployment figures from *National Institute Economic Review*, National Institute for Economic and Social Research, October 2006
Other figures are consensus forecasts from: ONS, *Forecasts for the UK Economy*, HM Treasury, November 2006 and *World Economic Outlook*, IMF, September 2006

Global financial market conditions

Despite tighter financial conditions and the May/June sell-off, equity markets recovered to perform well in 2006

Although the positive environment for equities of low interest rates appears to be ending, equities generally had a good year in 2006. Leading indices in the UK, US and Euro area all grew by over 10%. The FTSE 100 index grew by 10.7% in 2006 and some US indices performed extremely well. Stock prices around the world (and particularly in emerging markets) were hit by an increase in volatility in May/June 2006, apparently reflecting an increase in risk aversion among investors and increased concerns over the inflation outlook in the US. From the start of the sell-off on 10 May to the trough on 13 June, the S&P 500 index fell by 7.5% and the FTSE 100 index fell by 9.6%. Emerging-market economies with a heavy dependence on commodities or those with relatively weak fundamentals were worst hit. The benchmark stock market indices fell by 42.5% and 27.3% in Colombia and Turkey respectively over the period of the stock market turbulence. Confidence in emerging markets has since returned and most emerging-market indices have recovered, making gains in 2006. While volatility remains at recent historic lows, the factors that have contributed to it (such as widely available, cheap funding and high risk appetite) could quickly reverse, potentially resulting in a deterioration of global financial market conditions.

Chart B3: Major international equity indices

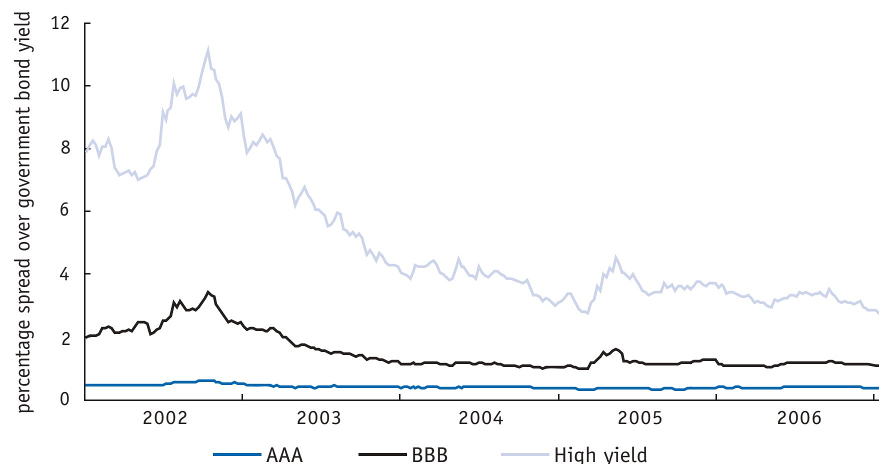


Source: Datastream

The May/June risk-reduction trades increased yields and volatility, but markets recovered relatively quickly

Global corporate-bond spreads remained historically tight during 2006, having escaped the risk-reduction trades of May/June remarkably unscathed. Benchmark borrowing costs have also remained unusually low, although there was a slight increase in government bond yields during the first half of the year. This probably reflects the fact that central banks around the world have been raising interest rates in response to mounting global inflationary pressures. Yields on US Treasuries fell in the second half of the year, perhaps reflecting investors' increasing reservations over the economic outlook. Despite a considerable widening in May/June, yields on emerging-market debt also remained low in 2006 because emerging markets' credit quality strengthened. However, improved financial conditions, large current-account surpluses and considerable repayments of government debt in many emerging markets contributed to a slowdown in emerging-market net sovereign debt issuance in 2006. Overall, gross issuance of bonds and notes in the international debt securities market remained strong in 2006 as the fall in sovereign issuance was offset to a degree by an increase in private corporate issuance.

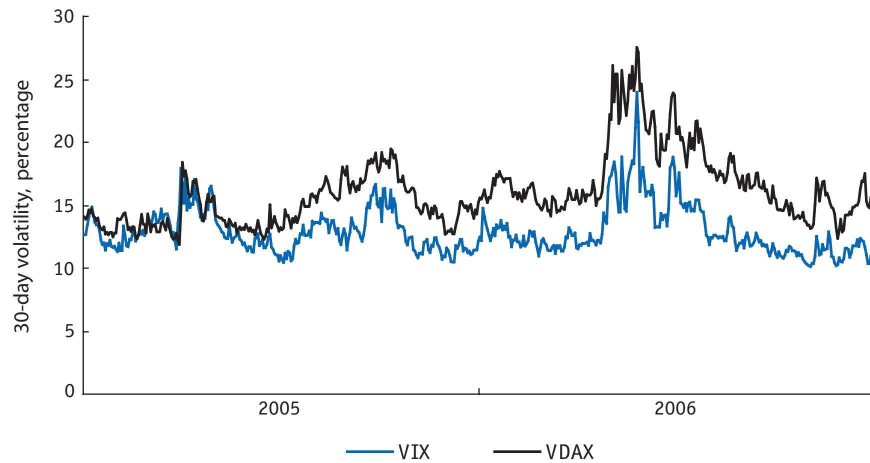
Chart B4: Global corporate-bond spreads



Source: Merrill Lynch

Implied volatility, which reflects the financial markets' uncertainty over the future path of equity markets, increased markedly across the global financial markets during the May/June 2006 sell-off. The increase was temporary in the US, where implied volatility returned to historically low levels. In the Euro area and Japan, implied volatility also fell after the financial market turbulence, but has remained at higher levels since June. Globally, volatility is still at historically low levels, which can only be partly explained by improved fundamentals, such as low and stable inflation and continuing GDP growth. The risk remains that investors are mis-pricing risk premia and underestimating the uncertainties associated with geopolitical risk and tightening financial conditions.

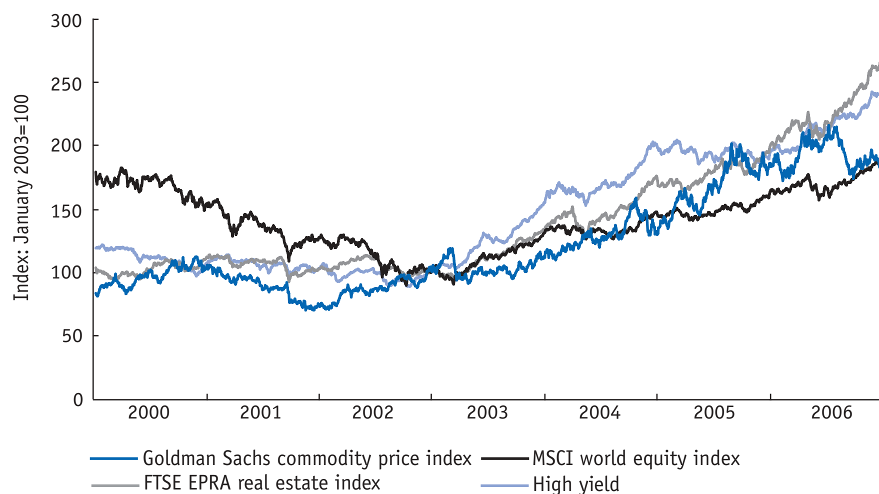
Chart B5: Implied volatility



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

The markets' pricing of risk (across a range of asset classes) is still thought by many to be too cheap, which raises the possibility of a rapid widening of spreads and significant price declines for riskier asset classes, such as commodities and emerging-market debt. This risk has become more pronounced due to an increase in correlations between different asset classes since 2003. Instruments that have been traditionally used to balance portfolios due to their low or negative correlation may no longer necessarily fulfil this role as effectively, because they now appear to be moving together. We discuss the implications of this in our *Reappraisal of risk* scenario.

Chart B6: Asset classes appear to be moving together



Source: Datastream

Although energy prices fell towards the end of 2006, commodity markets had a good year and non-energy commodities performed particularly well

Overall, commodity markets continued their strong performance in 2006, and industrial and precious metals composite indices increased by 64.3% and 21.2% respectively. Oil prices continued to increase during the first half of the year reaching nominal highs in July, but fell sharply after August 2006 on news of higher inventories, OPEC's decision to keep production quotas unchanged, and a market perception that geopolitical risk in major oil-producing countries had fallen. Natural gas prices weakened considerably in 2006 due to commercial and residential substitution away from natural gas as a result of record prices in 2005. Exceptionally warm weather in Autumn 2006 and early 2007 also contributed to lower energy prices.

High non-energy commodity prices were largely driven by continuing high demand for materials from China and emerging Asia, supply disruptions due to increased geopolitical and event risk, and low exchange inventories across many commodity products. Agricultural commodities gained 8.9% in 2006. The gains were relatively unevenly distributed, with ethanol-related demand for biofuels driving demand for corn and weather-related crop losses pushing up wheat prices. Like other asset classes, commodity prices fell during the May/June 2006 risk-reduction trades, but most indices quickly recovered to pre-May/June levels. In spite of considerable falls in oil prices towards the end of 2006, oil continued to trade at levels of around twice the 2003 mean. Going forward, strong global demand, particularly from Asia, and tight supply conditions indicate that risks to commodity prices and commodity-price volatility remain on the upside.

Alternative scenarios

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

The *Alternative scenarios* consider the implications of possible economic and financial developments and events for the financial services industry that are not directly captured by our *Central economic scenario*. We explore the transmission mechanisms through which these scenarios can affect the economy and financial services sector, and highlight some of the potential implications. We are not making forecasts and do not attempt to quantify their impact. Similarly, we do not make an assessment of how likely the scenarios are to occur or the possible triggers that could cause them to crystallise. The *Alternative scenarios* are a method by which it is possible to analyse the potential chain of events and knock-on effects of a change in economic and financial circumstances.

Alternative scenarios *explore the potential implications and transmission mechanisms of developments in the external environment*

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 therefore enables us to prioritise better the risks that we face and, in turn, assists us to 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 – firms should use the scenarios that are most relevant to their business model.

Our Alternative scenarios *from the* Financial Risk Outlook 2006 *are still important*

In the previous edition of the *Financial Risk Outlook* our *Alternative scenarios* were: a significant increase in oil prices; a slowdown in global consumption; and a large and disorderly depreciation of the US dollar and rising interest rates. These scenarios are still relevant in the current economic and financial climate (see box on page 28), but we have chosen to explore three new scenarios for 2007. They are: human influenza pandemic; reappraisal of risk; and a deterioration in personal credit quality.

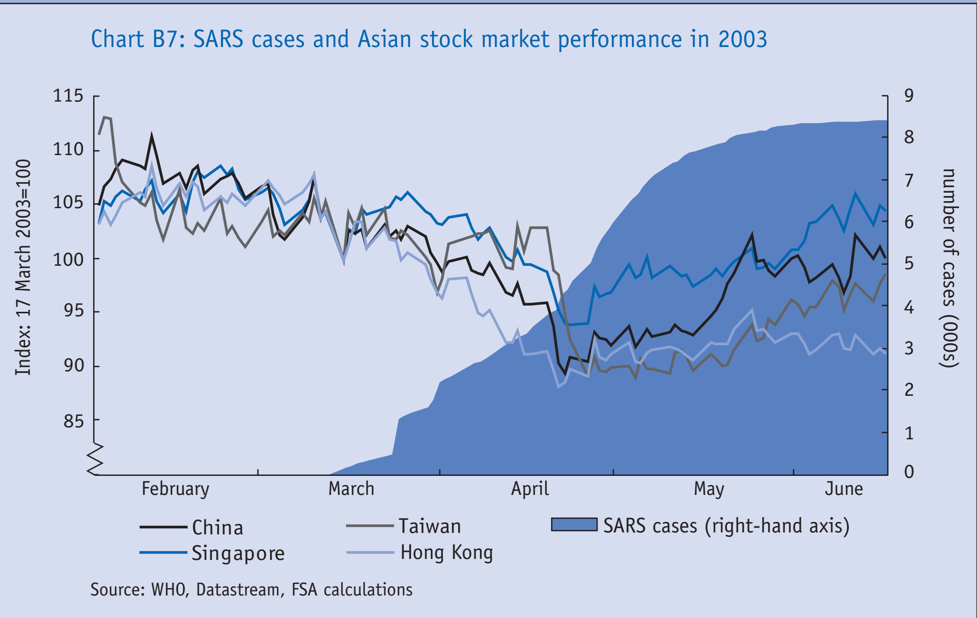
Human influenza pandemic

This scenario considers the impact of the emergence of a virulent strain of pandemic influenza and its implications for the UK economy and financial markets. We take the UK Department of Health's central assumptions on the physical characteristics of the pandemic (morbidity and mortality rates) as the basis for our scenario.[2]

The emergence of a highly virulent, novel, avian influenza A virus in East Asia has led many scientists to suggest that should the virus mutate to a form that could easily transmit between people, we could face a global human influenza pandemic.

Despite considerable uncertainty over the characteristics of a possible pandemic strain, a pandemic would have significant and prolonged implications for the UK economy, consumers, markets and us.

Chart B7: SARS cases and Asian stock market performance in 2003



Source: WHO, Datastream, FSA calculations

In this scenario, we assume that due to globalisation and extensive global trade flows, a local outbreak of virulent human influenza could not be confined before spreading to other regions. Increased capital flows and increasing use of offshoring and outsourcing in financial services also ensure that the global economy and financial markets could not be isolated from the effects of the pandemic.

The main driver of economic and financial impacts would be people's altered behaviour due to fear of infection and the need to take precautions against exposure, rather than the expected increase in mortality. As was seen in the case of SARS in 2003, people would attempt to avoid face-to-face interactions to prevent infection, which would lead to absenteeism from work and a fall in consumer confidence and tourism.

Risks for firms and markets

- Fear of infection would probably lead to a fall in consumption, which could coincide with a fall in exports as goods flows were disrupted. The resulting losses to businesses would be likely to lead to falling equity prices and prolonged volatility after the outbreak. Lower consumption and lower production of goods could lead to an economic recession.
- Firms with large exposure to insurance, tourism or sectors that are directly dependent on voluntary face-to-face contact (for example, entertainment, leisure and restaurants) could see their balance sheets deteriorate, as losses for such businesses increased and firms defaulted on their obligations.
- Firms' operational capacity could be tested as the level of staff sickness and absenteeism increased. Customer service standards could suffer unless firms have adequate business-continuity plans in place. Back-office operations that are outsourced overseas could also be disrupted, which could lead to delays in the processing of paperwork and increased backlogs, although this might be partly offset by lower demand for retail financial products during a pandemic. Losses from absenteeism and lost productivity would be likely to increase significantly.
- During a pandemic, investor confidence could fall and investors could seek safer assets, such as gold and government bonds. Increased risk aversion could lead to a considerable repricing of high-risk financial instruments and turbulence in global financial markets. Liquidity in the markets could fall, and investors could find it difficult to exit positions in assets that were considered at a higher risk. Emerging markets that were seen to be particularly vulnerable to the pandemic could see their spreads widen as investors sought to exit them for safer assets. This could lead to a prolonged period of volatility in emerging-market assets.

2 *Influenza Pandemic Contingency Plan*, Department of Health, October 2005.

- The cost of capital could increase as capital flows were disrupted and risk premia increased. This could result in considerable volatility in capital markets, especially if the economic impact of the pandemic was not short lived. Uncertainty over the disease characteristics could mean that investors would remain wary for a prolonged period of time after the pandemic had peaked.
- General and life insurance firms would be likely to face a considerable financial burden from increased claims on life, health, professional-indemnity and third-party liability insurance. In an environment of falling equity markets, insurance companies would need to ensure that they are in a position to meet their short-term liabilities, potentially over a number of pandemic waves. The concentration of losses could mean that reinsurers come under pressure in an environment where it is already difficult to raise capital.
- Consumer indebtedness and defaults on mortgages and unsecured lending could increase as consumers prioritise their own or their relatives' health. Banks' and other financial institutions' balance sheets could deteriorate due to increased defaults on mortgages and unsecured credit.
- The pandemic could give rise to unusual, or non-contractual, circumstances that could produce situations where firms had to resolve issues efficiently and quickly. Firms' reputations could suffer if they were not seen to be treating customers fairly during a pandemic.

Risks for consumers

- Household finances would be likely to come under pressure as absenteeism from work could lead to lower incomes. This could undermine consumers' ability to meet their mortgage or other loan repayments, which could lead to increased mortgage repossessions and personal bankruptcies.
- Disruption to infrastructure and increased staff sickness at financial institutions could mean that consumers are unable to access financial services or purchase financial products that are due for renewal, such as mortgages or insurance cover.
- Consumers could see the value of their long-term savings and pensions fall as equity markets come under pressure. The volatility in other retail financial products would also be likely to increase. This could lead to a fall in consumer confidence in long-term savings products and more generally the financial services industry.
- A fall in consumer confidence and an increase in consumers' fear of infection could lead to lower consumption and increased savings as consumers avoid shops and other public places. However, any increase in savings is only likely to materialise for consumers who have secure incomes and salaries that continue to be paid despite an increase in absenteeism.

Some ways our work could be affected

- We would have to allocate more resources to ensuring firms' risk management and ability to meet their obligations remain robust. We would also have to provide continuing guidance and, in some instances, provide waivers to allow the continuation of operations.
- Lower consumer confidence in financial markets and poor performance by some firms could mean that we would need to devote more resources to maintaining the overall confidence in the UK financial system. We would continue to liaise with the Treasury, other government departments, the Bank of England and other international regulators to minimise the impact on financial stability.
- Potential disruption to financial infrastructure during a pandemic could mean that consumers were unable to access financial services. We would need to ensure that consumers were not treated unfairly during a pandemic influenza outbreak, or its aftermath.
- We would have to prioritise our resources during a period of heightened absenteeism of our own workforce and ensure our own business-continuity plans were robust and able to deal with increased volume of communications from firms (for example on issues concerning regulatory forbearance).
- These events could lead to severe illiquidity and stress market infrastructure and orderliness. As a result we would need to work with market participants, the Treasury and the Bank of England to decide whether the closure of markets was necessary.

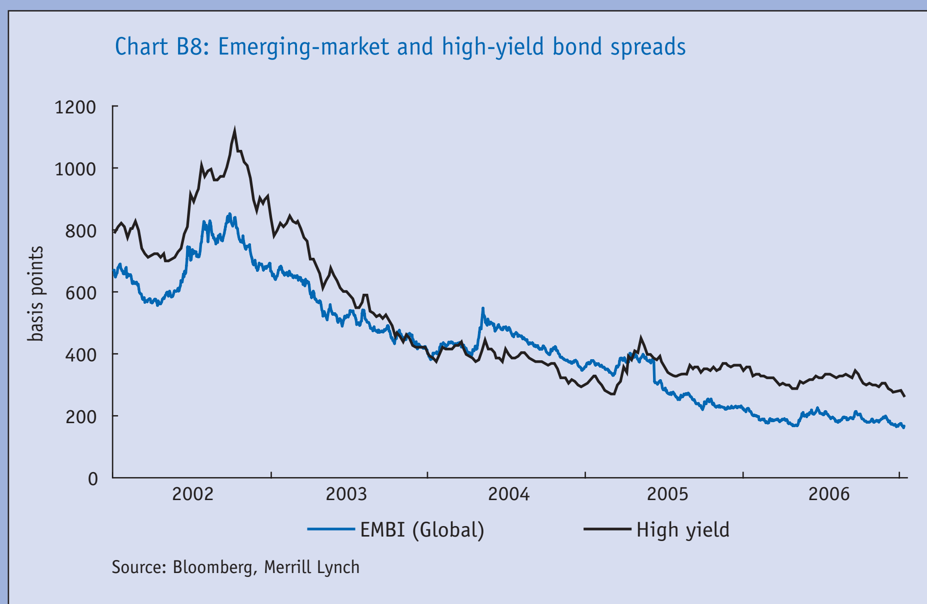
Reappraisal of risk

This scenario considers the impact of a global reappraisal of risk, which involves a widening in risk premia across all asset classes, but particularly affecting emerging markets and high-yield assets.

Global liquidity (which can be defined in a number of ways) has been ample in recent years, as central banks have maintained official interest rates near historic lows. The growth in available funds for investment has been further bolstered by the accumulation of foreign-exchange reserves in a number of emerging economies, as well as the investment of profits from oil-producing nations. The resulting large pool of accessible financing has driven down the returns from traditional lower-risk investments in developed nations, encouraging investors to look towards less well understood and potentially riskier asset classes, such as commodities and high-yield and emerging-market debt, as well as riskier strategies, such as 'carry trades' (borrowing on low interest rates in order to buy something else yielding a higher interest rate, often in a different currency), with the aim of amplifying returns. This is the phenomenon commonly known as the 'search for yield'.

The search for yield has so far been supported by a favourable global economic backdrop and a low volatility environment. This has strengthened the performance of emerging-market economies and at the same time encouraged the view that sovereign and corporate debt from these regions has become less risky. While a compression of emerging-market spreads can be partly explained by an improvement in the underlying fundamentals of these economies, it is possible that the risk could still be underpriced and insufficient differentiation drawn between investments. Search for yield has also resulted in the compression of yields for corporate debt and increased demand for commodity investments. While these developments have been taken to indicate that the riskiness of high-yield corporate debt has fallen and that high commodity returns will be sustained, investors may have been under-compensated for the risk that they have been taking on.

Chart B8: Emerging-market and high-yield bond spreads



Source: Bloomberg, Merrill Lynch

Many investors have adopted strategies of which success depends on the continuation of the benign conditions, indicating that they perceive low risk premia to be a permanent feature of the markets. However, a deterioration in global economic conditions or some other shock could result in an increase in volatility from the recent historic lows. The transition from a low volatility environment to one where volatility returns to its historical levels would not necessarily be smooth. Carry trades and other investment strategies that have exploited the search for yield could be unwound abruptly as investors repatriate funds amid a fall in the availability of low-cost funding for riskier strategies and an increase in risk aversion. Positions in a range of other risky assets could also be reversed in such a scenario.

Risks for firms and markets

- If economic conditions were to deteriorate, risk aversion among investors could increase and they could seek to liquidate positions in higher-risk asset classes (as was seen in May/June 2006 when investors sought to exit emerging markets and commodities). This could lead to crowded exits, draining liquidity from the market and causing erratic price swings in commodities, emerging-market equities and debt, and high yield debt.
- Volatility across the markets could increase for a prolonged period of time, resulting in a lasting aversion to higher-risk assets and more complex strategies and products. Volatility could quickly spread to other markets and to assets with lower risk premia.
- The fact that many asset classes and investment strategies that have traditionally tended to be weakly correlated are now more strongly correlated with each other could exacerbate the impact of this scenario on investors, as most of their portfolio will be re-priced in the same direction. Firms could see their balance sheets deteriorate quickly as the values of their portfolios fall.

- The search for yield has also been characterised by the 'carry trade', which has become popular due to the availability of low-cost funding and financial innovations that allow risk to be split up and managed. In this scenario we could see these carry trades unwind rapidly, resulting in increased exchange-rate volatility, which could lead to significant capital losses for investors.
- Non-conventional managed investment vehicles, such as hedge funds, have grown very rapidly. These vehicles are typically highly leveraged and take considerable risks, entering and exiting markets with relative speed. If there were a global reappraisal of risk and volatility were to increase, we could see an increasing number of hedge funds and other non-conventional investment vehicles fail, which could exacerbate the price movements in the markets if liquidity in the markets fell as a result.
- There could be a loss in consumer confidence in the financial intermediation industry if consumers felt that they had been given inappropriate or inadequate advice, which was then exposed by adverse market movements. Consumer complaints could increase if consumers felt their investments had been poorly managed or if they underperformed their expectations.

Risks for consumers

- Retail consumers have become increasingly exposed to more risky asset classes through investment funds that pool consumers' funds and participate in these markets. This could lead to significant capital losses for consumers, especially for those with inadequately diversified portfolios.
- The performance of pension funds and other vehicles for consumers' long-term savings could fall if there was a widespread reappraisal of risk in financial markets. If consumers' financial provision for their later life were to fall, the savings gap could widen.
- Increased volatility in capital markets could reduce consumer confidence in the financial markets, leading to a lower take-up of financial products in general.

Some ways our work could be affected

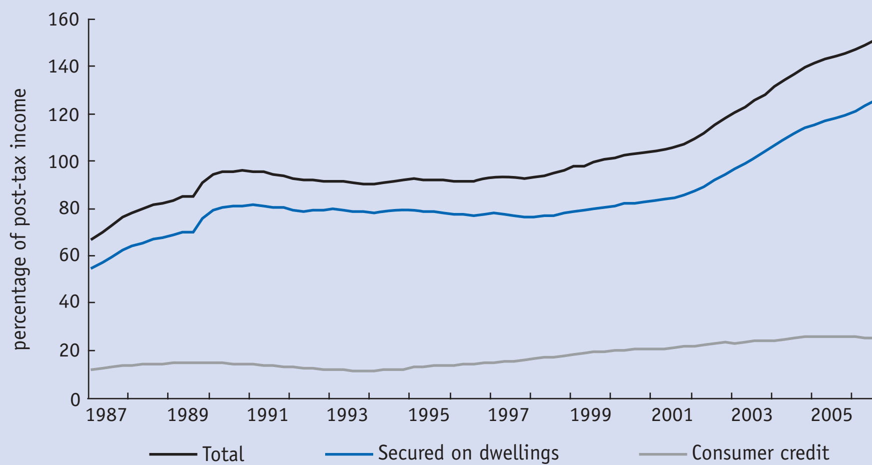
- The need for robust risk-management practices in firms would be highlighted, and we would need to ensure that firms' risk-management practices remain robust during these more testing financial market conditions.
- We would need to liaise particularly closely with the Treasury and the Bank of England to ensure that overall financial stability was not adversely affected.
- We would need to allocate more resources to financial capability and to investigating claims that consumers had not been treated fairly. We would also need to devote more resources to ensuring that consumer confidence in retail financial products would not suffer during and after the reappraisal of risk.

Deterioration in personal credit quality

This scenario considers the impact of continued high growth in personal debt on the financial services sector in the UK.

Personal debt levels have continued to climb, reaching record highs as a proportion of income. Recent increases in UK interest rates have added to the debt-servicing burden of households at the same time as spending power has been eroded by the increased cost of many non-discretionary items such as utility bills. The number of individuals experiencing debt-servicing difficulties has already picked up sharply, as evidenced by the significant rise in individual insolvencies. This has occurred against a background of rising employment and above-trend economic growth.

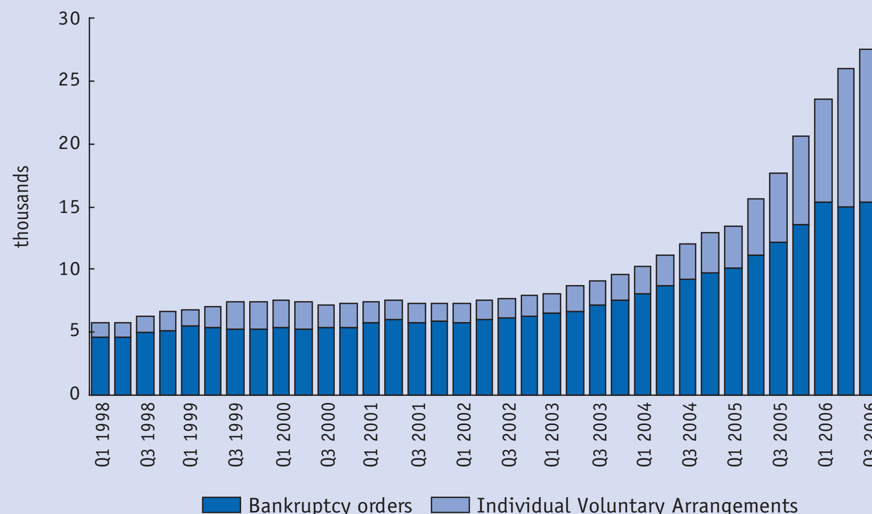
Chart B9: Personal debt as a proportion of income



Source: Bank of England, ONS

To date, debt-servicing difficulties have been largely confined to the renting population. Homeowners have increasingly relied on the higher value of their houses to withdraw equity in order to finance further spending and to refinance unsecured debts. While house price inflation has re-accelerated, this rate of growth is unsustainable in the longer term. In a benign scenario, house-price inflation would slow gradually to a level more in line with the rate of growth in average earnings. However, there is a risk that house prices could fall, in which case we might see a significant number of consumers who are unable to convert unsecured debt into secured debt, and therefore could struggle to meet their financial obligations due to the higher interest cost of unsecured lending.

Chart B10: Individual insolvencies in England and Wales



Source: The Insolvency Service

Risks for firms and markets

- High returns in the personal lending sector have made the sector increasingly attractive to financial institutions. A deterioration in these returns as a result of mounting arrears, particularly in the sub-prime sector, could lead to increased credit losses for these firms.
- The numbers of consumers facing debt-repayment difficulties could continue to increase. Arrears on secured and unsecured lending would continue to increase, resulting in higher numbers of mortgage possessions and moves by financial institutions to recover unsecured debt through the courts and via charging orders. This, in turn, would depress house prices further.
- Firms holding securitised mortgages, particularly if they are impaired, would see their portfolios deteriorate if consumer-credit quality and/or the housing market were to deteriorate. Rising levels of consumer defaults could create difficulties for lenders who rely on securitisation to finance further secured lending.
- Firms, particularly those which rely on one particular business line (such as credit card or other non-secured lending) for their earnings, could be affected by both lower income and higher write-offs.
- Lending to those with impaired credit could increase as a larger proportion of the consumer market had problems with credit quality. Firms would need to adapt their business models, for example by investing in their asset-recovery process, and make active use of it to manage stress testing and the increased risks involved.
- Consumer complaints over the mis-selling of debt could increase, which could pose reputational risks to firms. The financial intermediation industry and banks would need to ensure that those customers who are experiencing debt-repayment difficulties were treated fairly given their circumstances.

Risks for consumers

- High levels of personal debt could mean consumers will need to devote an adequate amount of time to ensuring their future assets meet their future financial needs. Pension planning may be diverted in favour of meeting short-term liabilities, which would have significant repercussions for consumers' provisions for retirement.
- The number of consumers seeking some form of formal debt resolution through, for example, a Debt Management Plan, an Individual Voluntary Arrangement (IVA) or bankruptcy is likely to increase. This could have considerable implications on individuals' future financial planning, as consumers who have had debt-repayment difficulties could find it difficult to obtain credit on terms they find acceptable in the future.
- Consumers' future investment decisions could be impaired due to the legacy of debt. This is particularly the case for pension arrangements, particularly those relying on riskier strategies such as buy-to-let, which fail to meet their needs. Consumers could be attracted towards even higher-risk assets in order to maintain returns.

Some ways our work could be affected

- We would need to allocate more resources to ensuring that prudential risks for firms, particularly among those whose lending is relatively concentrated, are managed appropriately.
- Consumer complaints could increase if consumers felt that they had been given inappropriate advice. We might need to allocate more resources to ensuring that consumers are not and have not been treated unfairly in the past.
- Our consumer-information priorities might shift. There would be a greater emphasis on informing households of options available for resolving debt issues.
- In an extreme scenario where consumers' credit quality deteriorated rapidly, we would need to liaise closely with the Treasury and the Bank of England to ensure that overall financial stability was not affected and that consumers maintained a level of confidence in the financial services industry.

Our 2006 *Alternative scenarios* are still relevant, and there have been a number of developments confirming the potential for these scenarios to pose a risk to the financial services sector in the future.

Sustained and significant increase in oil prices

Oil prices continued to rise in the first half of 2006 but fell in the autumn due to investors' reduced perceptions of geopolitical and event risk (for example, reduced tensions in the Middle East and the relatively uneventful US hurricane season) and of news of higher available supplies. In spite of the fall in prices towards the end of 2006 and in early 2007, oil prices continue to trade at a significantly higher level than the historical average. Higher oil prices have coincided with tighter financial conditions around the world, which has increased pressures on both producers and consumers. Higher oil prices contributed to higher inflation expectations around the world, and many central banks reacted by raising interest rates in 2006. Although the path of oil prices could be difficult to predict in the short term, the risks to oil prices continue to be weighted on the upside due to the persisting direction of demand and supply pressures.

Slowdown in global consumption

Consumer borrowing continued to grow in the major economies and in many emerging markets in 2006, and the risk of a synchronised restructuring of household balance sheets remains a concern going forward. In the UK, personal debt levels have risen to record highs as a proportion of income and individual insolvencies have increased substantially. In the US, consumer spending slowed towards the end of 2006 on the back of slowing housing markets, and consumers came under increasing pressure to switch from largely asset-based consumption to income-based consumption to sustain spending. Considerable uncertainty remains over whether the economic growth in regions outside the US has been self-sustaining or whether other major regions (such as Japan and the Euro area) have decoupled from the US. There were increasing fears in late 2006 that the effects of slower consumer spending in the US could spread to the rest of the world through trade, causing the global economy to slow down.

Large and disorderly depreciation of the US dollar and rising interest rates

The US continued to run a large current-account deficit (6.6% of GDP) in 2006, which was financed by a continuing demand for dollar-denominated assets from the rest of the world (particularly Asia and oil-exporting countries). While foreign investors broadly remained prepared to finance the deficit, there was some indication that a number of investors had begun to diversify their reserves away from US Treasuries to gold and non-US dollar-denominated assets. There was also anecdotal evidence that the burden of the deficit financing was shifting from Asian central banks to oil-exporting countries, which have increasingly recycled their oil revenues to US dollar-denominated assets.

Investor concern over the strength of the US economy and the continuing widening of global imbalances was demonstrated in November 2006 when the US dollar sharply depreciated against the euro and sterling. The US dollar's weakness was also reflected in equity price movements in Europe. The narrowing of the positive interest rate differential between the US and the Euro area could also be negative for the dollar going forward. As long as the global imbalances remain large, the depreciation of the dollar and higher interest rates in the US to support the currency remain a plausible scenario for the financial markets.

Risks to financial stability

Financial stability risks are those risks which, if they were to crystallise, would have the potential to result in a major and rapid disruption to the effective operation of a core function of the financial system. At present, the risk of a financial stability event occurring is relatively remote, although there is a range of plausible event risks that could crystallise. Adverse shocks are not necessarily financial stability risks, as long as the financial system is capable of absorbing those shocks and continuing to function smoothly. Instead, financial stability risks are either systemic weaknesses, shocks or transmission mechanisms that have the potential to undermine the ability of the financial system to function in its normal fashion. A functioning financial system is characterised by a contractually certain link between suppliers of funds (investors or depositors) and demanders of funds (borrowers) with both efficient and effective price formation and the transfer and acceptance of risk.

The global economy and financial stability

Our Central economic scenario *for the global economy is benign, but we see a number of challenges on the horizon*

Global economic conditions are benign at present, but as we highlight in our *Central economic scenario* there are considerable challenges ahead. While the risks to financial stability, either economic or political, are relatively low at present, if economic conditions were to significantly deteriorate, financial stability could be tested. Geopolitical risks, whether they are security related (for example the Middle East or northeast Asia, notably North Korea) or economic (for example rising protectionist pressures) also appear to have risen over the last year. By their very nature, these events' ramifications can be difficult to quantify. Nevertheless, they can still pose threats to financial stability.

Event risk

The complexity of financial markets has increased, which means that the financial system also faces more complex shocks

The global economy and financial markets have performed well for a significant period of time; growth has been robust, inflation has been subdued, and volatility has remained low. However, this period of economic and market stability does not mean that the financial system is necessarily in a position to withstand the impact of a significant event. Financial markets have become increasingly complex since the last financial stability crisis, which implies that transmission mechanisms for shocks have also become more complicated and possibly more rapid. Market liquidity remains abundant (irrespective of how it is measured), but it is still important for market participants to consider how they would operate in an environment where liquidity is restricted.

Over the last few years, correlations between asset-class price movements have increased significantly. Moreover, it is well known that major events can change long-established correlations between financial instruments. Such structural developments can reduce the reliability of models and change the valuation of some financial instruments (for example collateralised debt obligations) that factor correlation risk into their pricing models.

Correlations between markets have increased

The correlations between markets in different geographic areas have also been increasing. This calls into question some of the benefits of geographic diversification, either in an investment portfolio or within a group. Moreover, in a world with increasingly globalised industries and financial or product markets, the repercussions of a given event are unlikely to be restricted to the precise geographical area where the crisis has originated. This means that the ripple effects of a localised event could spread widely over geographic areas and to many different financial markets.

Event risk is a likely trigger for financial-stability problems. We define event risks as unexpected, isolated events, such as natural disasters (which may increase in frequency due to climate change, (see page 33), global or regional pandemics, large corporate failures, political instability in a major economy, or terrorist attacks, which could have far-reaching implications for financial systems worldwide by exposing existing vulnerabilities in the system. These events can expose firms to greater downside risk, particularly where there are weaknesses in risk management or where firms have increasingly moved out on the risk curve in the search for yield. Operational or legal risks can also crystallise as a result of these events.

The crystallisation of a risk event will have both first-order and second-order effects. Some of these effects are highly predictable and should already be factored into stress testing and scenario analysis. However, other variables, such as individuals' reactions to an event, are highly unpredictable and are very difficult to factor accurately into scenario analysis and stress-testing programmes.

The mechanisms through which crystallised event risks can be transmitted to the wider financial system are fairly predictable, and these transmission mechanisms ultimately inform our *Priority Risks*. A crystallised event risk could cause any of the following.

- Operational problems for a wide range of firms. In markets where participants carry unsecured credit risk during settlements there is a risk that payments might slow down or even stop.
- A reduction in the supply of and increase in the cost of liquidity. Market participants could struggle to manage their positions in certain instruments, and could find it difficult to sell large quantities of a position in an attempt to maintain liquidity or reduce the impact on solvency. In such a market, it would also be difficult to establish the value of positions with certainty. This would be exacerbated if participants have not fully or accurately documented such transactions.
- A variety of legal problems for market participants. As was exposed by the Herstatt Bank failure in 1974, legal finality of settlement can potentially be called into question if a market player faces difficulty. It is also worth noting that relatively new markets in financial products have not been tested in this way.
- Stress for reinsurers, which often provide the cover of last resort.
- A slowdown in the trading of instruments that are used as collateral to secure payments. These can include certain government bonds or corporate bonds of large issuers.

Our Alternative scenarios *explore three plausible risks to the financial system*

We also look at the possible transmission mechanisms for plausible risks to financial stability in our *Alternative scenarios*. These scenarios could be triggered by an event or a more slow-burning development in the economy and financial markets. Of our three *Alternative scenarios*, the *Reappraisal of risk* scenario poses particular risks to financial stability through a possible increase in investors' risk aversion and a consequent repricing of risk across different asset classes. This scenario could crystallise rapidly, even in an environment of relative calm, an example of which was seen during the May/June 2006 risk-reduction trades. The transmission mechanisms for our *Human influenza pandemic* scenario are primarily through the uncoordinated actions of individuals. An outbreak of pandemic influenza could result in prolonged stress to the global economy and the financial system if consumer and investor confidence in the global financial markets were to dramatically fall. We also look at consumer borrowing in our *Deterioration in personal credit quality* scenario. High levels of personal debt increase the risks of consumers restructuring their household balance sheets, the implications of which could potentially have serious macroeconomic consequences but would be unlikely to raise financial stability risks.

Stress testing

It is important that firms incorporate stress testing and scenario analysis into their business models…

Stress testing and scenario analysis of extreme events (whether political, economic or market) are essential components of firms' planning and risk-management processes. By using stress testing and scenario analysis, senior management can assess and adjust their view of the risks that face their firm, plan mitigating action and identify risk concentrations. Sudden and dramatic changes in risk parameters can lead to a situation where markets behave unexpectedly and where traditional forms of risk mitigation (such as hedging strategies) cannot be used, thereby putting the firm under stress. Testing 'what if' scenarios, particularly those out in the tail, can reveal sensitivities to abnormal market conditions and hidden weaknesses, such as unexpected correlations between seemingly unrelated exposures. From a systemic standpoint, there are significant benefits from the industries that we regulate having robust risk-management practices, as this can make the system as a whole more resilient to a financial crisis.

We recognise that the financial services industry is improving its risk-management processes. However, we also think that many firms still need to make further progress to reach the standards reflected in the Comprehensive Approach, a view of good practice in stress testing that was developed in cooperation with the industry.

In 2006, we conducted a thematic review of stress testing at ten large firms in the banking, building society and investment banking sectors.[3] During these visits we were struck by the relative weakness of the firm-wide stress events at some of the firms. This evidence suggests that few firms were seeking out scenarios such as those that might require a dividend cut, generate an annual loss or result in shortfalls against capital requirements, while still remaining plausible. The current level of profitability and capitalisation in many firms may provide part of the explanation. Additional reasons could be that firms underestimate the likelihood of severe events or, where mitigating action is envisaged, they overestimate their ability to take action that is both effective and timely.

3 *Stress testing thematic review*, FSA Dear CEO Letter, October 2006.

Business-continuity planning

… and keep their business-continuity plans up to date

Firms should regularly test and review their business-continuity plans to ensure that they have systems and processes in place able to cope with major operational disruptions from high-risk events, such as terrorist attacks, natural disasters and global pandemics. In their planning and testing programmes, firms should pay close attention to external dependencies which might render them vulnerable during a major event. Those dependencies include major financial counterparties, key suppliers of goods and services, and infrastructure providers such as power, water and telecoms. An influenza pandemic would present a particular challenge to business-continuity planning, both because of its extended duration and because it would impact personnel more than physical assets. Our *Alternative scenario* outlines the implications for firms, consumers and us from a global influenza pandemic.

International regulatory cooperation

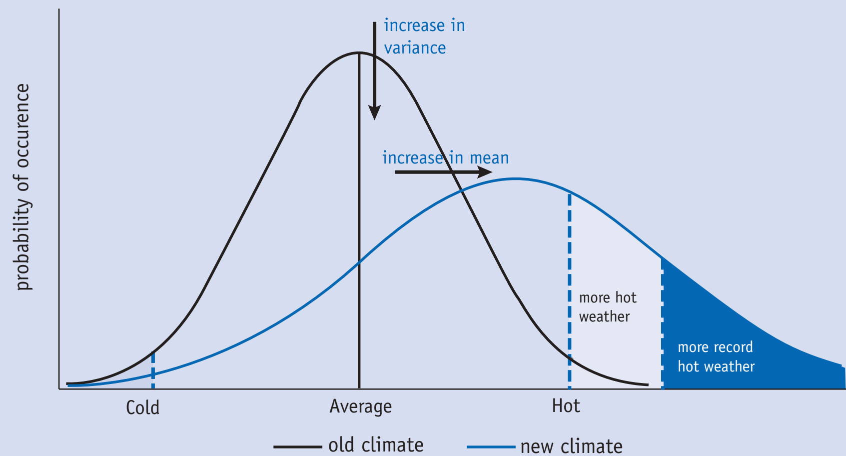
As we have mentioned, in an increasingly globalised world, there is a heightened potential for the crystallisation of a major risk in one jurisdiction to transmit to another, triggering an international financial crisis. There are a number of transmission channels through which the UK could be affected by such a problem overseas, including cross-border exposures or movements in international financial markets. UK-based firms could also be affected by being the subsidiary or associate company of a firm in an affected country or, more remotely, because of their connections with a financial centre that is experiencing difficulties. Of course, this potential for contagion could also work in the opposite direction, with a problem originating in the UK being transmitted elsewhere.

In light of this risk of global contagion, it is important for regulators to work together internationally, particularly to ensure that their crisis-management arrangements are as well coordinated as possible. We continue to maintain close links with regulators in all major financial centres and share the common objective of ensuring arrangements among authorities in a crisis are adequate, efficient and effective. We consider that further developing these arrangements is a priority.

Climate change poses considerable risks and challenges to the financial sector

Since the 1960s, the frequency and size of catastrophic natural events has increased dramatically. Scientific consensus is that this increase in the frequency of extreme weather events and the rise in mean global temperature can only be explained by human-induced climate change. The impact of climate change on global GDP, through increasing damage to infrastructure and loss of life, is likely to be considerable.[4] The financial services industry faces considerable challenges in adapting to the changing climate, but there are also significant opportunities in developing strategies and products that enable the industry to cope with the changing external environment.

Chart B11: The changing distribution of extreme and average weather due to climate change



Source: Intergovernmental Panel on Climate Change, Third Assessment Report 2001

Climate change will continue to cause disruptions to business operations and put companies' physical assets at risk through increasing frequency of extreme weather events (for example hurricanes, tropical storms, typhoons and flooding in coastal areas). Physical damage to businesses and the disruption to supply chains is likely to cause volatility in equity markets, which will transmit to volatility in investment returns for both retail and wholesale investors. The financial centres of London, New York, Tokyo and Hong Kong are all located in coastal areas, and are likely to be particularly affected as flooding increases and changes in soil composition weaken buildings' foundations. Commercial property will be at risk, lowering the value of investments. Increasing use of offshore centres for outsourced financial services also exposes the global financial system to climate change, as extreme weather events and a rise in sea levels destroy infrastructure around the world.

The insurance industry will have to meet an increasing number of claims from weather-related events that occur both at an increasing frequency and with growing severity. Claims on both personal lines (for example health and home insurance) and commercial lines (physical damage to insured assets or Directors' and Officers' liability insurance) are likely to be affected. The correlation of seemingly unrelated events is also likely to increase as one event will predispose a region to another. This kind of 'clustering' of events and the increasing frequency of extreme events are likely to put considerable pressure on insurance companies' capital requirements. Insurance companies are likely to need more capital to cover liabilities in an environment where it is considerably more difficult to raise capital.

Climate change is likely to increase the cost of capital markedly, as investors demand a higher premium for putting their capital at risk. This is likely to result in considerable uncertainty in capital markets across different asset classes. Climate-change impacts and losses are likely to be geographically unevenly distributed, potentially leading to considerable population migration and regional conflict, which would increase the risk premia in these regions. Emerging-market spreads could widen as the risk of investing assets in areas where the costs of climate change are likely to be higher increases. The banking industry is exposed to climate change not only through its exposure to financial and capital markets, but also through its holdings of collateral, of which value is likely to become increasingly uncertain.

New products are likely to emerge to take advantage of the changing operating conditions, which is an opportunity for the financial services sector, but also involves considerable risks. The climate and weather-forecasting models that are used to value weather-dependent financial instruments are highly reliant on the accuracy of the data and models. A key feature of weather and climate change is that it is highly unpredictable. This means that any increase in global mean temperatures could completely change the accuracy of models as traditional feedback loops that have kept the global ecosystem balanced could reverse, stop working or accelerate. The number of new products that either allow hedging against climate-change impacts or improve firms' reputations as they are seen to be 'green' is likely to increase dramatically over the next few years. It is important that firms understand the risks involved with these products and manage their portfolios accordingly.

Firms that are not seen to be acting either in the best interest of consumers as the external environment changes or ensuring that they minimise their climate impact could face severe reputational risks. Reputational risks could cause firms to lose customers and also expose them to litigation if they were not perceived to be treating customers fairly. While a number of financial services firms have explored the implications of climate change on their business, some parts of the industry are still behind in their efforts to stress test their businesses to the changing business-operating conditions.

4 *Stern Review on the Economics of Climate Change* (HM Treasury, 30 October 2006) estimates that abrupt and large-scale climate change could cost 5%-10% of global GDP.

Developments in industry

Banks and building societies

The diverse nature of the major UK banks enabled them to withstand the deterioration of the retail banking environment in 2006. While banks are set to remain both profitable and highly capitalised in 2007, the sector will face a number of risks, especially if the business operating environment were to deteriorate. In the retail market, these include: dealing with increasing arrears on unsecured lending; preparing for a possible sharp weakening in the housing market and adjusting their business model in response to resistance from consumers; as well as scrutiny from the public authorities into their charging and marketing practices. In the wholesale markets, banks' risk appetite, which has risen in a low-volatility and spread-compressed market, has also increased the potential risks that could arise from adverse developments. It is possible that favourable credit-market conditions could change, and banks need to assess how they would cope with a less benign environment.

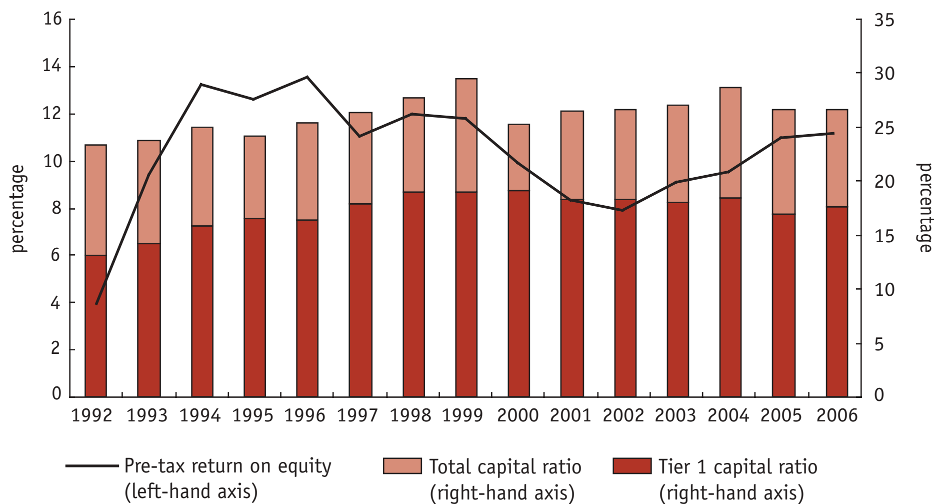
Performance and financial strength of UK banks

Major UK banks remain highly profitable and well capitalised, and are well placed to cope with future uncertainties in the operating environment

While major UK banks' profitability, as measured by the return on equity, is still below the levels observed in the mid-1990s, it remained at healthy levels in 2005/06. The overall capital ratio slipped from 12.3% to 12.2% and the proportion made up by tier 1 capital increased from 7.8% to 8.1%.

Profits continued to grow in the first half of 2006 compared with the same period in 2005. This increase in profitability was achieved despite an increase in retail-impairment charges resulting from strong growth in the number of personal bankruptcies and Individual Voluntary Arrangements (IVAs). This is discussed in more detail in *Consumers' engagement with industry*, Section D. The strength of profits reflects many banks' efforts to diversify their businesses, both geographically and by business line.

Chart C1: Major UK banks' profitability and capitalisation



Note: Figures for 2006 are for the first half of the year only.
Source: Bank of England and Company accounts

Income for the nine major listed UK banks continues to show strong growth, increasing by 10% in 2006. In contrast to previous years, the breakdown of growth between net-interest income and non-interest income was fairly well balanced, at 10.2% and 9.9% respectively. As in the recent past, income growth was boosted by revenue from international business, capital market activities and corporate lending, which offset slowing growth in UK retail lending. These are generally lower-yielding assets, so this diversification may also have contributed to the relatively small decline of 0.09% in net-interest margins. This could have been greater had some of the lending not been in more risky areas with higher margins (such as debt finance for private equity buyouts).

The banking sector is likely to face a number of challenges in the retail market over the medium to long term. These include: dealing with increasing arrears on unsecured lending; preparing for a possible sharp weakening in the housing market and adjusting their business model in response to resistance from consumers; as well as scrutiny from the public authorities into their charging and marketing practices.

Performance and financial strength of UK building societies

Building societies continue to face strong competition from other mortgage providers…

Building societies continue to face an increasingly competitive operating environment within their core markets – prime-residential mortgages and retail savings. Net-interest income fell to 1.06% (of mean assets) in the first half of 2006, down from 1.45% in 2000.

The sector has responded to competitive pressure in a number of ways. Costs have fallen in line with falling interest margins and management expenses have been reduced to below 1% of mean assets. However, it may be difficult for many building societies to make further efficiency gains. Some building societies have responded to cost and competitive pressures by seeking mergers to reduce unit overheads through economies of scale. Cost cutting has also helped to hold the sector's solvency ratio reasonably steady, falling only from 12.1% to 12.0% between 2000 and mid-2006.

… and have responded to the competition by moving into areas with higher returns, but also higher risks

Like the banks, some building societies have also moved into new, higher-risk areas of business, such as commercial and sub-prime lending and, to a more limited extent, investment advice. Total lending to the corporate sector by building societies grew by an annual rate of over 20% in the 12 months to June 2006. Most of this lending will have been for commercial property, and such loans now constitute about 8% of building societies' assets. For some building societies these higher-risk activities are relatively unfamiliar areas of business, and management teams need to undertake a thorough *exante* examination of changes in strategy, recognising and understanding the greater risks they run as well as the higher returns that they may offer.

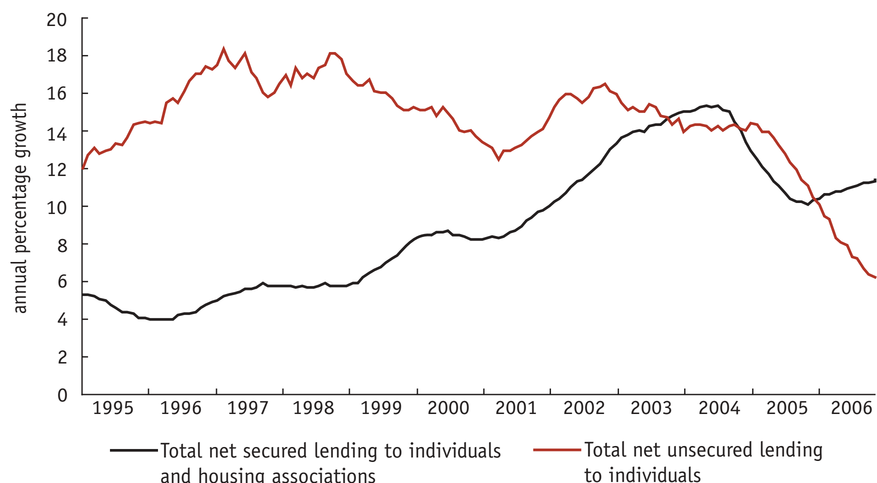
It is likely that the pressures on building societies will continue in the future. Overall, credit quality in the building society sector still appears to be relatively good. Arrears above 2.5% of balances on building society mortgages and repossessions on building society mortgages account for only 0.43% of total balances, which is about half that for banks. However, the equivalent figures for building society subsidiaries (which hold a significant proportion of the sub-prime, buy-to-let and other non-standard lending of the sector) are currently at more than five times the building society-only number. As we discuss below, the increases in consumer debt, bankruptcy and IVAs will have an impact on asset quality across the whole of the sector during 2007, but particularly on non-prime lending.

Lending growth in retail credit

Against expectations, mortgage lending grew rapidly in 2006, but the rate of growth of unsecured lending continued to fall sharply

In early 2006 the consumer-credit cycle appeared to have turned, as the growth rate in consumer lending slowed for both mortgages and unsecured lending. Arrears, especially in credit cards, had also begun to rise. However, contrary to expectations credit growth has remained robust in 2006, but mortgage lending and unsecured lending have behaved in quite different ways.

Chart C2: Growth in outstanding consumer lending in the UK



Source: Bank of England

Overall, consumer lending had risen by 10.4% in the year to November 2006, taking total UK personal debt to around £1.3 trillion.[1] Growth in unsecured lending continues to decelerate, as demand dampens and the banks tighten lending criteria. Consumers may also be taking advantage of relatively low interest rates to refinance unsecured borrowing through other sources of debt, such as secured loans or instalment credits. At the end of November 2006 annual growth in net unsecured lending had fallen to 6.2% year-on-year.[2] In contrast, the rate of growth of secured lending increased during the year. The strength of secured lending has been underpinned by sustained growth in house prices.

Competition and increasing house prices are driving some banks and building societies to offer borrowers larger mortgages

Faced with the continuing rise in house prices and competition in the mortgage market there is evidence that some mortgage lenders are relaxing their lending criteria. Although lenders have stressed their commitment to more effective affordability tests, some firms have announced they are prepared to lend on significantly higher income multiples than was previously the case. Lending on high-income multiples may be appropriate in certain circumstances, but it raises questions about whether lenders have adequately assessed their borrowers' ability to cope with higher interest rates. More generally, firms will need to ensure that these sales meet the affordability and other responsible lending requirements that we, and market participants, expect.

Buy-to-let mortgages also showed a considerable increase in volumes over 2006. This, coupled with a further rise in the level of buy-to-let mortgages in arrears, could translate into rising impairment charges for lenders if economic conditions were to deteriorate over the course of 2007. The competitive devaluation of the security margin in 2006 (with increases in maximum loan-to-value and decreases in required minimal rental cover) could also magnify the difficulties the industry would face in the event of weaker economic or housing market conditions (see box on opposite page).

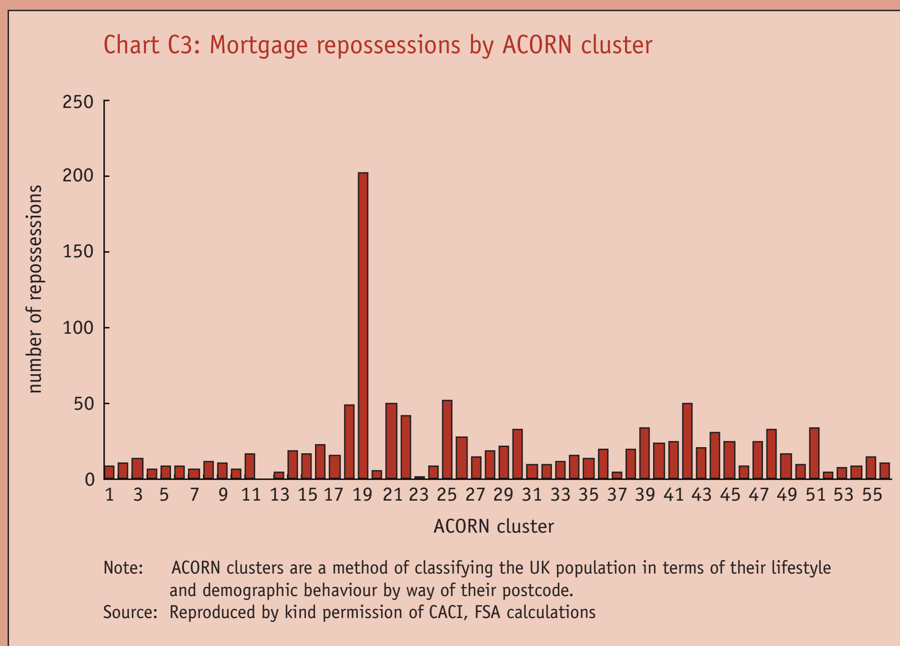
1 *Monetary and financial statistics ("Bankstats")*, Bank of England, December 2006.
2 Ibid.

Mortgage repossessions

The recent rise in mortgage repossessions has led to an increase in the number of repossessed properties being sold at auction. We have created and analysed a sample of repossessed properties using data from auctions, the Land Registry, the 2001 population and housing census, geodemographic profiling and our product sales data.[3] The sample shows that in February 2006, around 8% of lots offered at a typical national property auction were sold by order of mortgage lenders as repossessions. By December 2006, this figure had risen to around 25%.

Geodemographic profiling of the postcodes of the repossessions suggest that the majority are in buy-to-let areas. Almost 80% of the repossessions occur in areas where home ownership with a mortgage is not the predominant form of tenure. The high level of repossessions in buy-to-let properties reflects the negative net rental returns and the low rates of capital appreciation on newly built properties in the last couple of years. The average price of a new flat (which make up 45% of the possession sample, but only 8% of the mortgaged housing stock) increased by just 0.8% between the second quarter of 2004 and the first quarter of 2006.[4]

Chart C3: Mortgage repossessions by ACORN cluster



Note: ACORN clusters are a method of classifying the UK population in terms of their lifestyle and demographic behaviour by way of their postcode.
Source: Reproduced by kind permission of CACI, FSA calculations

Data on buy-to-let arrears suggests that, while these are rising, they are below those of standard mortgages (see Chart C5). This implies that some of the properties that have been repossessed and sold at auction could originally have been purchased for the purpose of buy-to-let, but were purchased with a standard mortgage, rather than a buy-to-let mortgage.

We continue to analyse the sample, but we have already identified a number of cases of suspicious activity. These involve, for example, individuals providing false information to lenders on their income level, on their status as purchasing for own use and possibly pretending to be first-time buyers. These types of behaviour could be designed to obtain relatively low-cost, highly-geared loans for the purpose of purchasing properties to let, and constitute potential fraud.

If consumers are found to have committed fraud this will have serious consequences on all areas of their life, not just their ability to obtain credit. What is also apparent from this analysis is that these consumers do not understand the risks associated with the buy-to-let property market and do not have alternative sources of finance to cover periods where they are not receiving rent payments.

Given the recent increases in interest rates, as discussed in our *Central economic scenario*, Section B, there is a risk that the number of properties taken into possession will rise sharply in the coming months. Mortgage lenders could face losses if they do not increase their vetting procedures to address this type of consumer behaviour. There is also a significant risk that mortgage lenders do not know the true quality of their lending book and therefore any stress testing that they have carried out may not be reliable.

While this analysis raises concerning issues, particularly for consumers, we do not think that it is a systemic issue for banks. Properly financed and managed buy-to-let properties have a better arrears profile than prime mortgages (see Chart C5).

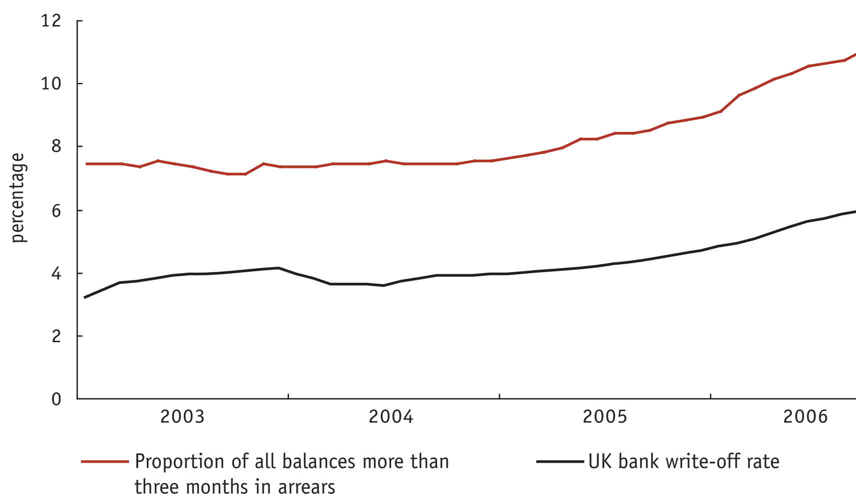
3 The sample consists of 1,400 properties sold at 27 auctions in England and Wales. This accounts for 30% of the stock of mortgage repossessions at the end of 2005.
4 Mixed adjusted house prices for England and Wales, *House Price Statistics Quarterly Report*, Communities and Local Government Department, 5 June 2006.

Impairment charges

Impairment charges for unsecured loans are rising sharply

For the major UK banks, impairment charges grew rapidly in 2005/06. Nearly all of the growth reflected the decline in asset quality of the unsecured retail-loan book. Data for credit cards show that in September 2006, 11% of outstanding balances on credit cards were more than three months in arrears, up from 8.5% in September 2005.[5] The percentage of credit card balances written off by banks during 2006 stood at 5.9% in December 2006.[6]

Chart C4: Credit-card arrears and write-offs



Source: APACS, Bank of England and FSA calculations

A number of factors have contributed to this deterioration. The level of personal-sector indebtedness, particularly among certain vulnerable groups, has been a cause of concern for some time and we also discuss it in *Consumers' engagement with industry*, Section D. The effect of the gradual increase in interest rates (see *Central economic scenario*, Section B) has also affected the situation.

Borrowers' attitudes to debt may be changing, but banks must also acknowledge that their lending criteria in earlier years may have been too relaxed

Attitudes to debt may be changing in that borrowers are now more willing than before to contemplate ways to reduce or avoid debt obligations. The stigma of bankruptcy may have been reduced, as shown by the rising use of IVAs and other debt-management solutions. The use of IVAs is discussed in a box in Section D. A higher tendency to take on debt could also be a contributing factor in the shift of attitudes towards indebtedness.

However, banks must also acknowledge their contribution to the problem of previous lending decisions and address any lessons learnt. It is evident that lending criteria, especially in 2003/04, were not sufficiently rigorous. There is an implicit recognition of this in the extent to which lenders have tightened loan and credit card criteria over the past year, contributing, as noted above, to the slowdown in unsecured loan advances.

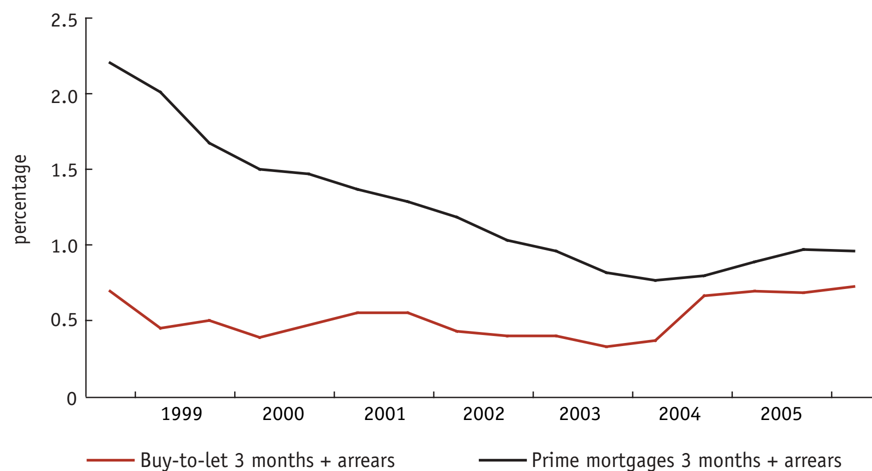
5 APACS.
6 Bank of England and FSA calculations.

Impairment charges for mortgage lending have remained low, but could rise significantly during 2007 for more risky types of lending

Good credit conditions coupled with rising house prices have ensured that secured-lending impairment charges and arrears remain stable and near historic lows across most of the mortgage-lending industry. This is encouraging, but given that consumers would tend to default on lower-priority unsecured lending before risking repossession of their homes, there is still the possibility that problems are accumulating below the surface.

Since 2003 there has been a noticeable upward trend in the proportion of properties taken into possession, albeit from a very low base; the trend accelerated during the first half of 2006. Arrears are also increasing for more risky types of mortgage lending, such as lending to sub-prime borrowers and buy-to-let mortgages.

Chart C5: Buy-to-let arrears



Source: Council of Mortgage Lenders

The trends in lending, arrears and loan impairment in the retail sector suggest that we may see some further difficult adjustment in 2007. The process of adjustment to a situation where we can feel more comfortable about the ability of personal-sector borrowers to manage their debts in less benign economic circumstances may take some years to work through the system. Much will depend on the outlook for the economy and markets. A benign economic environment that supports consumer confidence and limits any possible increase in unemployment would cushion the impact. However, as discussed in *Economic and financial conditions*, Section B, while the current economic environment is still benign, there are some risks on the horizon.

Corporate lending conditions and standards

Corporate lending has remained strong, fuelled by a favourable credit environment

Corporate credit quality remains cyclically strong. Lending has been supported by a strong earnings performance from the non-financial sector and favourable economic conditions. Demand has also been driven by the recent surge in M&A, including leveraged buyouts (LBOs) and debt restructuring. Lending to UK non-financial companies grew by 16% year-on-year in June 2006, a similar rate to that which we observed in 2005.

The favourable credit environment has supported this growth. Corporate failures in the UK remain near historic lows, with data for the third quarter of 2006 showing a 4.3% decrease on the same period in 2005. The number of liquidations is now below half the peak levels seen in the early 1990s. Nevertheless, there is a general expectation that credit quality will soon start to deteriorate.

One feature of the present credit cycle has been the willingness of lenders and investors to gain exposure to speculative-grade credits. In part, this has reflected the very low levels of defaults since 2002, and also the desire of lenders and investors to earn higher yields as interest rates are still relatively low and spreads on investment-grade credits have remained so narrow. This is discussed in more detail in *Economic and financial conditions*, Section B.

However, the financial health of companies that are often highly leveraged tends to rely heavily on the strength of the economy and the level of interest rates. With the global economy expected to slow in 2007, these companies may start to come under pressure and consequently default rates could rise.

Leveraged finance

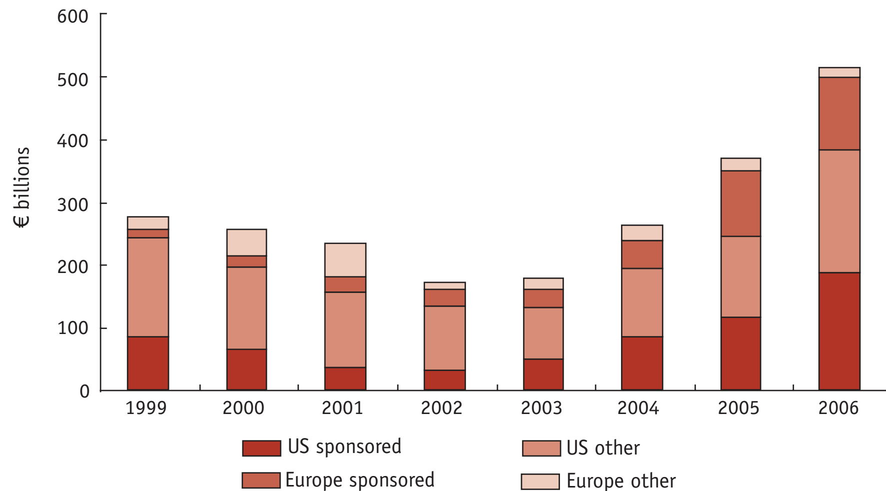
Banks have been offering higher leverage on bigger deals with weaker loan covenants

The previous edition of the *Financial Risk Outlook* noted a rapid increase in leveraged lending, much of it associated with an equally rapid growth in the private equity market. The trend has continued in 2006, and there have been significant increases in both the size of deals and in the amount of leverage within their financing structures. As the average deal size has grown, banks' LBO exposures have become more concentrated, with firms' top five deals representing, on average, 47% of their exposures. The average leverage on the five largest transactions, measured by the debt/EBITDA ratio, was 6.41. This is a historically high figure, and also well above the leverage seen on smaller transactions.

Many firms are limiting their exposure by distributing the debt that they underwrite. Banks were, on average, only holding around 20% of the original debt for their top five transactions 120 days after the completion. The remainder was sold to a range of buyers, including institutional investors, hedge funds and firms which specialise in the structuring of debt instruments such as collateralised loan obligations (CLOs). Nevertheless, a shift in market sentiment could result in banks being obliged to sell on debt at a loss, or even being unable to find buyers.

The increase in leverage has been driven, at least in part, by the rise in asset prices for these deals. However, it also reflects the high degree of liquidity and increased willingness to hold riskier assets. The private equity and leveraged loan markets show clear evidence of capital chasing assets, as the prices of deals are bid up through competition from competing private equity groups and their financing banks. There is also evidence of erosion of loan covenants, with less robust triggers that reduce not only protection for lenders but also the extent to which loan covenants can give early warnings of corporate distress.

Chart C6: New issue leveraged loan volumes in the US and Europe

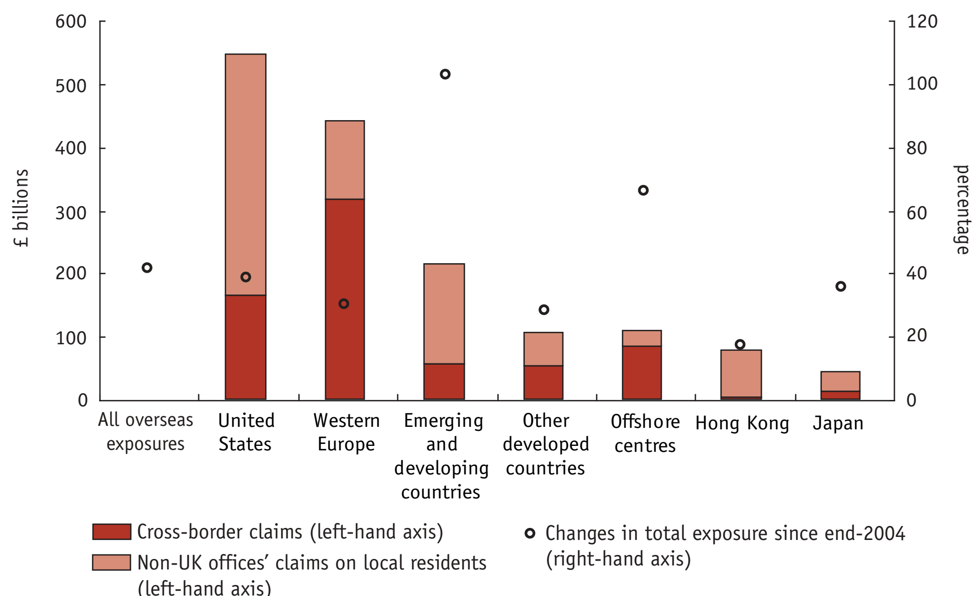


Source: Standard & Poors LCD

International lending

The UK-owned banks' total overseas exposure has risen by 42% since the end of 2004, as they have sought to diversify away from mature domestic markets. In absolute terms, growth in UK-owned banks' exposure to the US has been the most significant, with the majority of this being due to organic growth. However, in percentage terms, the strongest growth has been in exposure to emerging markets (up 104% since the end of 2004). Much of this expansion has taken the form of lending from local offices to local consumers or businesses in local currency, rather than in traditional cross-border lending. For many banks, such lending is part of long-term strategies to diversify their business and to increase their presence in fast-growing markets.

Chart C7: UK-owned banks' overseas exposures, June 2006



Source: Bank of England

Geographic expansion may offer business benefits but it also presents risks in terms of corporate-governance arrangements, management stretch and overall risk management. The risk associated with expanding overseas is very dependent on the type of business being undertaken. Developed markets may represent lower risks than emerging markets, but their growth prospects will usually be lower and they may not offer as much in terms of risk diversification. The benefits from geographic diversification may be reduced in an environment where the correlations between the economic performance of different regions are increasing.

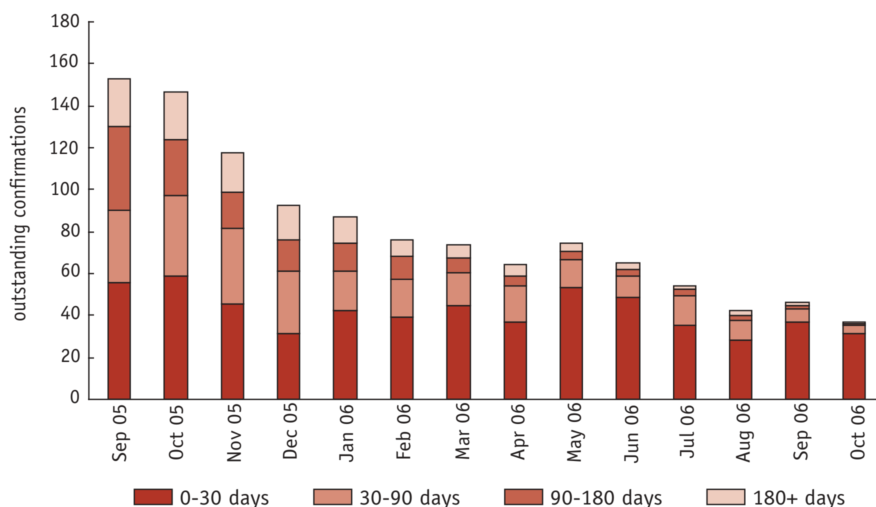
Operational risks in the derivatives markets

Further good progress has been made in dealing with problems in credit derivatives, but backlogs in equity derivatives also need attention

The risk that back-office systems are unable to keep pace with the rapid growth and development of front office trading continues to be one of our *Priority Risks*, Section A. The previous edition of the *Financial Risk Outlook* described the problem of backlogs in outstanding trade confirmations for credit derivatives and outlined the discussions between regulators and major firms that led to a series of industry measures to reduce the backlogs.

Credit-derivative trade volume growth continued unabated in 2006. Recent surveys show the notional value of global contracts more than doubled in 2005, especially in indices trading and related products, which had an estimated notional growth of 900%.[7] The progress made in dealing with the problem of outstanding trade confirmations has continued. With trade volume growing by 31% among the major dealers, the same group managed a cumulative 84% reduction in credit derivative confirmations outstanding longer than 30 days, in the year following September 2005.[8] Confirmations outstanding for less than 30 days, which were not specifically included in the reduction programme, have also fallen significantly over the year.

Chart C8: Credit derivatives outstanding confirmations by age



Source: FSA

The industry is continuing to work on achieving a steady state in settlement standards, for example with the introduction of an industry novations protocol in October 2005, which required the pre-notification to all parties of new trade assignments. There has also been rapid increase in industry use of automated confirmation and settlement platforms, increasing the ease and speed with which confirmations can be processed.

7 *Global Credit Derivatives Survey*, Fitch, September 2006.
8 FSA data.

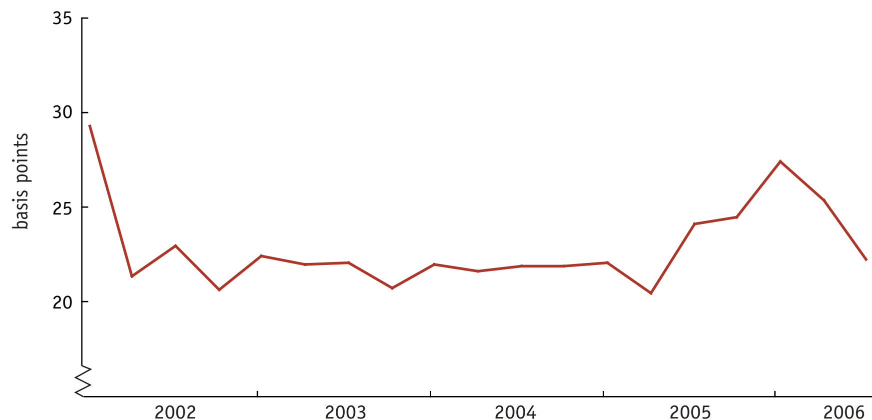
However, at the same time we have observed a general deterioration in equity derivative outstanding confirmations over the last year as trading volume has grown. A significant backlog has emerged, though not yet on the same scale as the credit-derivative backlog. Regulators, in collaboration with the industry, are therefore widening their focus to include equity derivatives in efforts to reduce outstanding confirmation backlogs. The equity derivative market has different characteristics to that of credit derivatives, and may require different solutions, but the project will be able to draw from the lessons of the previous exercise.

Investment banking

Investment banking and capital markets participants had a record year in 2006. Prospects for 2007 depend on continuing high levels of investor confidence and risk appetite

Investment banking had its strongest year ever in 2006, benefiting from buoyant global equity markets, a benign credit environment, continued risk appetite and a measured rise in inflation. Growth came from both traditional sources, such as M&A, and also new revenue sources such as private equity, leveraged loans, structured credit trading, and hard asset investments in support of commodities and energy businesses. Trading continues to be the main revenue driver, and the main risks for 2007 could come from decreasing investor risk appetite, de-leveraging, and alternative investment managers, such as managers of hedge funds, changing from marginal buyers of risk to marginal sellers of risk.

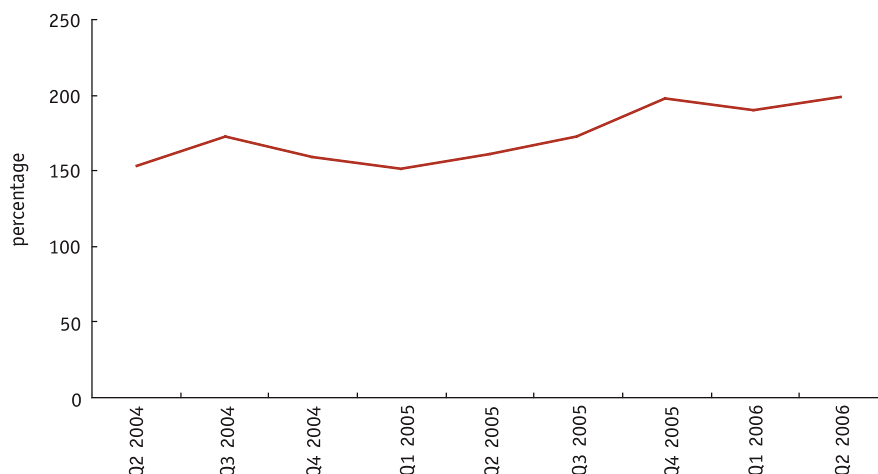
Chart C9: Average net VAR/average tangible equity



Source: Quarterly filings of selected US investment banks

Absolute market risk as measured by value-at-risk (VAR) continued to climb in 2006 but in line with firms' capital, leading to a slight decrease in the ratio of market-risk-VAR-to-tangible-equity over 2006 from 27 basis points to 22 basis points. The increase in VAR was driven by all risk categories, but notably by commodity and equity risk. However, investment banks are increasing exposures to less liquid assets which might not be captured by VAR models. For the main US broker dealers, less liquid assets as a percentage of tangible equity increased from 150% to 200% between 2004 and 2006. Less liquid assets are mainly comprised of loan commitments (particularly loans related to private equity), principal investments and goodwill.

Chart C10: Less liquid assets as a percentage of tangible equity



Source: Quarterly filings of selected US investment banks

Collateral management

The continued growth and development of trading underlines the importance of prudent collateral management

The continued growth and development of traded risk in markets such as over-the-counter (OTC) derivatives and the increasing range and complexity of products being traded reinforce the importance of the management of collateral. Not only is this important for managing a firm's own funding (given the rise in illiquid assets), it is also an essential component of counterparty credit-risk management. For the prime brokers, continued growth in hedge funds and competitive pressures among dealer banks necessitate a better understanding of policies around eligible collateral, margining policy, collateral disputes, collateral valuation and concentration, and stress tests.

We are working with the Federal Reserve Bank of New York, the Securities and Exchange Commission (SEC) and others to examine counterparty credit-risk exposures to hedge funds where collateral management is an important dimension.

Prime brokerage

Growth in the number of hedge funds and the amount of assets under management has continued this year, with clear implications for investment bank exposures to hedge funds through their prime brokerage and derivative businesses. Growth in the business has been accompanied by continued fierce competition among investment banks to provide services. There is the risk that competition could influence prudential collateral standards and margin requirements, with some funds soliciting advantageous lending terms such as zero initial margin.

Hedge funds have become increasingly important investors in illiquid products such as structured credit derivatives, leveraged loans and private equity. This makes it important that banks and prime brokers have the means to provide appropriate valuations, and suitably stress test hedge fund portfolios for market liquidity and concentrations.

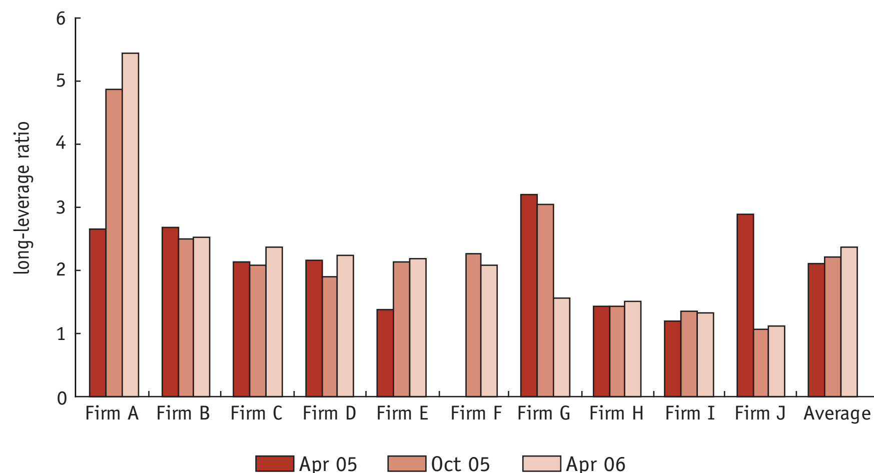
Our most recent survey of the counterparty positions of some of the major banks was again generally reassuring

Our semi-annual survey on the hedge fund exposures of a sample of large prime brokers based in London has continued to give generally reassuring results. Gross exposure to hedge funds again rose rapidly, with an increase of 29%, with the bulk of the increase going to the largest hedge funds by size. However, aggregate leverage remains moderate. Hedge funds are also discussed in *Asset management*, later in this section.

The orderly winding down of the hedge fund Amaranth should not be a cause for complacency for prime brokers

The recent winding down of the hedge fund Amaranth showed that, in this case, investment banks effectively mitigated counterparty credit exposures, and that prime-broker margining had been set appropriately. However the orderly winding down of the fund should not cause complacency among prime brokers and creditors, because a less benign market environment might have resulted in a more disorderly outcome. Banks should be vigilant in determining the risk management and governance standards of hedge fund clients.

Chart C11: Hedge funds' long-leverage ratio by firm (April 2005 to April 2006)



Source: FSA Prime Brokerage Survey

Risk appetite and stress testing

Banks and building societies are searching for new, and often innovative, ways to enhance returns across the range of banking activities. These firms need to ensure they have the resources (both human and financial) and the appropriate systems and controls in place to be able to manage any increase in risk appetite. A key tool to determine the adequacy of these resources is stress testing, as this allows firms to test their resilience to a range of different risks. Stress testing is discussed in more detail in *Financial stability*, Section B.

Stress testing has been a key part of the supervisory programme for some years, and many firms have developed tests which capture the risks of their businesses and challenge their assumptions. However, good practice is not being followed in all firms and progress needs to be made in devising realistic and challenging tests. It is also important that firms ensure that their senior management are involved, both in setting the tests and in taking the results fully into account in their risk-management practices.

Capital markets and financial exchanges

Activity in capital markets continued to grow in 2006 as more investors and firms sought higher returns. As the economic outlook for 2007 is still relatively benign, albeit with the risks weighted to the downside, we expect the developments that we saw in 2006 to continue. The growth in market activity raises challenges for us and for firms, particularly with respect to operational risk. There are also risks arising from market consolidation.

Financial exchanges and infrastructure

There are potential operational and regulatory risks from consolidation of financial exchanges

Proposed or potential consolidation of financial exchanges presents risks to the operation and regulation of UK financial exchanges and markets. These include the risk of markets being moved outside the current regulatory regime or the risk of disproportionate non-UK regulations being imposed on UK markets or participants. The consolidation of financial exchanges may also have implications for the competitive position of London as a financial centre.

In part, consolidation reflects the commercialisation of financial exchanges and greater competitive pressures between exchanges, and also between exchanges and other trading venues. Competition is likely to intensify with the implementation of Markets in Financial Instruments Directive (MiFID) in November 2007. Moreover, these competitive factors may result in greater financial and strategic risks being taken by financial exchanges and produce greater potential for conflict of interest between commercial and regulatory objectives. It may also become more difficult to manage existing conflicts of interest and there may be increased pressure to reduce regulatory overheads and introduce incentive schemes that could create disorderly or artificial trading. Greater competition between trading venues could potentially lead to a fragmentation of trading, which could give rise to issues of regulatory concern, including transparency and monitoring of markets.

Cross-border market infrastructure groups pose regulatory challenges

We take a neutral stance on the ultimate ownership of Recognised Bodies,[9] providing they continue to meet their regulatory requirements. A majority of Recognised Bodies are already part of larger, cross-border groups. This has increased the regulatory risks for us, as these groups increasingly operate at a group level, outsourcing functions within the group and harmonising operations. In particular, areas such as effective corporate governance, adequate financial resources, control over outsourcing, and managing conflicts of interest are high-priority issues in the regulation of UK Recognised Bodies.

We are increasingly dealing with other regulators, either bilaterally or as part of formal regulatory colleges, when UK-regulated entities are part of cross-border groups containing other regulated bodies. This requires effective Memoranda of Understanding, well-functioning cross-border regulatory-college arrangements, and other vehicles to enhance our working relationships with our overseas counterparts.

9 Recognised Bodies are the market-infrastructure service providers comprising financial exchanges and clearing and settlement houses.

Valuation of illiquid and complex assets

Capital invested in alternative asset classes is increasing, alongside growth in the amount of money exposed to structured products. Some of these products are illiquid and their complexity may make them difficult to value. This can lead to a wide dispersion in opinion among market participants as to the price at which the products should be fairly marked for valuation purposes. When sufficient liquidity develops in OTC markets, specialist third-party data providers may then offer pricing services which pool and distribute consensus pricing for many products, greatly adding to price transparency, at least to those subscribing to their services. Additionally, credit-rating agencies are expanding their focus from credit risk to the provision of market-risk analysis on many derivative and structured instruments. The integrity of the valuation process can be strengthened by appropriate use of independent pricing, and some market participants will need to change their practices when Financial Accounting Standards 157 (FAS 157), Fair Value Measurements, becomes effective.

There is a continuing requirement for many parties involved in trading and pricing complex and illiquid assets to consider their inherent conflicts of interest. These arise when the same party makes investment decisions and also plays a key role in the pricing of the same investments. In particular, this is important for those professionals whose remuneration is directly linked via an incentive arrangement to the declared investment performance of a portfolio containing investments for which the professional has assigned prices.

Market abuse

Firms need to strengthen their market abuse controls

Some firms continue to face high legal, reputational and regulatory risks from not having appropriate systems and controls in place to prevent market abuse. We have had concerns for some time that, in some areas, standards of market conduct may be falling below required levels. There is a risk to market confidence if investors do not feel confident about the cleanliness of the markets. Those firms that, as part of their daily activities, receive significant amounts of market information must ensure that they do not exploit the information that they have legitimately received for illegitimate purposes or engage in other unacceptable behaviour.

From 1 July 2005, all firms regulated by us have been required to notify us of any suspicious transactions by submitting a Suspicious Transaction Report. Some firms are not meeting this requirement, and should focus on improving their controls to help prevent abuse occurring. Many firms also need to place greater emphasis on providing adequate market-conduct training to their staff.

There may be a particular need to strengthen the controls of inside information relating to public takeovers. The leakage of information relating to these deals is at present too prevalent.[10] A wide range of firms are involved in these deals, including issuers, lawyers, PR firms, financial printing firms, and debt and equity providers, and each needs to have high standards to reduce the risk of information leakage.

10 *Measuring market cleanliness*, FSA Occasional Paper Series 23, March 2006.

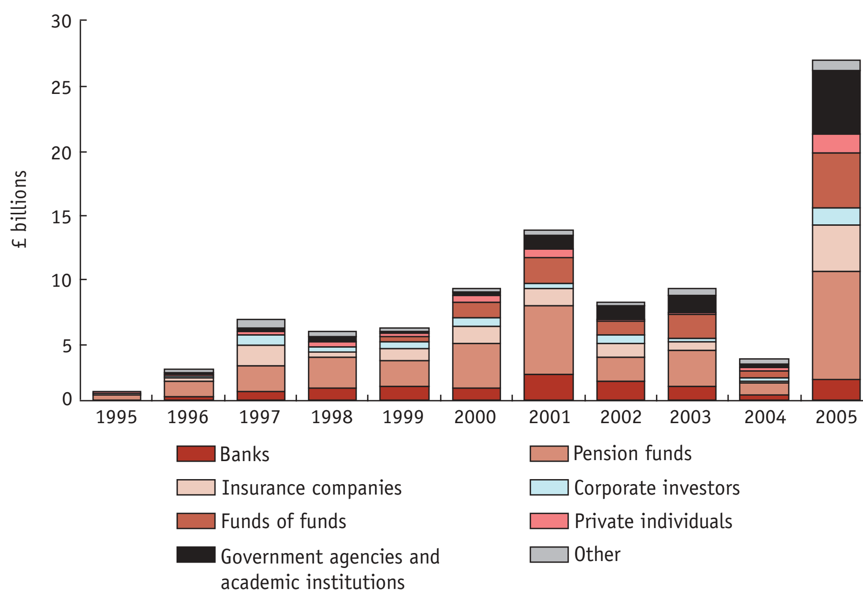
Credit markets have continued to grow with increasing involvement from hedge funds and other new investors. There is a risk that price sensitive private-side information is being used to trade related public instruments, such as bonds or single-name credit default swaps. Firms should ensure that their systems and controls are adequate and that any sensitive information is properly handled and that any potentially abusive behaviour can be detected.

Private equity

The role of private equity in capital markets is increasing

There has been substantial growth in the amount of capital allocated to private equity funds; in the first half of 2006, UK-based private equity fund managers raised £11.2 billion and there are indications that the amount raised will surpass the 2005 record. This, combined with the considerable appetite of the debt market for leveraged finance products, has fuelled a significant expansion of the private equity market. With this growth, the private equity market is becoming an increasingly important component of a dynamic and efficient capital market. As the market continues to grow and mature we expect its positive contribution to increase over time. However, there are a number of risks inherent in the sector.[11] The flow of price-sensitive information in relation to private equity transactions is increasing as the transactions become more complex and more parties become involved in the market. This creates considerable potential for market abuse.

Chart C12: UK funds raised by source



Source: BVCA

11 These risks are discussed in more detail in our Discussion Paper on private equity (*Private equity: a discussion of risk and regulatory engagement*, FSA DP06/6, November 2006).

The potential for abuse is also increased by the involvement of participants in both public and private markets and the development of related products that are traded across different markets. Material conflicts can arise in private-equity fund management between the responsibilities the fund manager has to itself (including the owners of the fund and the fund staff), the investors in the separate funds or share classes they manage, and the companies owned by the funds. Advisers and leveraged-finance providers also face significant conflicts of interest (particularly where they take on multiple roles in relation to an individual transaction) between their proprietary and advisory activities and between their different clients.

The ownership of economic risk might be difficult to determine in the case of a credit event

The amount of credit that lenders are willing to extend on private equity transactions has risen substantially. The default of a large private equity-backed company, or a cluster of smaller private equity-backed companies, would have negative implications for lenders, holders of the debt, orderly markets and, in extreme circumstances, financial stability and elements of the UK economy. The duration and potential impact of any credit event may be exacerbated by operational issues that make it difficult to identify who ultimately owns the economic risk associated with a leveraged buyout. This confusion could, in addition to affecting market confidence and possibly market liquidity, damage the timeliness and effectiveness of work-outs following credit events. In an extreme scenario, this could undermine an otherwise viable restructuring.

UK retail investors currently have only limited access to the private equity market via Venture Capital Trusts (VCTs) and a small number of private equity investment trusts. Indirect access is also limited as few UK pension or insurance vehicles have committed significant capital to private equity. While the UK aims to have broad, deep and liquid capital markets, there may be a gap in UK markets as there is no market that lists certain types of private equity-related vehicles, which subsequently seek a listing in other EU jurisdictions.

Although transparency to existing investors is extensive, transparency to the wider market is limited and is subject to significant variation in methodology and format. This could make relative performance assessment and comparison complex, which may deter investment by various professional investors who may not be comfortable interpreting the information. It could also lead to ill-informed investment decisions by such investors.

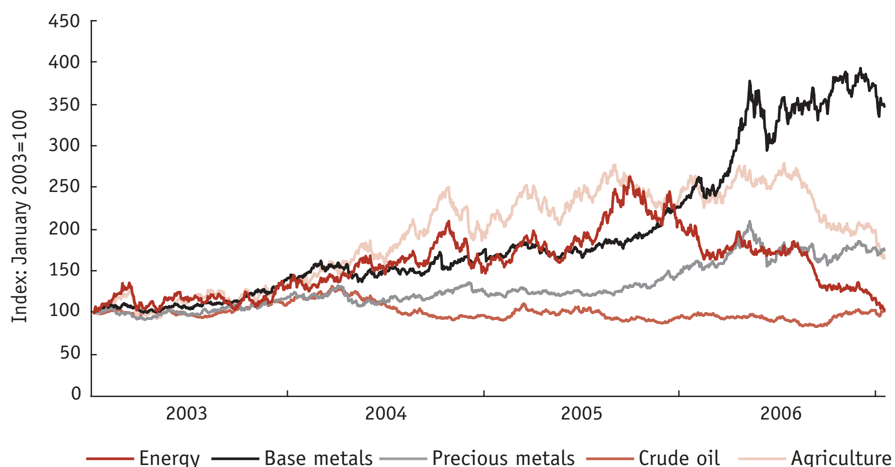
Commodity markets

2006 was another strong year for commodities

Exchange-traded volumes in commodity markets have continued to increase and are expected to increase further, with growing interest in these markets from a wider range of new participants, for example hedge funds, and from the media. The move away from domination of commodity markets by industry specialists places greater demands on the market's knowledge base. The interest in commodity markets has been driven by record prices across many commodity products and a belief that returns are likely to remain high for the foreseeable future.

New products that allow retail investors access to the markets, or products that have been tailored to meet demands from changing external environment, for example climate change (refer to box on climate change in *Economic and financial conditions*, Section B), have become increasingly popular, which has also drawn new investors to commodity markets. However, investors should be aware that volatility is an inherent characteristic of commodity markets and is expected to remain high. Investors were reminded of the volatile nature of commodity markets in May/June 2006, when a broad-based increase in investors' risk aversion led to sharp falls in commodity prices. The performance of commodity markets is also discussed in *Economic and financial conditions*, Section B.

Chart C13: Movement in commodity prices



Source: Datastream/Dow Jones-AIG sub indices

Asset management

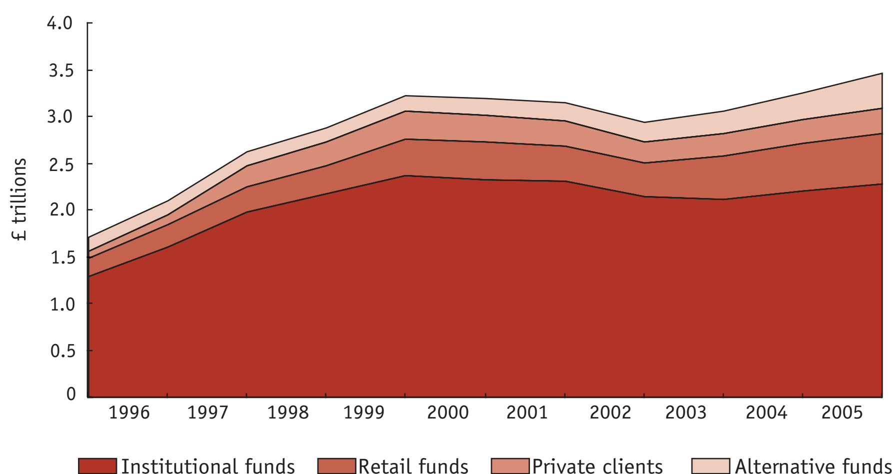
Rising markets over the past three years have enabled traditional asset managers to benefit from cost-cutting efforts they made during the equity market downturn of 2000 to 2003. However, traditional asset managers are facing increasing competitive pressures from alternative providers such as hedge funds and private equity managers. Regulatory reform and rising demand from retail and institutional clients for products with more complex features also place demands on sector participants.

Business conditions

Assets under management continue to increase

The asset management sector has continued to benefit from the upward trend in equity markets since the 2003 trough, and business continued to pick up in 2006. Assets under management (AUM) at UK firms exceed £3.45 trillion, of which approximately 23% are managed for non-resident clients.[12] The sector has benefited from positive performance from the main asset classes, with retail and alternative funds in particular enjoying positive net inflows. Contributions to institutional assets have remained stable but defined-contribution schemes, which are offered almost exclusively by the life company-owned asset managers, have enjoyed the majority of contributions.[13]

Chart C14: Growth of funds under management in the UK



Note: Estimates from IFSL
Source: IFSL estimates based on IMA, ONS, ComPeer, Eurohedge, BVCA and IPD data

Between the end of 2004 and 2005, the proportion of equities as a percentage of total holdings across all UK AUM increased from 46% to 51%, owing largely to the gains in equity markets. The proportion of AUM allocated to bonds has decreased from 37% to 33% and cash instruments from 9% to 8%.[14] Emerging-market equities have also grown in popularity,

12 *Fund Management*, International Financial Services Limited (IFSL), August 2006.
13 *Purple Book: DB pensions universe risk profile*, The Pensions Regulator and the Pension Protection Fund, August 2006.
14 *Asset Management Survey*, IMA, July 2005 and July 2006.

but the May/June 2006 sell-off and their continued volatility could moderate demand for these assets. The demand from fund managers for infrastructure assets has also recently increased and the prices of these assets have climbed.

Our *Central economic scenario*, Section B, is that the business-operating environment, while still benign at present, is likely to be somewhat more challenging in the future. The asset management sector in the UK, with its high degree of exposure to equities, will experience some downward pressure on profitability should the equity market track any downturn in the economy. In such a scenario, UK-based asset managers may seek to find means of reducing costs through, for example, reducing headcount and outsourcing operations.

Traditional asset managers are moving into new and alternative areas

Demand for products such as hedge funds and private equity are leading traditional firms to use alternative strategies. Institutional funds are increasingly moving to 'alpha'-generating strategies[15] that are employed by hedge funds and funds of hedge funds. Recent data shows that the number of pension funds allocating to hedge funds has increased from 5% in 2005 to 7.5% in 2006.[16] This trend has also been reflected in pension-fund trustees allocating a greater proportion of their assets to other alternative strategies including property and private equity.

Many of these alternative products and strategies are offered by traditional asset managers as well as more specialist investment houses, and we expect to see a degree of convergence between traditional and alternative firms in the future. At present, some of the largest managers of hedge funds in Europe are traditional asset managers. The risk of a conflict of interest between managers that run both types of fund remains, though our supervisory work has identified processes to help mitigate this risk.

Specialist mandates and products yield higher fees for asset managers, and a trend has slowly emerged towards the greater use of performance fees across the board. As a greater proportion of the fund managers' profit may be generated by these types of strategies and fees, there is a risk that the sector could become more susceptible to a market downturn should business operating conditions become more challenging. The corollary to this is that this exposure to performance-related fees could result in increased profitability for asset management firms under favourable market conditions.

Since 2003 net sales of non-UK domiciled funds have grown from 1% to 21% of the UK market.[17] The increasing use of offshore locations (mainly Ireland and Luxemburg) for fund domiciles and a growing range of asset management services, may pose challenges to our ability to manage regulatory risk. For example, it can be difficult to obtain a clear and comprehensive view of a group's activities, particularly if a greater proportion of collective investment scheme (CIS) operators choose to locate more of their activities outside the UK.

15 The term 'alpha' refers to the expected return an asset manager earns over and above the market return.
16 *UK Pension Plan Liability and Asset Allocation Survey 2005* and *European Asset Allocation Report 2006*, Mercer Investment Consulting.
17 *Taxation and the Competitiveness of UK Funds*, Investment Managers Association and KPMG, October 2006.

Regulatory change

Firms need to continue to implement regulatory reforms

At a European level, the Capital Requirements Directive (CRD) and MiFID will have a significant impact on the asset management sector in 2007. These come into effect in the UK in January 2007 and November 2007 respectively (refer to *International dimension to regulation*, Section F). Arguably, the volume and the level of complexity of the regulatory change and the demanding timetable for implementation pose a particular challenge for asset management firms. There is a risk that firms may underestimate the workload associated with these reforms and incur considerable last-minute costs or additional compliance risk.

The CRD changes the prudential regime for most asset management firms and introduces some new concepts, such as the quantitative assessment of operational risk, these may be unfamiliar to many asset managers and will require consideration at all levels within a firm. In addition, many managers will need to reconsider the categorisation of certain types of capital in meeting their capital resource requirement. This, together with the diversity of prudential regimes that apply across different types of asset manager, introduces a level of complexity to prudential assessment that has previously not been seen and increases the risk of asset managers failing to maintain appropriate resources.

The implementation of MiFID will affect, among other things, how firms categorise clients, execute trades, report transactions and outsource portfolio-management services. There is a risk that firms may experience significant costs and be required to affect changes in operational focus. In addition, we recognise that there exist certain dependencies for asset managers in implementation, such as in the renegotiation of business terms with their trading counterparties, in particular in respect of best execution requirements, which may add further complexity to this risk.

Retail market

Retail investors are increasingly accessing a wide range of investment products

Retail investors have access to a wide variety of investment products, including CIS, unit-linked products and structured deposits, that give them exposure to the underlying assets and markets. They also increasingly have access to more complex structured and listed offshore products. While the proliferation of these products offers consumers benefits as part of a balanced portfolio, there is a danger that consumers may not fully understand the risks associated with them. To date, these more complex products have been primarily targeted towards high-net-worth investors and consequently the accompanying disclosure materials may not include the risk descriptions and explanations needed by a less sophisticated retail investor.

Retail consumers are also becoming increasingly involved in property investment. Growth in the property market has increased the popularity of property funds in recent years, and in the first nine months of 2006, property funds represented 21% of total retail inflows.[18] There is some concern that if there was a significant correction in the property market, retail investors could be adversely affected both by a drop in the value of their residential property and through any exposure to the commercial property sector in their fund portfolios.

18 *Quarterly Investment Fund Statistic – Q3 2006,* Investment Managers Association, November 2006.

The primary channel through which retail consumers access asset management products is the financial intermediary sector. The sustainability of that group of distributors remains crucial to the sale of these products, and there is a risk that any relative strengthening in the market share of other distributors, such as retail banks, could undermine the market share of investment managers in the investment products category. The further development of manager-of-manager and fund-of-funds products could benefit many asset management firms if, for example, retail banks were to gain market share.

There is a risk that firms may not comply with their regulatory responsibilities as product providers and fail to treat customers fairly.[19] Asset managers need to be fully conversant with their responsibilities with respect to the sale of products through all types of intermediary. They also need to develop effective product design and targeting strategies. In addition, asset managers need to enhance their understanding of their distributor intermediaries in order to facilitate the fair treatment of consumers by distributors. The need to increase this understanding is particularly important in light of the heightened complexity of consumer needs and products (refer to *Banks and building societies*). However, the wider use of wrap platforms[20] and fund supermarkets by intermediaries in product selection makes it increasingly difficult for product providers to identify the end customer and characterise the suitability of a particular product for that customer.

Dealing commission

There has been evidence of market failure in trade execution where the execution and research costs have been bundled together and where some firms have used 'soft' commissions to pay for IT systems and training. The use of such arrangements to pay for goods and services other than execution and research lacks transparency. There is a risk that asset managers could face conflicts of interest in their relationship with brokers, and would not be directly accountable to their clients for expenditure on bundled and softed items. This lack of transparency makes it difficult for customers to tell whether the manager is acting in their best interest including obtaining sufficient value for money on their behalf. We have introduced new measures to improve disclosure practices, whereby firms will be expected to split their commission between execution and research.

Risk management and the use of derivatives

The use of derivatives continues to increase

Many asset managers are moving into new and more complex strategies, including hedge funds, liability driven investments and absolute-return retail products. This has meant that the use of derivatives has increased. At the end of 2005, 65% of UK asset management firms indicated that they were following strategies that involved the use of derivatives, compared with 62% for the same period in 2004.[21] Asset managers use derivatives for various purposes, ranging from hedging risk and reducing their cost of financing to exploiting arbitrage opportunities or transferring credit risk. We expect that the use of derivatives across the industry will continue to grow. Retail investors can access derivatives through Undertakings for Collective Investments in Transferable Securities (UCITS) III funds, many of which

19 *The responsibilities of providers and distributors for the fair treatment of customers,* FSA Discussion Paper, September 2006.
20 Wrap platforms are web-based tools designed to enable financial advisers to manage their underlying assets within their client's portfolio.
21 *Derivatives in fund management: reaching the tipping point*, Financial News, May 2006.

allow the use of derivatives for investment purposes, and sales of these funds have also been growing. We expect retail fund managers to continue to launch products with strategies that feature the use of the broader investment powers granted under UCITS III. It is important that consumers are informed of the risks associated with investing in these funds.

The growth in the use of derivatives may pose operatinal risks for some asset management firms

The increasing complexity of business operations has increased demands for back-office operations and processing. There is a risk that some firms' existing systems and controls may be unable to deal with this increase in complexity of products and underlying assets. Similar to the situation we observed with the backlog of OTC credit-derivative trades the growth in the use of derivatives by some traditional asset managers may be getting ahead of their back offices, operational systems and staff. For example, staff may be inadequately trained or equipped to understand the implications of buying, pricing, owning, valuing and selling derivatives beyond their simple use in hedging strategies. Several asset management firms have indicated to us that they have needed to pause to take a look at their systems and personnel to ensure their systems and controls match the requirements of the new products. It is crucial that firms build and retain the expertise to effect appropriate use of derivatives. There is a risk that insufficient expertise and therefore oversight will be retained by asset managers if they simply outsource this to counterparties or to fund fiduciaries, though these latter firms have an important role in effecting oversight.

We do not believe that the strategies using derivatives themselves increase the riskiness of products, as these methods are frequently used to control risk. However, there are significant cost implications in building and maintaining the resources necessary to assess adequately the multiplicity of issues that more intensive investment in these assets presents. This includes the need for managers to ensure that investments meet the requirement of any underlying client mandate or retail fund strategy.

As we outline in *Economic and financial conditions,* Section B, changes in correlations between asset classes will affect many different sectors, including asset management firms. Investment approaches employing hedging techniques or investing through derivative strategies require correlation calculations to determine the potential exposure of the portfolio. Given these changing correlations, there is a risk that managers who rely on out-of-date assumptions or who are affected by rapidly changing markets could realise significant losses.

Many traditional asset managers who have developed hedge fund businesses, are venturing into private equity or are involved in managing complex products, such as collateralised debt obligations (CDOs). As the range of strategies followed by asset managers broadens and asset management businesses become more complex, there is an increasing risk of conflicts of interest.

Long-term savings and the pension-fund market

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

UK consumers are faced with increasing responsibility in planning for their financial future (refer to *Priority Risks*, Section A and *Consumers' engagement with industry*, Section D). This increase in consumers' responsibility will present significant challenges and opportunities for the asset management sector, as it plays a role in servicing the long-term financial needs of UK retail consumers.

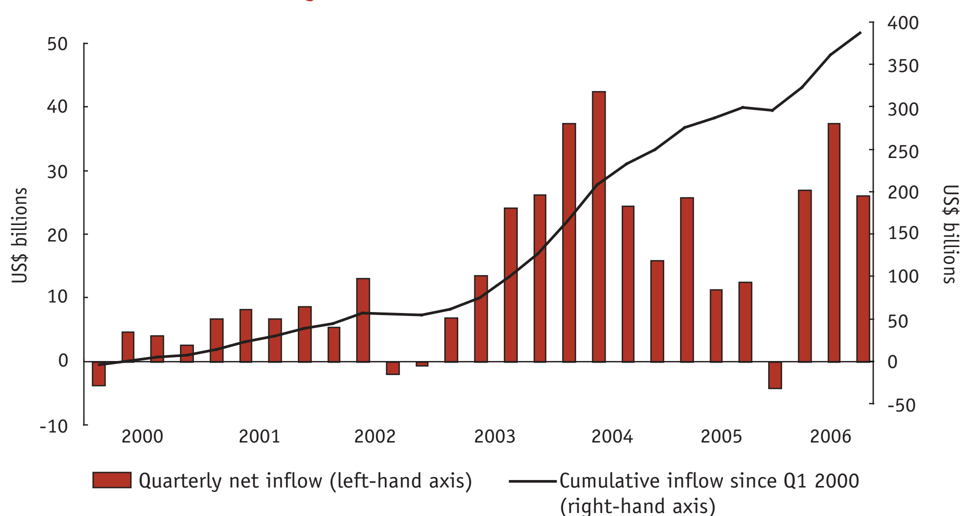
Central to the issue of long-term savings is the operation of pension schemes. A significant number of defined-benefit pension schemes have now closed to new members and new schemes are predominantly defined contribution. A number of new firms have established businesses to 'buyout' the assets and liabilities of existing defined-benefit pension schemes. This new sector has been labelled 'bulk purchase annuities' and is discussed further in *Life insurance*. There is a risk that firms who do not adapt their business models (and systems and controls) to take into account this significant development may lose out in comparison to their peers.

Hedge funds

Hedge fund returns have improved since 2005

Global inflows into hedge funds for 2006 are estimated to be close to the record inflows seen in 2004. This is despite several testing periods for many hedge fund managers in 2006, including the May/June sell-off for those funds that were exposed to emerging markets or commodities (see our *Central economic scenario*, Section B). The May/June risk-reduction trades affected performance across virtually all strategies. Performance has subsequently recovered and is estimated to have improved from 2005. It has also been broadly positive across all hedge fund strategies with the exception of 'dedicated short'. The HFRI weighted composite index is estimated to have returned 12.9% in 2006, improving on 2005 when it returned 9.3%. This compares with the wider equity market performance over the same period, as measured by the MSCI global index, which returned 13.5% in 2006 and 13.7% in 2005. The FTSE 100 and the S&P 500 made gains of 10.7% and 13.6% respectively in 2006. Another hedge fund industry benchmark, the CSFB Tremont index showed gains of 13.9%.[22] Poor performance relative to benchmark equity indices could reduce flows to the sector and encourage hedge funds to increase their risk profiles.

Chart C15: Global hedge fund inflows



Source: Tremont Asset Flows Report (2006)

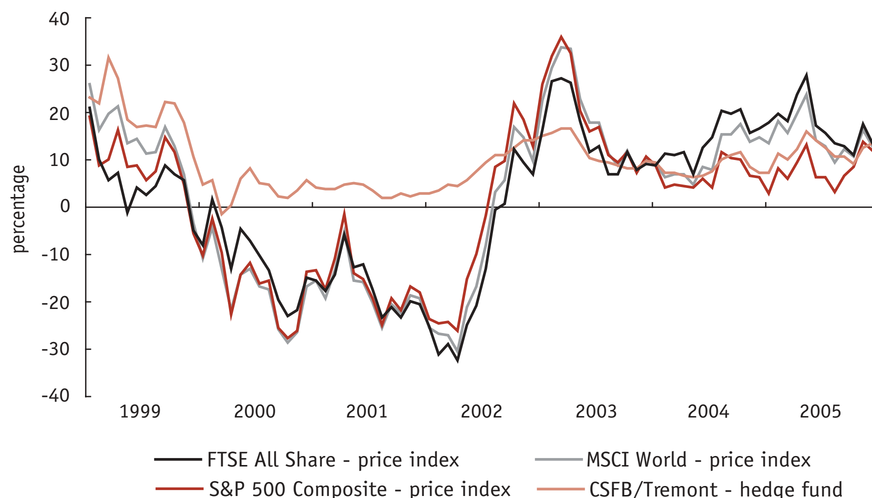
22 Datastream, Hedge Fund Research.

Hedge funds continued to grow in 2006 with London continuing to be the centre of hedge fund management in Europe. The growth in hedge fund assets is attributable primarily to the capital inflows from institutional investors. These inflows have largely favoured the more sizeable managers who have developed operational platforms that are attractive to institutional investors. Funds over US$1 billion in size now account for over half of assets managed. The presence of institutional money in the sector could represent an increased risk to our consumer protection objective. However, there is also a general consensus that the conditions attached to this new money are improving risk management standards within the industry.

In a bull market it is difficult to determine how much 'alpha' hedge fund managers are providing their investors

There is a continuing debate as to whether hedge funds are truly providing 'alpha' to their investors, which has typically been used to justify their higher fees. This is a difficult issue to determine in a broad-based bull market, when total return will necessarily include a higher absolute contribution from 'beta' than in a flat or bear market. There is therefore a risk that hedge fund managers who propose to deliver 'alpha', but in fact deliver performance predominately through 'beta', could see significant fund outflows. The increasing number and asset size of hedge funds could also make delivering 'alpha'-based strategies more difficult. There is an indication that some fund managers may be taking increasing risks to generate 'alpha' in an environment of low market volatility and where good investment opportunities can appear to be limited.

Chart C16: Annualised returns of major equity and hedge fund indices



Source: CSFB/Tremont and Datastream

As is underlined in *Banks and building societies*, over the course of 2006 our surveys of major hedge fund counterparties suggested that, although leverage is rising, it remains relatively low and counterparties' exposures operate with generally comfortable levels of collateral over margin requirements.

In September 2006, Amaranth Advisors LLC, a multi-strategy hedge fund, lost an estimated US$6.4 billion on initial AUM of US$9.2 billion. The majority of the losses came from the fund's energy trading on natural gas swaps. The fund was significantly leveraged, and ran into trouble when it was forced to unwind most of its unrelated positions to satisfy its margin calls, compounding losses for investors. This unwinding process seems to have been carried out in an orderly fashion with minimal systemic impact. However, hedge funds can pose a risk to the financial system if they are highly leveraged or have an investment strategy in illiquid assets. The situation could have been worse if credit conditions had been tighter or if there were a number of funds executing the same trade.

Managers face legal risks if valuations are materially inaccurate or misleading

There remains a risk that firms may not be adequately managing the conflicts of interest that arise when managers provide valuations of complex, illiquid instruments to administrators. The fees earned by fund managers are usually formulated as a product of AUM and performance of the fund. This could potentially lead to a temptation for managers to overstate the value of assets. Managers face considerable legal risks if valuations are materially inaccurate or deliberately misleading. Valuations are an important issue for all fund managers, but they represent a particular challenge for those hedge fund managers who use more illiquid instruments such as distressed debt, complex derivatives, real estate and private equity. About 20% of hedge fund assets may be invested in illiquid or difficult to value assets.[23]

We have carried out a substantial amount of work in order to mitigate the risks arising from mis-valuation of assets by hedge fund managers. The valuation of UK-managed hedge fund assets typically involves third-party administrators (TPAs), which provide another level of challenge for valuations. However, for illiquid assets there is often no publicly agreed price for an asset, and TPAs may have to rely either on a valuation model, which is frequently developed by the hedge fund manager, or on price quotes from the hedge funds' counterparties. These sources of price information may be insufficient to be considered independent. There can often be a wide dispersion in opinion among market participants as to the price at which the products should be fairly marked for valuation purposes.

Firms may not be disclosing the existence of side letters which grant preferential material terms to certain investors, to their entire investor base. There is a risk that non-side letter investors would be potentially disadvantaged by inadequate disclosure. For example, a major investor in a fund with a side letter could redeem its investment, forcing the fund to sell its liquid assets and leaving non-side-letter investors with a fund that only has illiquid investments.

There is potential for all those who trade in the markets to profit from information that is not publicly available. Hedge fund managers are active market participants and thus there is a risk that without adequate systems and controls in place, information could be used inappropriately. Going forward we will be particularly interested in potential abuse where managers

23 *Asset pricing and fund valuation practices in the hedge fund industry*, AIMA, April 2005.

use information stemming from their involvement in private transactions, for example in the loans, credit or private-equity markets, to their profit in the public markets. However, many firms already have systems and controls in place to limit the potential for insider trading. Examples of these include lists of 'restricted securities'[24] and 'hard stops'.[25] Managers must ensure that securities in relation to which the firm has price-sensitive information are placed on the restricted list.

24 'Restricted securities' are a list of names of companies whose securities cannot be used by the firms' managers and traders.
25 'Hard stops' are systems designed to immediately prevent traders and managers from investing in restricted securities.

Life insurance

Life insurers reported robust sales in 2006, having experienced benign economic conditions. While headline new business sales have surged, it is not clear how much of the new business written is actually new money coming into the market. The outlook for life insurers in 2007 is more mixed, particularly given the significant strategic challenges on the horizon for which firms need to prepare. Among the issues that the sector will face, pension reforms are expected to continue and will place demands on both the industry and consumers.

Financial position of the life insurance industry

Financial strength of with-profits life insurers has continued to improve

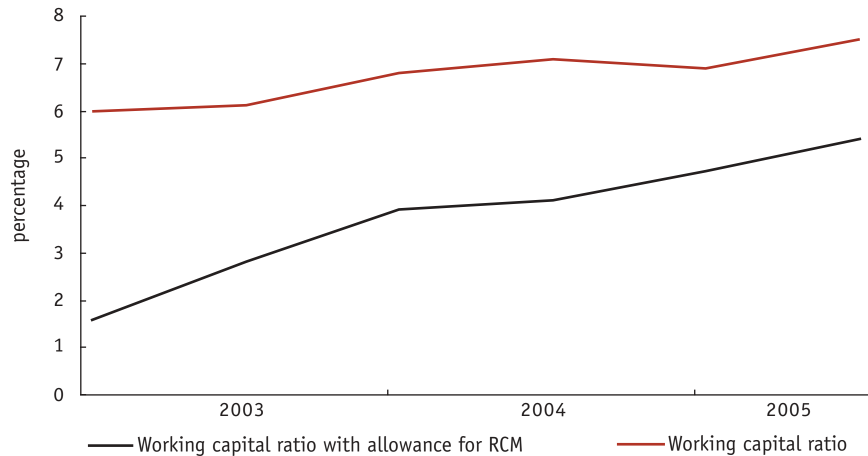
Over the course of 2005 and the first half of 2006, the financial strength of UK with-profits life insurers continued to improve. While solvency levels appear lower than those experienced in the late 1990s, there has been a sustained improvement in firms' capital position since 2003. This stabilisation illustrates the progress that the sector has made with managing its risks. Our 2006 review of insurers' risk-management practices also highlighted the fact that firms are now increasingly aware of the commercial benefits of robust risk management (the review is discussed in more detail in *General insurance)*.[26]

Until our recent reforms, the key statutory measure of the financial strength of a with-profits insurer had been the free-asset ratio. However, due to changes in the regulatory regime to make solvency requirements more risk based, evaluating the strength of a with-profits fund increasingly focuses on the amount of realistic working capital held by a fund before and after making allowance for a risk capital margin (RCM). The RCM reflects the amount of capital required to be confident that funds are likely to withstand specified adverse scenarios, including fluctuations in asset markets.[27]

Our preliminary analysis of the realistic balance sheets for the first half of 2006 is encouraging. In the 12 months to June 2006, the aggregate level of realistic working capital rose by 6% to £31.7 billion before allowing for the RCM and £22.8 billion after deducting this margin, representing a post-RCM working capital ratio of 5.4%.[28]

26 *Risk Management in Insurers*, Insurance Sector Briefing, December 2006.
27 The RCM reflects the amount of capital required to withstand falls in asset markets using a series of stress tests detailed in our realistic reporting regime. This regime applies to firms holding with-profits liabilities of more than £500 million.
28 Post RCM working capital ratio defined as working capital for fund, net of the RCM as a proportion of total assets available to the fund.

Chart C17: UK with-profits insurers' industry aggregate working capital



Note: Industry ratios presented as aggregate of component elements for both closed and open funds. No ratios presented prior to 2003, due to absence of requirement to calculate RCM and inconsistencies in data.
Source: FSA

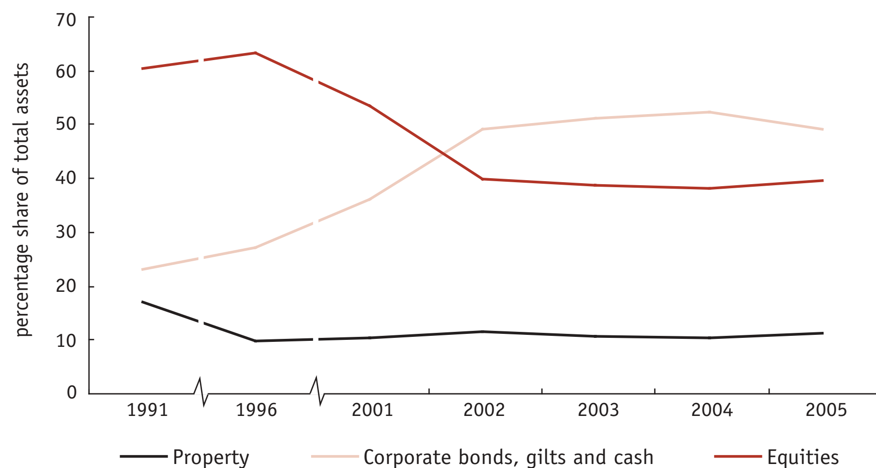
The aggregate RCM fell from £11.1 billion in June 2005 to £8.9 billion in June 2006. This development reflects firms' continued attempts to reduce the risk in their portfolios, increased hedging of guarantees and development of management responses to adverse scenarios. However, positive investment conditions have also played a role as the FTSE 100 index rose by 14% over the 12 months to June 2006 and fixed income yields increased by 37 basis points over the first half of 2006.

Investment portfolios

Firms continue to review their investment portfolios

The investment portfolios held by with-profits funds have undergone considerable change since 2002, with firms' senior management rebalancing the asset mix of their funds to reduce the level of investment risk. This has resulted in firms substantially reducing their exposure to more volatile asset classes such as equities and increasing the proportion of their assets held in corporate bonds and gilts. Throughout 2005, equity exposures remained relatively constant, increasing by one percentage point to 39% of total assets. However, it is important to note that this industry aggregate conceals significant variations in the level of exposure to equities within individual funds.

Chart C18: With-profits funds asset allocations



Source: FSA

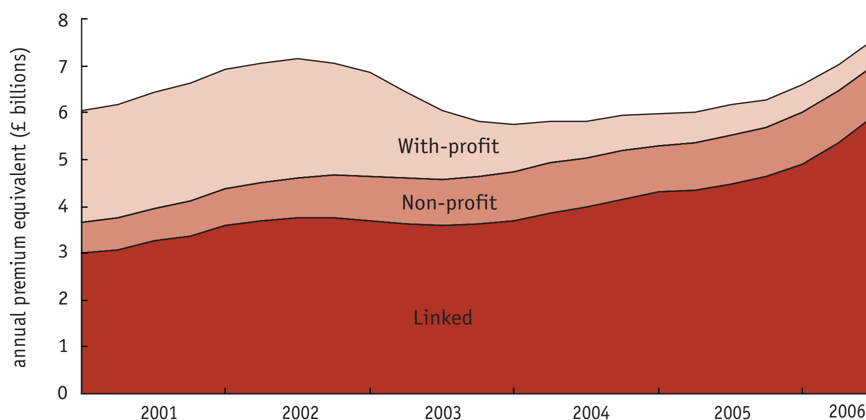
Sales of life insurance products

Headline sales figures suggest impressive new business growth in 2005 and 2006

Life insurers have experienced a strong upturn in new business in the last 18 months. The increase in sales has been attributed to increased investor confidence driven by strong equity-market returns as the FTSE 100 has risen by 89% from its March 2003 trough. In addition, advisers were more active in reviewing customers' pension arrangements following the simplification of pension tax rules in April 2006.

We have highlighted the trend of new business moving away from with-profits policies in favour of unit-linked products in previous editions of the *Financial Risk Outlook*. This trend has continued, and at the end of 2005 with-profits policies accounted for just 8.6% of new life insurance business, compared with 40% at the end of 2000. A noteworthy implication of this trend is that the move away from with-profits funds, which feature smoothing and guarantees, into unit-linked products means that policyholders are bearing an increasing amount of investment risk.

Chart C19: Sales of new life insurance products



Note: Figures for 2006 are for the first half of the year only.
Source: ABI

Despite impressive new business results there are concerns regarding persistency

For the first half of 2006, headline figures suggest a surge in the volumes of new pensions business, with a 24% increase in contributions in comparison to 2005. Furthermore, the provisions of A-Day (simplification of pension tax rules that came into effect on 6 April 2006) appear to have stimulated an increased uptake of certain types of pensions products. For example, sales of self-invested personal pensions (SIPPs) in the second quarter of 2006 were 135% higher than in the second quarter of 2005.

While headline new business figures have surged, it is questionable how much of the new business written is actually new money coming into the market. Statistics from the Association of British Insurers (ABI) for the first half of 2006 suggest that a sizeable proportion of new business is attributable to transfers of existing pension savings. For instance, 53% of new single-premium pensions business was fund transfers, either from other insured pensions arrangements or from occupational pension schemes.[29] Similarly for SIPPs, the surge in demand consisted largely of transfers (71%). While an increase in the volume of pension transfers was expected after A-Day as consumers sought to review their pension arrangements, the intensity of the recycling of premiums has been higher than expected.

29 Based on annual premium equivalent (APE) values.

Low levels of persistency pose risks to insurers

Pensions business, particularly where there is a large upfront commission to an intermediary, typically needs to be on insurers' books for a number of years to become profitable. If contributions are discontinued earlier than the insurer anticipated when pricing the product, unprofitable business could be written. Consumers need to be aware that firms typically impose exit penalties to recover some of the high initial commissions paid by firms. Nonetheless, negative persistency shocks will ultimately affect the profitability, and thus the sustainability, of firms' business models. Reconciling the need to secure distribution in an increasingly competitive market while achieving a profitable and sustainable business will test many insurers in the near future. In part, this risk is captured by our *Priority Risk* on the distribution of retail investment products.

Pension reforms

Pension reforms create both long-term strategic opportunities and significant operational challenges for insurers

We highlighted the potential impact of pension reforms on the life insurance sector in the previous edition of the *Financial Risk Outlook*. We believe that pension reform, including tax simplification for pensions, offers commercial opportunities for insurers to capture market share and develop new product lines. However, these reforms also pose risks if firms fail to put in place controls to ensure that new business is prudently priced.

The combined impact of A-Day changes in the medium term and the proposed personal account scheme[30] in the longer term is likely to drive insurers to review their product mix and business model. An auto-enrolled, low-charge scheme of personal accounts could have particular implications for current and future pensions business.

The Department for Work and Pensions anticipates that in the long run, the personal accounts system could have between £100 billion and £200 billion of funds under management, and could generate an increase in household savings of up to £5 billion a year. However, a proportion of inflows to the personal accounts system is likely to come from funds which would otherwise have been invested in insured schemes. As a result, there may be a reduction in demand for certain types of insured pensions. Thus, current assumptions underpinning pricing may prove too optimistic.

Pension reforms could present a threat to the fair treatment of consumers

In addition to the risks posed to the sustainability of some firms' business models, pension reform represents a potential threat to the fair treatment of consumers. Contrary to our concerns, most insurers have effectively responded to the impact of A-Day by putting in place back-office systems to cope with the pressures of consumers reviewing and moving their pensions. However, questions remain about the extent to which insurers have developed successful controls over product design, incentives and training materials they may offer to financial advisers. The recent increase in transfers into SIPPs, highlights this issue. While many of these transfers are no doubt in the best interests of consumers who require more flexible pension arrangements, the suitability of the product and the motivation for many of the transfers remains unclear. Insurers should consider to what extent their remuneration systems and information provided to intermediaries may be driving potentially unsuitable transfers.

30 *Personal accounts: a new way to save*, Department for Work and Pensions, December 2006.

Life insurers are increasingly subject to competition from other financial institutions

Long-term savings and pensions have traditionally represented an important portion of the business written by life insurers. However, life insurers have recently been subject to increased competition from other sectors, such as asset management. Industry commentators suggest that increased competition is resulting in life insurers winning smaller proportions of new business. Furthermore, the role of the insurer in the value chain is increasingly under pressure as 'open architecture' products, offering funds from a variety of providers within a single tax wrapper, become increasingly popular. This process of change is being driven by the view that asset managers offer superior investment management and specialisation.

Some life insurers are responding to these developments by reviewing their business models and product mix, with many analysts predicting that life insurers may seek to reduce their exposure to less profitable business such as savings and pensions. Instead, a 'back-to-basics' approach of focusing on traditional life products, such as protection and annuities business, that offer higher margins and less competition, could become more popular. Furthermore, we are seeing evidence of consolidation in the life sector as firms seek opportunities for M&A in response to competitive pressures. Ensuring that the future strategy is sustainable will be a key challenge for firms' senior management. Failure to do so may adversely affect our statutory objectives of maintaining market confidence and securing the appropriate degree of protection for consumers.

Longevity and annuities

Unanticipated changes in life expectancy continue to pose risks

We identified the potential impact of unpredicted changes in life expectancy as a considerable risk to life insurers in the previous edition of the *Financial Risk Outlook*. We continue to consider this to be a key risk, particularly the potential impacts of greater than expected improvements of longevity on firms who write annuity business.

Assessing and pricing longevity risk is key to underwriting annuities. An important tool for estimating longevity is the use of mortality tables showing expected developments in life expectancy. Here, the 'medium cohort' projection, issued by the Continuous Mortality Investigation Board in 2002, is widely used. However, evidence to date suggests that actual improvements in life expectancy may soon exceed those anticipated in the medium cohort projection. To manage this risk, insurers must carefully evaluate their assessment of expected mortality improvements, and use suitably prudent assumptions when pricing and setting reserves to ensure that they will meet their future liabilities. Furthermore, as part of our risk-based capital regime, we require firms to assess the adverse scenarios that may present unexpected risks, and the amount of capital buffer they hold as a mitigant. We expect firms to review their longevity assumptions regularly, and will continue to challenge these assumptions where they appear to be overly optimistic.

There is increased competition in the bulk-purchase annuity market

Traditionally the bulk-purchase annuity (BPA) market has been dominated by a very small number of insurance companies. This appears to be changing and there is much focus on new entrants to the market – both actual and prospective. Analysts have valued the assets of UK defined-benefits occupational pension schemes at between £600 billion to £1 trillion, and both existing and newly authorised entities are expected to compete for management of these assets and the annuity liabilities of insurance funds. Such arrangements can benefit scheme members through refreshed investment-management techniques, cost efficiencies and better capitalised funds.

BPA providers are authorised insurance companies, and have to comply with our prudential and conduct of business rules. Therefore members of schemes managed by BPA operators will benefit from the same protections afforded to all insurance policyholders. However, it is vital that both newly established and incumbent firms use prudent assumptions when assessing and pricing the risks they accept from ceding schemes, and effectively manage any potential misalignment of interests between their shareholders and scheme members.

Relationship between insurers and intermediaries

The relationship between life insurer and intermediary is a key factor in ensuring the fair treatment of consumers

Financial advisers remain the primary distribution channel for life insurance products. Thus, insurers are exposed to an indirect, but considerable, reputational risk via their distributors. The relationship between insurer and distributor is also an important determinant of the quality of advice which consumers receive, and can make a significant contribution to fair treatment of consumers. Our recent work on the possible segregation of responsibilities between providers and distributors identified five key responsibilities for product providers.[31] Of particular relevance to life insurers are the responsibilities to design and test products that are suitable for consumers; to select appropriate distribution channels for those products; to provide appropriate information to distributors and consumers; and to deliver prompt and fair post-sale service (refer to *Retail intermediaries*, Section D).

We emphasised the important role life insurers would have in helping advisers to understand the implications of A-Day on pensions business in the previous edition of the *Financial Risk Outlook*. The issue of the provider-distributor relationship will continue as the pace of pension reforms is expected to be substantial. As a product provider, insurers play a crucial role in ensuring that advisers are equipped with clear, reliable and understandable information in order to offer informed ongoing advice on a consumer's portfolio. We have commissioned research which indicates that when reviewing existing portfolios that contain a with-profits component, some advisers either exclude with-profits from the span of the advice they give to their clients or transfer policyholders out without giving appropriate consideration as to whether the policy continues to meet their clients' needs. We are working with the industry to agree ways of ensuring that advisers have the information to evaluate their clients' with-profits holdings and to advise them on their continued suitability. Insurers have a key role to play in this process by ensuring that advisers can engage with the Principles and Practices of Financial Management document to obtain accessible and relevant information on the fund, and are kept informed of material changes to the product.

Closed with-profits funds

Managers of closed funds need to ensure fair treatment of consumers

The reputation and performance of closed with-profits funds remains an important issue. The closed-funds sector manages over £100 billion of policyholder funds, representing 23% of total with-profits assets. We have seen continued competition for, and consolidation of, closed with-profits funds in 2006. Closed-fund consolidators may bring benefits for policyholders. New management may refresh the strategy and operation of the fund. In particular, increased economies of scale and initiatives to improve operational efficiency may present savings in expense costs following the transfer. This may have a positive effect on the solvency of the

31 *The responsibilities of providers and distributors for the fair treatment of customers*, FSA Discussion Paper, September 2006.

fund, and in some cases, may possibly assist in reducing investment constraints. The fair treatment of policyholders is a particularly critical issue for closed funds. Firms need to balance policyholder and shareholder interests carefully.

We continue to supervise all with-profits funds closely to ensure that customers are treated fairly and that any transfer of ownership is not detrimental to consumer interests. The results of our work on the quality of post-sale communications are mixed. While the problems are not restricted to closed with-profits funds, we continue to emphasise that communications with consumers must be accessible, clear and timely. They also need to provide information on important aspects of the funds' operations such as the investment strategy, any guarantees and any dates free of market-value reductions.

Regulatory issues

European Directives are driving significant regulatory change

The key regulatory development for life and general insurers, is the drafting of Solvency 2. This is a fundamental review of the capital adequacy regime for the European insurance sector, aiming to establish a revised set of EU-wide capital requirements. We are actively participating in the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) and thus helping in giving advice to the European Commission for drafting the framework Directive. CEIOPS conducted two quantitative impact studies in 2006, in which a large number of UK firms participated. The firms' engagement remains critical to help ensure that the framework promotes high-quality risk management and works in conjunction with industry developments (refer to *International dimension to regulation*, Section F).

General insurance

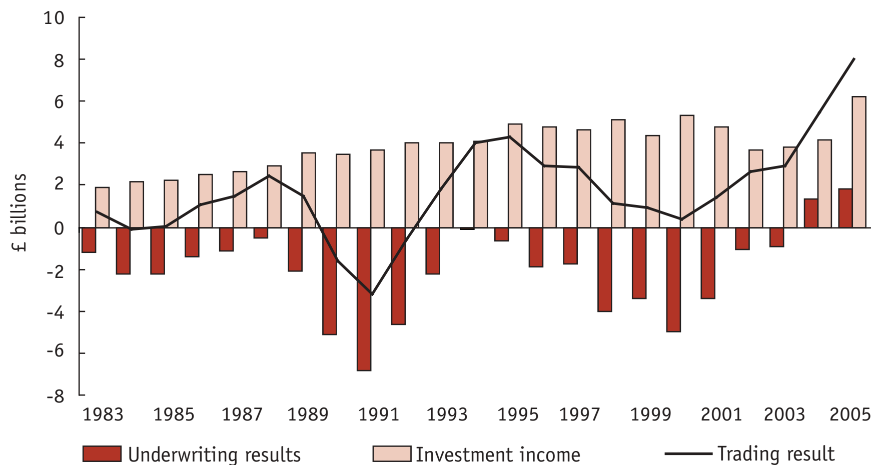
Given the absence of large catastrophe losses in 2006, the capital position of general insurers appears more stable than in 2005. Nonetheless, firms will continue to face risks arising from the underwriting cycle, climate change and terrorism. Consumers need to ensure they understand increasingly complex products such as payment protection insurance.

Underwriting cycle and profitability

2006 looks to have been a profitable year for general insurers globally

Given the benign underwriting environment, 2006 looks to have been an exceptionally profitable year for general insurers worldwide. The industry has traditionally made underwriting losses and has needed investment income to make money overall. In 2005, UK general insurers made an underwriting profit of £1.8 billion – only the second year since 1983 when the industry made an underwriting profit. Meanwhile, investment income rose to a record level of £6.2 billion as credit spreads were largely stable, global equity markets remained buoyant and insurers experienced strong positive cash flow. However, there is a risk that strong investment returns could encourage overly aggressive underwriting.

Chart C20: Worldwide general insurance business trading results



Source: ABI

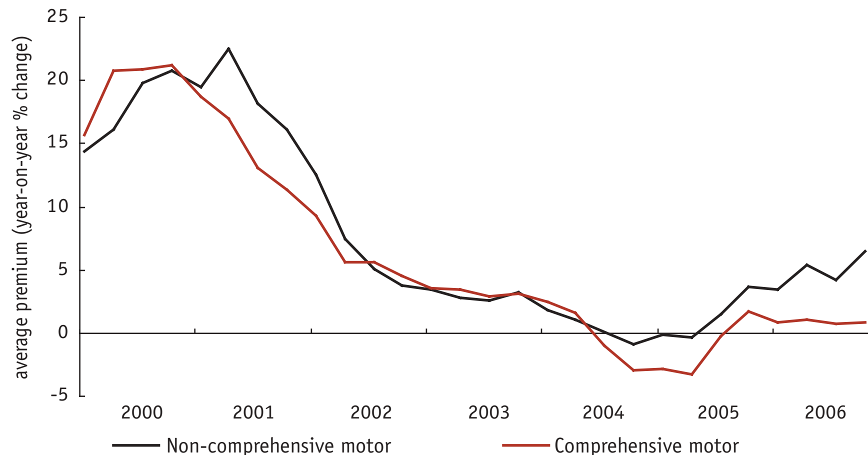
Underwriting cycle is still trading downwards

The general insurance market is cyclical in nature and the premium cycle has been trading downwards for a few years. The large natural-catastrophe losses in the Gulf of Mexico in 2005 slowed the pace of the decline, but did not halt it. Firms need to manage the down premium cycle very carefully as competition for market share leads to further price declines. In the past, this has brought about risks to the financial soundness of individual firms, where they have held insufficient economic capital against the risks they have taken on.

There is increasing anecdotal evidence in the UK retail market of firms promising to undercut renewal quotes for motor- and home-insurance policies. This is likely to erode the upward trend in premiums that we have seen in the past few years. In addition to potential solvency issues, the way in which these price promises can be portrayed raises concerns with regard to our consumer objectives. Firms writing business directly with consumers need to pay attention to ensuring their customers are treated fairly, particularly with

regard to financial promotions and product disclosure. Our thematic work in 2006 on this topic revealed some critical shortcomings. Most importantly, many 'price matching' promotions headline unsubstantiated price-savings claims, which may be unrepresentative of the scope of the actual cover.

Chart C21: AA premium index - motor insurance



Source: AA Insurance

Complex products pose risks for consumers

Retail general insurance customers face significant risks from high-risk, complex products, such as critical illness and payment protection insurance (PPI). When sold appropriately, PPI can provide valuable protection against changes in personal circumstances. Unfortunately, there remain significant concerns about the sales process for PPI, which may result in consumers being unable to make an informed decision about the suitability and cost of the cover. By not providing consumers with transparent information, firms are not making policyholders aware of limitations and endorsements to the cover. Furthermore, sales conversations are sometimes heavily biased towards a single premium policy.[32]

Risk management

While the evaluation of risk lies at the heart of insurers' business, inadequate risk-management systems, ineffective use of models, and inadequate management of exposures to reinsurers can prevent firms from identifying existing and emerging risks and pricing them correctly. Where risk management is inadequate, the firms in question will fall short of the requirements for firms to manage and control their affairs responsibly and effectively.

Insurers' risk-management practices are improving, but more needs to be done

Our thematic review of insurers' risk-management practices in 2006 revealed that significant and encouraging progress has been made since our previous review in 2003.[33] However, firms may have dealt with the areas that are most easily addressed, and further necessary developments will inevitably prove more difficult. For example, most firms have now documented their risk appetite, but there remains a substantial gap between defining and applying risk appetite, particularly for operational risk. Nevertheless, it is encouraging that more insurance firms are now recognising the commercial benefits of robust risk management, whereas before it had been largely seen as a compliance activity.

32 *The sale of payment protection insurance – results of follow-up thematic work*, FSA, October 2006.
33 *Insurance Sector Briefing: Risk Management in Insurers*, FSA, December 2006.

We have previously highlighted our concern that some insurers might place too much reliance on the output of catastrophe models when assessing their underwriting risks without proper consideration of alternative scenarios and inputs to the models. Having explored some of these concerns in 2006, we believe that issues caused by data quality are much less prevalent than we had initially thought. However, there does appear to be a concentration in models used, which could expose firms to significant unexpected losses. To mitigate this risk, firms need to ensure that they are not overly reliant on the models' outputs. This will also bring about benefits to the individual firms. Firms that were employing a relatively sophisticated approach to their use of models before the end of the 2005 windstorm season were less likely to have suffered serious disruptions or unexpected losses as a result of these events.

Key risks for general insurers

The identification and reporting of emerging and changing risks have been a cause of frequent concern. Given the pace and scale of change in the insurance market, it is increasingly important that firms maintain a comprehensive understanding of the risks to which they are exposed. This is an area where we think that more progress is needed, not least because of the implications of a forward-looking approach to risk-based capital.

Climate change remains a topical issue, and firms are doing more to assess its impact

The insurance industry has been ahead of other financial services sectors in recognising the importance of climate change on their businesses (see *Economic and financial conditions*, Section B). One broker's survey in Autumn 2006 suggested that insurers see natural catastrophes as their biggest future challenge, as they expect climate change to trigger more extreme weather events.[34] The Environment Agency recently warned that flooding represents a bigger risk than fire to UK businesses, with 10% of businesses at risk from some type of flooding at any one time. Climate change poses considerable risks to the insurance industry through increased claims on insured losses afflicted by increasing frequency of extreme weather events, while at the same time the cost of capital is likely to increase, making raising capital more difficult.

The insurance industry's increased efforts to evaluate the risks that they are exposed to due to climate change are positive. However, it is also important that consumers are aware that increasing levels of sophistication in underwriting could lead to increases in insurance premiums or tighter conditions for some domestic housing cover. Consumers should consider this when purchasing a new home. For their part, firms need to ensure that any relevant policy exclusions are explained to consumers in a clear, fair and not misleading manner.

Terrorism affects both firms and consumers

Terrorism, one of our *Priority Risks*, is another area where consumer understanding of cover provided in a policy (whether through retail motor and home policies, life insurance policies, health or travel insurance) is likely to be limited. Consumers often buy general insurance policies on the basis of price alone, and may not pay sufficient attention to the exclusions, including exclusion of cover in the event of terrorist activity. Our concern is not whether cover is included for specific risks, but whether significant or unusual exclusions are adequately disclosed so that consumers can then take an informed decision on what they are buying.

34 *Paying less, getting more* AON Market Report, European property, Liability and D&O Report, 2006.

Government-backed reinsurance arrangements remain important for commercial policies, as the potential losses from a single terrorist event could be larger than the private sector is willing to finance. Pool Re, a government-backed reinsurer, was established in 1993 to ensure that terrorism insurance for commercial property would remain available in Great Britain. In the US, a jurisdiction to which UK general insurers have a significant exposure, the Terrorism Risk Insurance Act is due to expire at the end of 2007. The absence of a federal backstop for insurance claims related to acts of terrorism could expose UK firms to significant risks.

Asbestos-related claims are increasing in the UK

Asbestosis is another known, serious problem, which resulted in severe difficulties for Lloyd's and the London Market in the early 1990s. We have seen indications recently that asbestos-related claims are increasing in the UK. We want firms to be adequately reserved and capitalised for expected costs of asbestos-related claims. This is particularly important where irreversible events, such as Part VII transfers,[35] are taking place. Asbestos assumption-setting is subject to a high degree of uncertainty, and firms need to deal with this by making adequate capital provisions.

Reinsurance

In sharp contrast to 2005, general insurance firms experienced a benign claims environment in 2006, which in turn has meant that the resilience of the reinsurance market was not tested. Late 2005 and 2006 saw the injection of significant additional capital into the sector, driven largely by a desire on the part of investors to find non-correlated investments with high expected returns. Our concern remains that these capital flows could reverse should expected levels of return fail to materialise.

Alternative reinsurance arrangements are growing, but from a small base

There are some signs of tighter capacity in the traditional reinsurance market, especially for retrocession, which has led to increasing consideration of alternatives, such as catastrophe bonds and sidecar arrangements. Although the issuance of catastrophe bonds has tripled in the past two years, these new solutions are still in their infancy and provide, in some cases, much less cover than traditional reinsurance. The implementation of the Reinsurance Directive in the UK may give rise to an increase in activity in this area, especially once there is clarity on the tax treatment of insurance special-purpose vehicles (ISPVs).

Competitiveness of London as an insurance centre

London's position as a leading insurance centre is being challenged

London's position as a leading insurance centre was questioned after the 2005 US hurricanes when a number of new reinsurers, referred to as the 'class of 2005', set up in Bermuda. The main drivers claimed for these new firms' choice of domicile were tax and – to a lesser extent – the UK regulatory burden, although the growing maturity and scale of the Bermudian market have also been cited. In addition, a number of established London insurance businesses, although retaining a presence in London, have recently redomiciled from the UK to Bermuda. Reinsurance is a global business and most firms manage their capital on a global basis. As such, it is not surprising that firms seek to make use of the relative advantages offered by different jurisdictions or diversify out of the London Market to improve growth prospects.

35 Part VII transfer refers to the transfer of the whole or part of the business of an insurer to another insurer or body.

The view of London has improved recently, with more observers highlighting the benefits of writing a diversified book of business and the value added by the London Market by attracting non-standard risks. This has meant that a number of overseas groups have sought to diversify by establishing operations in London. In addition, the Equitas reinsurance deal should also go some way towards addressing the perception of legacy problems in the London Market by bringing finality to the Lloyds' names. Separately, there have been for some time significant M&A transactions between managing agents, which has challenged the view of the market as stagnant and may well be the start of a further wave of consolidation.

Notwithstanding this, significant challenges remain for London. In particular, acquisition costs in the London Market are higher than in some competing jurisdictions, the reverse of the historic position. This demonstrates the need for reform of market processes in the London subscription market. Given the number of past abortive attempts at reform, it is important that the market succeeds this time in working together to tackle inefficiencies that impose transaction costs without corresponding benefits to consumers.

While the market's progress on contract certainty has been an encouraging example of how the market participants can work together to deliver solutions that provide real benefits to customers, it is just the first step. Two years ago we challenged the market to put an end to the traditional practice whereby insurance was often purchased in the London Market before full terms and conditions had been agreed. As a result, the insurer did not have certainty over exposure, the insured did not have certainty over coverage, and the broker was exposed to legal and other risks. The status quo was at odds with several of our principles for business, including those relating to communications with clients and to customers' interests. Overall, good progress has been made in this area in the subscription and non-subscription markets. The focus in 2007 will be on firms to make contract certainty part of the normal operation of the market and to reduce the number of legacy policies that are not contract certain.

Wholesale intermediaries

Wholesale insurance intermediaries (brokers in the London Market and regional brokers) came under FSA regulation in January 2005. Their relative newness to our regime is reflected in the risks we have identified for the sub-sector. These issues are fairly fundamental and can be directly linked to our high-level principles: shortcomings in handling client money; managing conflicts of interest; and problems with group structures and governance.

More work needs to be done on conflict of interest management

We raised the issue of managing conflicts of interest to wholesale intermediaries several times in 2006. It appears that conflict-management processes are generally now in place and there is a better recognition of the activities that may create the potential for a conflict of interest. Nonetheless, these processes are still relatively new in most firms and therefore often not tested in live and changing circumstances. Although managing conflicts of interest goes beyond remuneration, we have reviewed the issue of commission disclosure. We discovered that in some cases firms would disclose commissions but omit some items required by our current rules. Firms should review their procedures to ensure that they are compliant. In addition, we are going to undertake work to understand whether further mandatory commission disclosure is needed, looking at the nature of the market failure and the costs and benefits of regulatory intervention.

The business model for wholesale intermediaries has been under a spotlight in the past few years not just in the UK but globally, resulting in a squeeze on profitability. Combined with a likely further downturn in premium rates, this could result in further pressure on broker revenues. Many industry commentators are speculating that these trends may lead to long-awaited consolidation.

Regulatory developments

Solvency 2 and the Reinsurance Directive are key challenges

One of our *Priority Risks* concerns the substantial volume of international regulatory reform that firms are faced with. General insurers are no exception; besides the wide-ranging implications of the new Solvency 2 regime, discussed in *Life insurance*, the new EU Reinsurance Directive is a key regulatory development. The Reinsurance Directive came into force in December 2005 and must be implemented by December 2007.

As we already apply the same standards of regulation to pure reinsurers and direct insurers, the majority of changes are not significant for UK-authorised firms. The biggest change is our proposal to introduce authorisation requirements that are proportionate to the lower risks of ISPVs. Previously, an ISPV would have been regulated on the same basis as a traditional reinsurer, but under our new rules, ISPVs are supervised through our supervision of the ceding insurer. This will ensure an adequate level of consumer protection while allowing insurers to manage their capital more efficiently.

We are also currently reviewing our domestic general insurance conduct of business regime and assessing whether the conduct of business rules (ICOB) are delivering their intended benefits for retail consumers. The review is exploring whether ICOB provides sufficient consumer safeguards for the sale of protection policies, the risks of which are discussed above. It also examines whether ICOB delivers benefits to consumers taking out household and motor insurance, and whether there is a case for deregulation of these products, subject to the constraints imposed by the Insurance Mediation Directive and the Distance Marketing Directive.

Consumers' engagement with industry

Consumers face a more demanding environment

The benign economic environment has enabled many consumers to take advantage of rising house prices and expand their credit commitments. However, there is a risk that they could be ill-prepared for a weaker economic environment and hold an over-confident view about the future. Consumers are confronted with increasing individual responsibility across many areas of their lives and face complex financial decisions. The UK's ageing population poses particular challenges for government, firms and consumers in financing retirement.

Macroeconomic environment

Consumers have got used to benign financial markets...

The UK economy has experienced a sustained period of financial stability and economic growth. This has had a number of effects on consumer behaviour in retail markets and attracted consumers to new products and investment strategies. While economic conditions are still benign, we see a number of risks on the horizon with possible implications for consumer welfare (refer to our *Central economic scenario*, Section B).

...and might not be prepared if the external environment were to change

Rising house prices have reinforced a strong belief in the value of property investment to achieve both long- and short-term financial goals. Many consumers consider property to be a low-risk investment that will continue to provide high returns. However, even a small reduction in the growth rate of house prices could have a profound effect on consumers' investment and spending decisions. If house-price volatility were to increase, or there was a sudden rise in the perceived risk level of property investments, consumers could radically alter their consumption and saving patterns or restructure their balance sheets (refer to our *Deterioration of personal credit quality* scenario, Section B).

Relatively low levels of unemployment and high levels of economic activity have increased earnings, allowing many consumers to take on higher levels of personal debt. However, the unemployment claimant count is expected to rise in 2007, and growth in real household disposable income is expected to moderate slightly (see our *Central economic scenario*, Section B). Higher unemployment and reduced job security could reduce consumer confidence, and consumers could be less willing to take on borrowing commitments.

Many consumers 'live for today'

Interest rates have remained below the long-term average for a considerable period, which has led some consumers to believe that the supply of cheap, readily available credit is going to remain a permanent feature of the market. This has helped to facilitate maturing mortgage and consumer-credit markets, but, on the downside, fewer consumers now believe in the value of saving, and many consumers, particularly younger age groups, have a 'live for today' attitude.[1] Against the backdrop of economic and financial stability there is a real concern that many consumers hold an over-confident view about the future and would be ill-prepared if the economic conditions were to deteriorate. Higher energy prices and subsequently higher utility bills have eroded disposable income. The contribution of higher energy costs to inflation has meant that consumers, particularly those in lower income groups (for whom utility bills form a higher proportion of income), have had less income for savings and for meeting other financial needs.

The Bank of England increased interest rates from 4.5% to 5% in 2006 and by a further 0.25% to 5.25% in January 2007. Higher interest rates affect lending rates and the affordability of debt repayments, particularly repayments on variable rate mortgages. Even a relatively small change in interest rates could have a detrimental impact on a number of consumers, especially those whose mortgage payments are high relative to their household income.

Increased risk transfer from government and firms to individuals

Consumers face greater financial responsibility throughout their lives

The responsibility for financing consumers' short- and long-term needs has continued to shift from government and firms to consumers, a theme that we have highlighted in previous editions of the *Financial Risk Outlook*. Consumers face increased financial responsibility across many aspects of their lives. Demographic and social changes appear to have contributed to this trend and, while some consumers have been able to reflect the changing environment in their financial decisions, others show a lack of preparedness. This is demonstrated either through a lack of financial resources, a failure to appreciate the changes taking place or a general lack of ability to plan ahead.

Wider participation in the labour market means that 90% of working-age men and 68% of working-age women with dependent children are in employment, making childcare a major expense for many families.[2] The cost of education can also be a considerable expense for some parents, whether through the rising cost of fees paid for private education or for the premium paid for housing within the catchment area of well-performing state schools. A recent study by the Royal Institution of Chartered Surveyors suggests that the national average premium on the price of a house in the area of a popular school is 12%.[3] Parents may increasingly need advice on suitable financial products to meet the cost of childcare and education, some of which may involve products of a complex nature.

Consumer responsibility for the financing of education continues to grow

Individuals have also had to take on more responsibility for the funding of higher education. Variable tuition fees were introduced in 2006 and are currently limited to a maximum of £3,000 per year in England for under-graduate courses. The increased cost of tuition fees may be met by some

1 *Levels of Financial Capability in the UK: Results of a Baseline Survey*, FSA Consumer Research Paper 47, March 2006.
2 *Labour Force Survey*, Office for National Statistics, Spring 2005.
3 *Londoners least willing to pay a premium for school catchment area*, Royal Institution of Chartered Surveyors, October 2006.

parents, or, in the case of lower-income families, from financial awards. However, many students will have to meet the increased cost of fees themselves. Tuition fees, extra borrowing from the Student Loan Company to cover living expenses, and any additional credit will mean that many students will graduate with a considerable amount of debt. This could be in excess of £22,000 for those taking out the maximum student loan and with the highest tuition fees over a three-year course. The debt repayments for tuition fees and student loans are only paid back when the graduate meets an earnings threshold, and repayments are spread over a long period of time. However, the amount of debt often restricts the amount available for other financial needs, such as raising a deposit for a property purchase or saving for the future.

Financial responsibility for children appears to be extending beyond the traditional years of financial dependency. The acceleration in house prices, for example, has made it difficult for many first-time buyers to be able to afford to buy a property, and some parents are therefore assisting their children in making these purchases. Research by the Council of Mortgage Lenders (CML) suggests that over the past decade the proportion of young first-time buyers receiving help from parents has increased from around 10% to 50%.[4] Parental assistance may be becoming more commonplace, but parents who do so take on additional risks. They will be liable for the mortgage should their child get into financial difficulty and, by making a contribution, they may be helping their children at the expense of planning ahead for their own retirement needs.

The Child Trust Fund (CTF), with which children born on or after 1 September 2002 receive a voucher worth at least £250, was launched in 2005. It was intended to encourage parents to save for their children's future and provide children with a significant monetary boost in the early years of adulthood. A study conducted in the early months of the CTF scheme reported that some parents have found it difficult to decide what type of account to open. The study also highlighted that parents living in households with no earners, social-housing tenants, lone parents, parents with three or more children, and parents who found their credit commitments a heavy burden were less likely to have opened an account.[5] This is reinforced by the fact that in the first year the CTF was introduced, one in four vouchers were not used before their expiry date (if parents fail to open an account for the vouchers, HM Revenue & Customs opens an account on the child's behalf).[6]

Consumers will have to take on more responsibility for financing their retirement

Our ageing population continues to pose a considerable financial challenge for government, firms and consumers. It is increasingly important for consumers to take more responsibility for financing their later stages of life, as the financial responsibility for health and social care in old age is increasingly being borne by the individual. The Pensions Commission reported on the pressures placed on the state-pension system by an ageing population and the weakness in voluntary pension saving by consumers.[7] The demographic challenge is likely to continue the shift away from defined-benefit pension schemes to defined-contribution schemes (with an associated transfer of risk to consumers), as existing schemes come under funding pressures and

4 *Will the real first-time buyers please stand up?*, Council of Mortgage Lenders, February 2006.
5 *Saving for children: A baseline survey at the inception of the Child Trust Fund*, HM Revenue & Customs Research Report 18, September 2006.
6 *Child Trust Fund Statistical Report 2006*, HM Revenue & Customs, September 2006.
7 *Pensions: Challenges and Choices – The first report of the Pensions Commission,* The Pensions Commission 2004.

consumers face higher annuity prices. Proposals for the auto-enrolment of employees into a system of personal accounts may serve to encourage wider participation in long-term savings.[8] However, in the transition period to the launch of the new pension options, some consumers without pensions may delay making a commitment to save until new arrangements are available to them.

Increasing complexity of consumer needs and products

Consumers face more complex financial decisions and products to meet their changing needs

Consumers have increasingly complex and diverse lifestyles, and previous assumptions about consumers' circumstances can no longer be solely relied on. For example, there is more variation in employment (and switching jobs will often lead consumers to review their financial arrangements), and children are increasingly financially dependent on their parents further into their adult lives.

Trends in relationship formation and dissolution have also changed significantly. This has resulted in more second families having less financial security and more problems associated with long-term planning for some consumers. Although 2004 saw the third consecutive rise in the number of marriages in the UK, there has been a long-term decline in the number of marriages since 1972.[9] In 2004/05, around half of men and women were married and one in ten were cohabiting. However, the advent of civil partnerships (same-sex couples formed 15,672 civil partnerships in the UK between December 2005 and the end of September 2006) may have given some of these couples similar financial protections to those available to married couples.[10] The number of divorced people in England and Wales increased to 1.6 million divorced men and 2.2 million divorced women in 2004, compared with just 187,000 and 296,000 divorced men and women respectively in 1971. Family composition has also changed rapidly and fewer families have two parents; in 1971, 92% of families were headed by a married or a cohabiting couple, by 2005 this had fallen to 74% of families.[11]

Patterns of employment are also increasingly varied. Self employment in the UK has increased markedly in recent years, and since mid-2002 has been growing faster than at any time since the late 1980s. By 2003 there were over 3.5 million self-employed workers compared to less than 2.8 million in 1986.[12] While self employment can bring substantial flexibility in terms of fitting working hours around childcare responsibilities, it is also often associated with irregular income, and this financial insecurity may act as a constraint against making long-term savings contributions. The Pensions Commission highlighted that self-employed consumers were among a concentration of people heading towards an inadequate income in retirement.[13] Employees, meanwhile, may find their place of work changing more rapidly; in 1996, half of all employees had been working for the same firm for five years or less. By 2001 this had fallen to four years.[14] Although job tenure overall has remained relatively constant, there have been

8 *Personal accounts: a new way to save*, Department for Work and Pensions, December 2006.
9 *UK marriages rise for 3rd year running*, Office for National Statistics News Release, 7 February 2006.
10 *More than 15,500 civil partnerships formed*, ONS News Release, 4 December 2006.
11 *General Household Survey 2005: Overview Report*, Office for National Statistics, November 2006.
12 *Growth in self-employment in the UK*, Office for National Statistics, October 2004.
13 *Pensions: Challenges and Choices – The first report of the Pensions Commission,* The Pensions Commission, 2004.
14 *Job mobility and job tenure in the UK*, Office for National Statistics, November 2003.

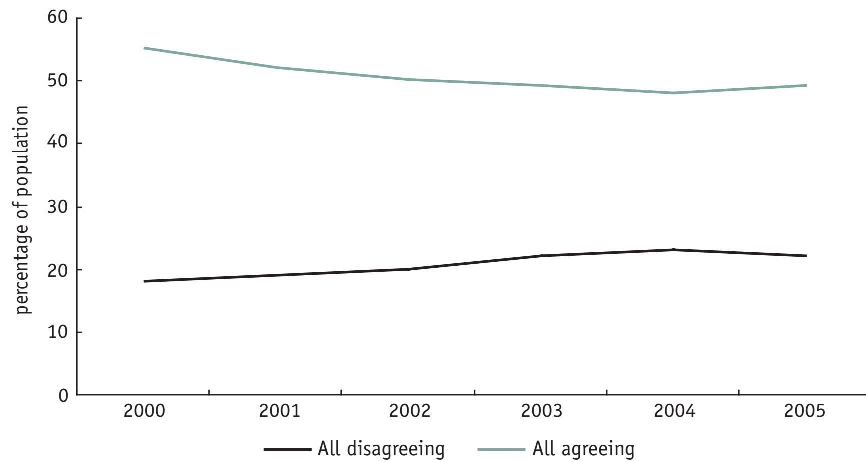
variations within demographic groups; tenure has increased for women with dependent children, but fallen for men aged over 50. Increased job turnover may mean that some consumers fail to make appropriate provision for their long-term savings goals.

Consumers may not understand all the risks involved in complex financial products

The complexity and range of available financial products has expanded to meet the changing needs of consumers. Some of these new products have previously only been available for wholesale consumers. While this increases consumer choice, consumers may not fully understand all the risks associated with some of these products, and firms may fail to recognise the changing needs of consumers. Complex products, in particular those involving combinations of investment and borrowing, have been mis-sold to consumers.

Consumers have responded with varying degrees of success to the more complex environment. Some consumers are able to leverage the increased variety of sources of information available to them to make better informed financial decisions, while others struggle. Insufficient communication of key product features and associated in-sales literature, or the sales process itself, may lead to consumers making unsuitable decisions, or even to disengage from financial markets entirely. Although the proportion has fallen slightly, research indicates that many consumers still find financial services confusing.

Chart D1: Consumers find the financial information they are sent confusing



Source: Henley Centre Headlight Vision, Planning for Consumer Change 2000-2005

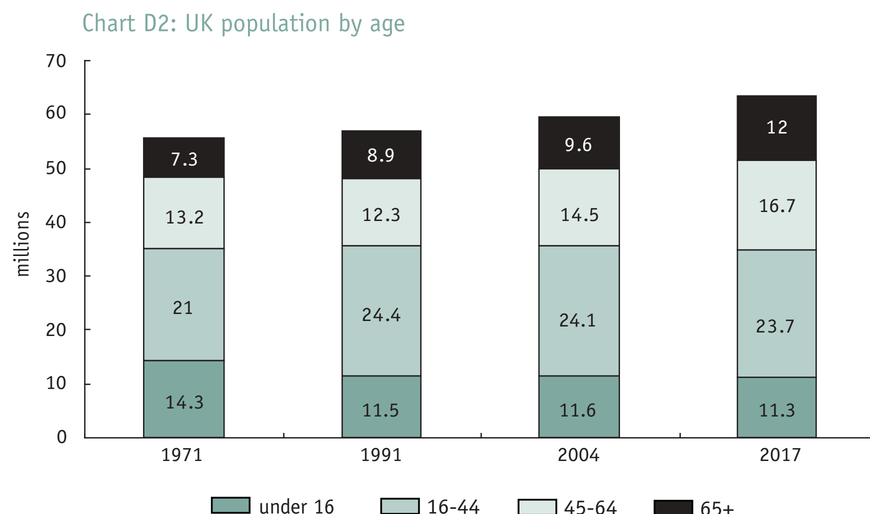
Demographic changes and longevity risk

The UK population is ageing…

The UK has an ageing population due to the combined effects of the 'baby boom' generations of the late 1940s to early 1960s moving into retirement age, a declining birth rate and increasing life expectancy. According to the latest population projections, total UK population will have increased from 60 million in 2004 to 64 million by 2017, and to 70 million by 2054. The old-age dependency ratio (the number of people above pensionable age to the number of people of working age) is forecast to rise from 27.1% in 2005 to 45% in 2035, with a large expansion in the older-age cohorts.[15]

15 *2004-based principal population projections*, Government Actuary's Department, October 2005.

Chart D2: UK population by age



Source: ONS/GAD

… and the rate of longevity improvement is subject to uncertainty, which gives rise to longevity risk

Although the long-term trend of an ageing population has been forecast over a number of years, the rate at which such change will occur is subject to uncertainty, particularly as it involves variables such as migration flows, birth rates, health issues and scientific developments. The increase in life expectancy among the older-age cohort has been particularly strong. This uncertainty makes it difficult for firms to price long-term risks arising from longevity. It also presents significant risks for government, firms and consumers in making long-term and retirement provision. Consumers could find it difficult to assess their long-term financial needs and the sustainability of their long-term savings and investment plans. Equally, firms could find it difficult to assess the need for pension provision due to changing actuarial projections of employees' life expectancy. It is also difficult for the government to assess the sustainability of state pension provision in the future. Longevity risk is also discussed in *Life insurance*, Section C.

Consumer borrowing is high

Many consumers appear to be managing their current levels of secured and unsecured debt. However, record debt levels and rising interest rates have heightened concerns that some consumers have unsustainable levels of debt, which could lead to an increase in the number of consumers facing debt-repayment problems. A situation where a significant number of consumers experience debt-repayment problems has implications for the UK economy, providers of credit and consumers.

Aggregate household debt within the UK has risen dramatically in recent years, reflecting both an increase in the level of debt held by individual households and an increase in the number of households that have access to credit. The level of secured debt as a percentage of disposable income reached 126% in the third quarter of 2006, while unsecured debt as a percentage of disposable income amounted to 26%. This is a considerable increase on the levels of 76% and 15% respectively in the late 1980s. Increasing numbers of households are already facing debt-servicing difficulties, as shown by the sharp rise in individual insolvencies. Debt-repayment difficulties have so far been concentrated among the renting population, potentially because homeowners have had access to mortgage equity to enable refinancing of unsecured debts. However, should the macroeconomic environment deteriorate, the number of consumers experiencing problems in meeting their debt repayments could increase substantially. The implications of this are explored further in our *Deterioration of personal credit quality* scenario, Section B.

Interest rates and income shocks

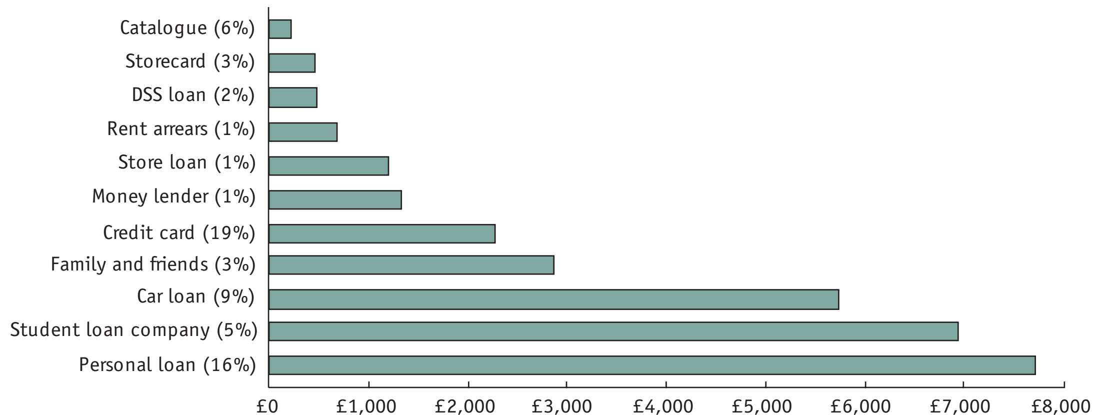
Interest rate rises may cause increased debt-repayment problems

The deterioration in consumer-credit quality has not yet spread to secured lending. However, even a small rise in interest rates could significantly increase the debt-servicing burden of mortgage holders. Should the macroeconomic environment weaken consumers could face increasing difficulties in meeting their secured and unsecured debt repayments. Any increase in personal incomes could be offset by the effect of interest rate rises, particularly for holders of variable rate mortgages. This would further reduce the proportion of income that consumers can put towards savings and meeting other financial needs, such as funding their retirement.

We recently commissioned a survey looking at people's financial commitments and their ability to cope with interest rate increases.[16] Just over 42% of respondents had some form of unsecured debt, and the median amount owed was £3,000. The most common type of debt held was on credit cards, with 19% not repaying their balance in full each month. The overwhelming majority of consumers with mortgage commitments were able to maintain their mortgage payments without any difficulty. While only a very small number of those surveyed were actually falling behind with their payments, a deterioration in the macroeconomic environment could result in many more consumers fall into difficulty, leading to a rise in mortgage and debt arrears, defaults and repossessions.

16 Fieldwork was conducted on the August and September 2006 Office for National Statistics omnibus survey, in which 2,404 face-to-face interviews were completed.

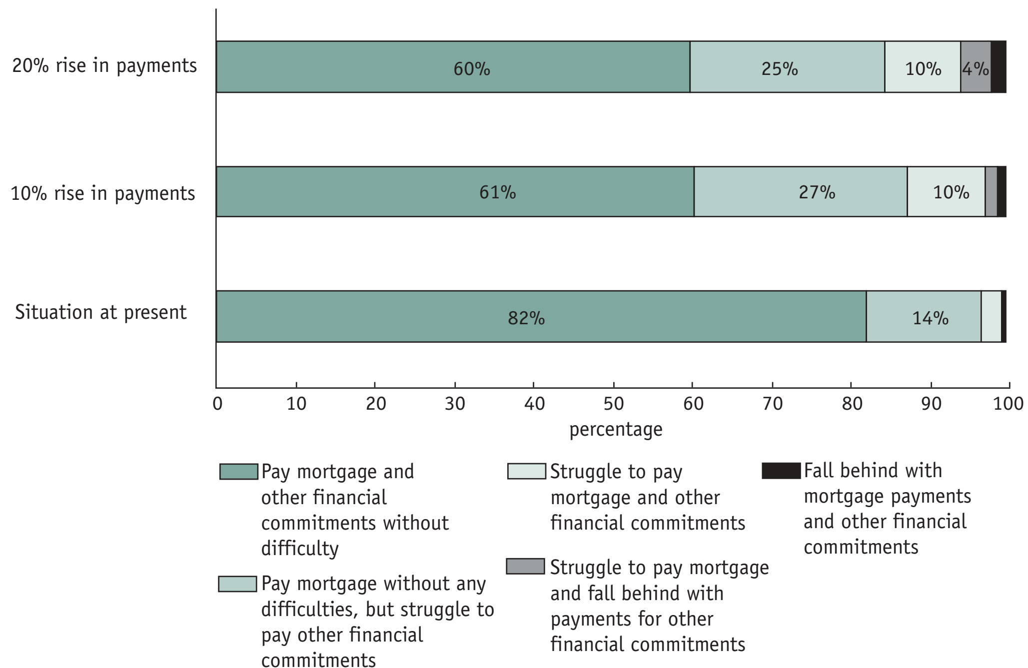
Chart D3: Average amounts outstanding for unsecured debt



Note: Figures in brackets indicate percentage of population who have the product.
Source: FSA/ONS (2006)

A relatively small increase in interest rates resulting in average mortgage payments increasing by 10% would have a fairly modest impact on most consumers' ability to repay their debt. While 10% of consumers said that they would struggle with both their mortgage and other financial commitments, 3% said they would fall behind with payments, half of whom said that they would fall behind with their mortgage (this represents a similar figure to 2005). When asked to consider a 20% increase in average mortgage payments, a similar proportion said that they would be able to cope with little or no difficulty at all. However, a higher proportion of people would show significant signs of financial strain: 6% said that they would fall behind with mortgages or other financial commitments.

Chart D4: The degree to which consumers are able to cope with an increase in mortgage payments



Note: Based on sample of consumers with mortgages.
Source: FSA/ONS (2006)

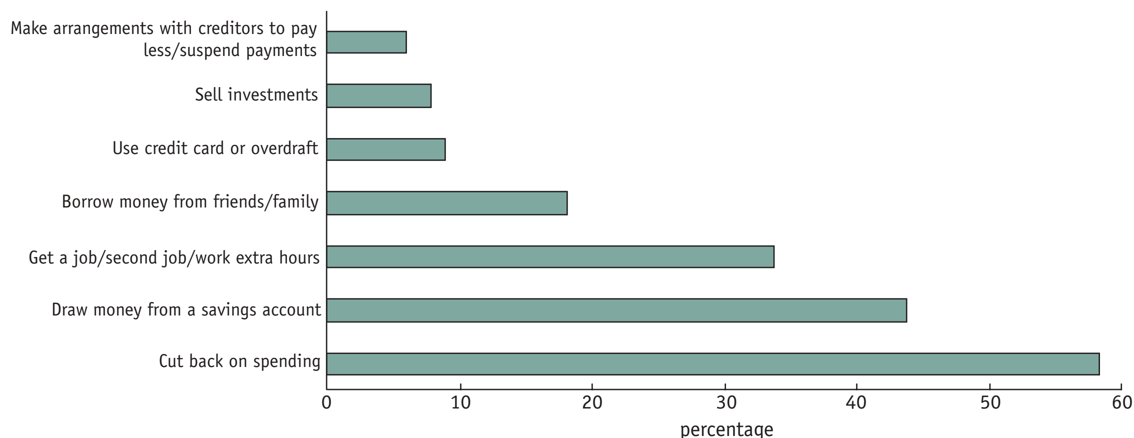
Many consumers do not have the reassurance of a safety net

Many consumers do not have adequate provision set aside to cope with a fall in income, despite income shocks being relatively commonplace.[17] We surveyed people who were in employment, or whose partner was currently employed, and asked what they would do if their income fell by 25% for a period of three months or more. The most common response was to reduce spending, followed by drawing on money from a savings or current account or by working additional hours. A third of respondents indicated that they had savings to fall back on. However, actions such as reducing spending or undertaking additional work may not be as easily achievable as consumers hope, possibly leading to financial difficulties. Even if consumers were able to take such actions, many respondents said that they would only be able to cope for a short period of time.

According to our survey, over a quarter of consumers in households with at least one person in paid employment are vulnerable to an income shock given the absence of any significant savings provision to replace lost income and reliance on borrowing to make ends meet. The most vulnerable groups are those on a low income or those who are currently struggling and over-indebted. However, even the consumers who are financially sound or managing reasonably well could face difficulties if they were to experience even a temporary fall in income.

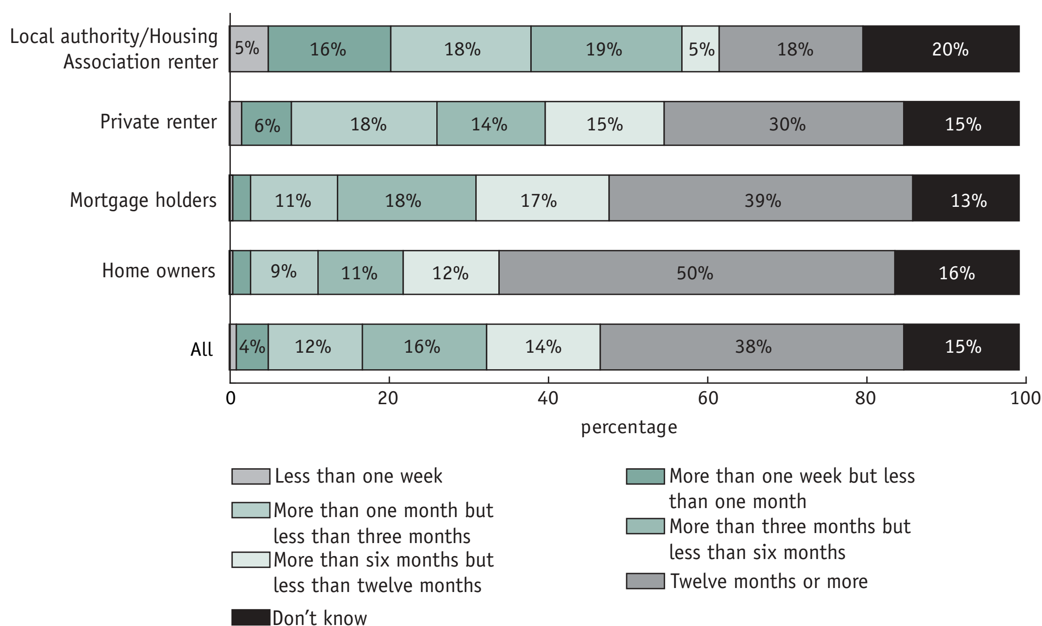
17 A study based on fieldwork conducted in 2005 found that 28% of people had experienced some form of income shock over the previous three years. *Overstretched: People at risk of financial difficulties*, Kempson, E and Atkinson, A, Personal Finance Research Centre, University of Bristol, November 2006.

Chart D5: Action consumers would take if they faced a drop in income



Note: Top seven responses displayed.
Source: FSA/ONS (2006)

Chart D6: The length of time respondents can make ends meet following a drop in income



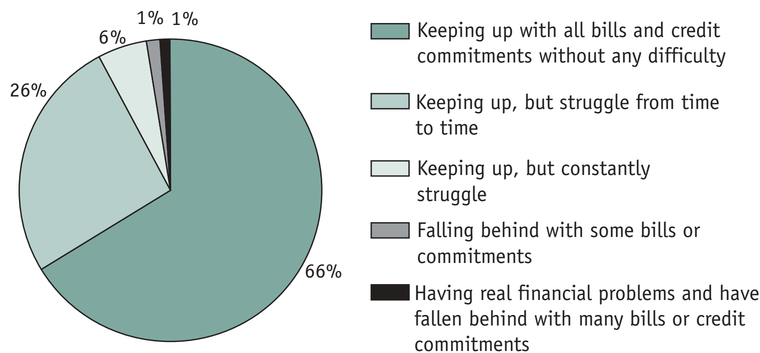
Note: Figures may not add up to 100% due to rounding.
Source: FSA/ONS (2006)

Some consumers are already experiencing financial difficulties

A significant minority of consumers are already facing financial difficulties

Our research also explored to what extent those in debt were able to cope with their current level of borrowing. The results indicate that, while most are keeping up with their bills and credit commitments without any difficulty, a small minority are having real difficulties and are falling behind with some or all of their bills and commitments. The figures suggest that over one million adults are currently falling behind with payments and a further two million are constantly struggling. Respondents living in rented accommodation, particularly those in local authority housing, were more likely to show signs of financial distress than those who owned their home outright, and almost 10% of respondents have experienced financial difficulties within the last five years.

Chart D7: The degree to which consumers are able to cope with bills and credit commitments



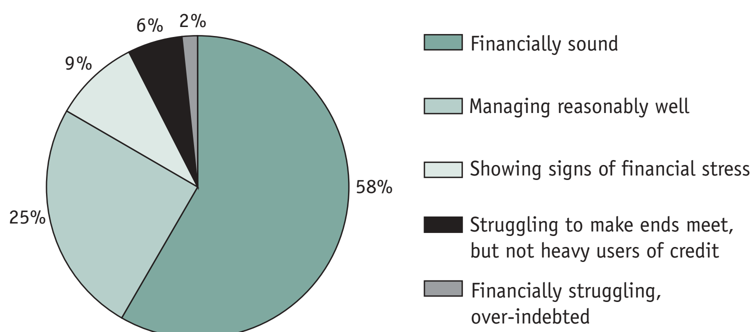
Note: Based on sample of consumers with bills or credit commitments.
Source: FSA/ONS (2006)

Further analysis of the study undertaken to measure the UK's level of financial capability examined people's financial situation in detail, including their assets and credit commitments. It identified five different groups of consumers who face varying levels of financial strain.[18] A majority of respondents, 58%, appear to be financially sound with no significant signs of financial distress. While their incomes are not especially high, they have low levels of unsecured credit or mortgages and tend to be older or retired. A quarter of the population are managing reasonably well financially, with relatively low levels of unsecured credit but heavier mortgage commitments. This group tends to be well-qualified, well-off and living in households with two earners. The third group, just less than 10% of consumers, shows signs of financial stress. They are always overdrawn and have high levels of unsecured debt and considerable mortgage commitments but little in the way of savings. This group is characterised by young and well-qualified consumers with reasonable incomes, who typically feel they are living within their means.

The last two groups are struggling financially but for very different reasons; 6% of the population are living on low incomes and finding it difficult to make ends meet. They do not have high levels of unsecured credit or mortgages, as many would not be eligible for such products, and have very low savings. More than 60% of this group are in a household with no one in permanent employment and they have the lowest levels of educational attainment of the five groups. The fifth group, representing just 2% of the population, are struggling financially and are over-indebted. The group is characterised by families with dependent children, headed by adults aged under 40. They are middle-income earners but have heavy unsecured credit and mortgage commitments relative to their income, with very little in either savings or investments. Consumers who are showing financial stress but currently meeting their debt repayments could reach a 'tipping point' if the UK macroeconomic environment were to deteriorate.

18 *Overstretched: People at risk of financial difficulties*, Kempson, E. and Atkinson, A., Personal Finance Research Centre, University of Bristol, November 2006.

Chart D8: The financial position of consumers in the UK



Note: Based on fieldwork conducted by BMRB (2005).
Source: Personal Finance Research Centre (2006)

Personal insolvencies, bankruptcy and Individual Voluntary Arrangements (IVAs)

Personal insolvencies are rising

The scale of consumer debt is not necessarily a cause for concern providing consumers are able to meet their borrowing commitments. However, there is evidence of a small, but growing, number of consumers who are showing signs of financial distress, in spite of a relatively benign economic environment (refer to our *Central economic scenario*, Section B). There have been sharp increases in personal bankruptcies, IVAs and mortgage repossessions (see the box on IVAs on page 89, and the box on Mortgage repossessions, Section C). Compared to the same period for 2005, individual insolvencies showed a 55.4%[19] increase in the third quarter of 2006, IVAs rose by 117.9% and mortgage repossession actions increased by 15%.[20]

Although the number of bankruptcies has increased, research commissioned by the Bank of England in 2006 suggested that a large majority of households (88%) would only consider bankruptcy as an option of last resort, or would never consider it under any circumstances. Only a small proportion said that they would seriously consider it as an option (7%).[21] This figure has not changed significantly from their research in 2005[22] or our earlier work in 2003.[23]

Many consumers feel there is a stigma associated with bankruptcy

Our latest research on consumer attitudes towards bankruptcy suggests that, although some consumers consider bankruptcy to be an easy way to escape from money problems, there remains a great deal of stigma surrounding this option. A small majority (56%) said that they considered bankruptcy to be an easy way to escape from money problems but 44% disagreed. Moreover, 82% consider it difficult for a consumer to re-establish their credit worthiness after bankruptcy. Of those surveyed, 39% considered bankruptcy to be socially acceptable, while 87% said that they would feel ashamed if they had to go through bankruptcy.

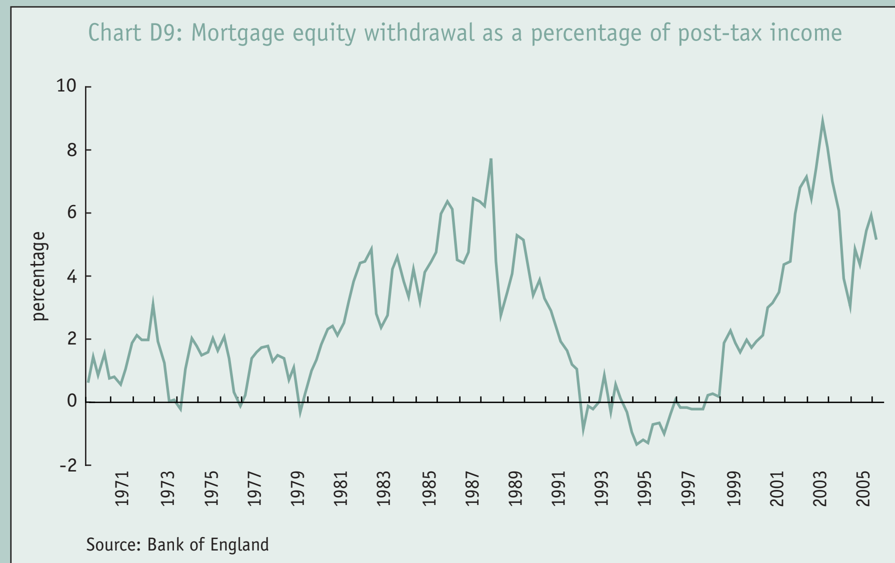
19 The Insolvency Service, November 2006.
20 The Department for Constitutional Affairs, November 2006.
21 *The state of British household finances: results from the 2006 NMG Research survey*, Bank of England Quarterly Bulletin, 2006 Q4.
22 *The distribution of assets, income and liabilities across UK households: results from the 2005 NMG Research survey*, Bank of England Quarterly Bulletin, Spring 2006.
23 FSA research conducted on the September 2003 National Statistics Omnibus Survey.

Individual Voluntary Arrangements (IVAs)

Total personal debt stood at £1.3 trillion at November 2006.[24] This increase can be partly attributed to the decline in household discretionary income, which has fallen by almost 10% since 2002/03, in part due to increases in utility bills and council tax.[25]

Total lending shows little signs of slowing. While banks appear to have tightened unsecured credit standards, particularly on credit cards, this has been offset by a rise in mortgage equity withdrawal. The rise in mortgage equity withdrawal could lead to secured lending becoming more compromised than is currently the case if consumers are unable to meet their debt repayments.

Chart D9: Mortgage equity withdrawal as a percentage of post-tax income



Source: Bank of England

We are already seeing increases in the numbers of consumers struggling to meet their debt repayments. Insolvency relative to real-debt levels now exceed levels seen in 1993 and 31,670 people in the UK sought insolvency in the third quarter of 2006.[26] One feature of the rapid rise in insolvency has been the growth in IVAs. An IVA is generally only appropriate if the debtor has sufficient money available to contribute towards repaying debts each month or additional assets which could be taken into consideration. Therefore, a typical IVA client tends to be someone in employment who has simply borrowed beyond their means. According to a survey by PricewaterhouseCoopers, 83% of debtors who went into an IVA in 2005 gave their principal reason for this as "excess of expenditure over income", rather than loss of income.[27]

The rate of growth of IVAs slowed sharply in the third quarter of 2006. However, it is too early to say whether this reflects a slowdown in the growth in personal insolvencies, as this decline could be a reflection of the characteristics of the market. For example, each IVA case must be supervised by an Insolvency Practitioner, of which there are only 1,600 in England and Wales. Financial institutions are also facing capacity constraints, which has led to an increase in the amount of time they are taking to process and respond to proposed IVAs. A number of financial institutions have increased their hurdle rates[28] for accepting an IVA, typically to 45% of the balance owed, which is higher than the typical average range of return of between 36% and 41%.[29]

As lending continues to increase, more consumers are likely to face financial difficulties and, therefore, more consumers are likely to seek IVAs. However, there is a risk that, due to the structural characteristics of the market, consumers who want IVAs may not be able to access them. These consumers may have to use alternatives such as debt consolidation, which will not be suitable for all consumers, particularly those with high levels of debt. Other consumers may take the more extreme step of declaring themselves bankrupt.

There has been some controversy about the way that IVAs are sold, with some parts of the industry suggesting that consumers are being encouraged to enter into an IVA when it might not be the most suitable option for them. To address these concerns, the British Bankers' Association (BBA) and representatives of the IVA industry announced in December 2006 that they are going to work together to create industry standards to regulate how responsible debt practitioners market and advertise their services.

24 Bank of England total personal lending data, November 2006.
25 *UK households 10% worse off than 5 years ago*, Ernst & Young, 30 June 2006.
26 Insolvency service data on personal insolvency, Q3 2006.
27 *Living on tick: the 21st century debtor*, PricewaterhouseCoopers, May 2006.
28 The hurdle rate is the minimum amount that the financial institution will accept for repayment before agreeing to an IVA.
29 *Living on tick: the 21st century debtor*, PricewaterhouseCoopers, May 2006.

Financial capability

Many consumers are unable to make financial decisions because of a lack of financial capability. In particular, many do not plan ahead for their future financial needs and therefore may face financial difficulties if their circumstances change or if the economic environment deteriorates. Many consumers have difficulties choosing the appropriate financial products to meet their investment and savings needs and some may not understand the risks related to products that they already own. Financial capability is only likely to improve in the medium to long term.

There are gaps in consumers' financial capability

Many consumers lack capability to plan ahead

While some consumers appear to be adapting well to new financial responsibilities and challenges, many consumers lack financial capability in key areas and do not feel confident in taking financial decisions. Our financial capability baseline survey, published in March 2006, measured consumers' financial capability across five key areas: making ends meet, keeping track of finances, planning ahead, choosing financial products and staying informed about financial matters.[30] The survey found low levels of capability in two main areas: planning ahead and choosing financial products.

Consumers' low capability at planning ahead has contributed to a low take up of financial savings products and retail investment products, thus leaving consumers ill-equipped to cope with the environment they face. Less than half of the consumers surveyed had any provision set aside to use in the event of a significant fall in income, leaving many vulnerable to employment shocks and reliant on state provision of financial assistance if this were to occur. A similar proportion had failed to make provisions to cope with any substantial unexpected (or even anticipated) expense they expected to face in the near future. A significant number of consumers appear to live for the moment, without really thinking about how they would cope if their circumstances were to change or making any provision for such a change.

The lack of capability in planning ahead could further exacerbate the savings gap in the economy. The Pensions Commission highlighted the scale of the weakness in voluntary pension savings; 11.7 million workers do not make any contribution to a private pension.[31] The proportion of the working-age male population contributing to a private pension fell from 52% to 48% between 1999/2000 and 2003/04, while working-age women saw a slight rise in membership from 39% to 40%.[32] Our research suggests the most common reasons for not having a private pension arrangement in place are affordability constraints or insufficient time in employment. Consumers without provision are therefore not offsetting pension contributions with other forms of savings, but relying heavily on future state-pension provision. Moreover, around one in five of those without a private pension arrangement said that they were often struggling with their finances, indicating that they

30 *Levels of Financial Capability in the UK: Results of a Baseline Survey*, FSA Consumer Research Paper 47, March 2006 and *Financial Capability in the UK: Establishing a Baseline*, FSA, March 2006.

31 *A New Pensions Settlement for the Twenty-First Century – The Second Report of the Pensions Commission*, Pensions Commission, November 2005.

32 *Pension Trends 2005*, Office for National Statistics, October 2005.

may have little realistic opportunity to make additional pension contributions due to affordability constraints. Those with low pension wealth also tend to have lower levels of other assets.[33] Failure to plan ahead may make consumers more reliant on state provision for financial assistance in the event that they experience a significant drop in their income. While there are signs that savings levels improved during 2005 and 2006, other survey research suggests the outlook may not be so positive.[34]

Many consumers have low levels of capability at choosing financial products

Despite the significant amount spent on financial products, consumers display a low level of engagement with the process of selecting appropriate products to suit their individual needs and switching between products is low; many simply renew their existing financial products without considering alternatives. Even when making a new purchase, many consumers do not compare alternative products to find the most competitive price. Consumers appear to be less sensitive to price and rely heavily on marketing literature, but many fail to carefully read the terms and conditions of products to ensure that they are suitable for their own circumstances. The potential consequence of this lack of financial capability is that consumers purchase products that are not suited to their individual needs and do not fully understand the risks involved. Consumers also display a worrying lack of knowledge of the financial products they actually hold. Not surprisingly, the lack of understanding is even greater where products are of a more complex design. Our survey found that 40% of equity ISA holders did not correctly identify that its value fluctuates with stock-market performance.

The risks associated with poor capability in choosing products could be further exacerbated if there is poor communication of product risks, costs and benefits. As well as not being able to choose the most suitable product, consumers may not be advised to buy the most appropriate product, as highlighted in our *Priority Risk* on retail distribution. This could further erode consumer confidence in taking financial decisions and in the financial services industry. Many consumers have a lack of awareness about the continuing suitability of a product for their (sometimes changing) needs; recent research found that almost a third of families who did have life assurance cover did not know how much cover they had, with only 49% convinced that they did have enough.[35] Similarly, 55% of those with a mortgage protection policy and 44% of those with income protection cover were convinced that they were appropriately covered.

Low capability is a particular problem for the young…

The lack of financial capability is most acute among younger people, who face a more demanding environment and need to take more individual responsibility than previous generations. Many young people will have taken on relatively large amounts of debt by the time that they have left full-time education. Younger age groups are also more accustomed to using credit than previous generations; 16% of 20 to 29 year olds use credit cards (that are not repaid in full each month) for day-to-day spending and 23% have been in financial difficulties in recent years.[36]

33 *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*, Banks, J, Emmerson, C, Oldfield, Z and Tetlow, G, The Institute for Fiscal Studies, October 2005.
34 *Savings Survey*, National Savings and Investments, Autumn 2006.
35 *Value of a Mum*, Legal and General, 2006 edition.
36 *Levels of Financial Capability in the UK: Results of a Baseline Survey*, FSA Consumer Research Paper 47, March 2006.

...and for the financially excluded

Poor levels of financial capability are also correlated with low take up and use of a bank account for day-to-day money management. Around one in twelve adults in the UK do not hold or use a bank account for day-to-day money management, and the majority of these people exhibit poor levels of financial capability and levels of engagement with the financial services market. Many of the consumers classified as 'struggling on a low income' (see Chart D8) do not hold a bank account and are particularly vulnerable to very high cost, and sometimes illegal, lending.[37]

The risks posed by a lack of financial capability will be influenced by the impact of the financial capability strategy, by changes in the wider economy, the impact of government policy (particularly on pensions), and the way firms respond to a more principles-based regulatory environment. However, any substantive and positive change in financial capability is only likely to occur over the medium to long term. In the intervening period, firms face considerable challenges in the way they engage with their customers and treat them fairly. The trend of increased individual responsibility suggests there is a significant risk of a mismatch between the responsibilities that many consumers are being asked to take on and their capability to make effective decisions.

37 *Financial inclusion: credit, savings, advice and insurance*, Twelfth Report of Session 2005/06, House of Commons Treasury Committee, November 2006.

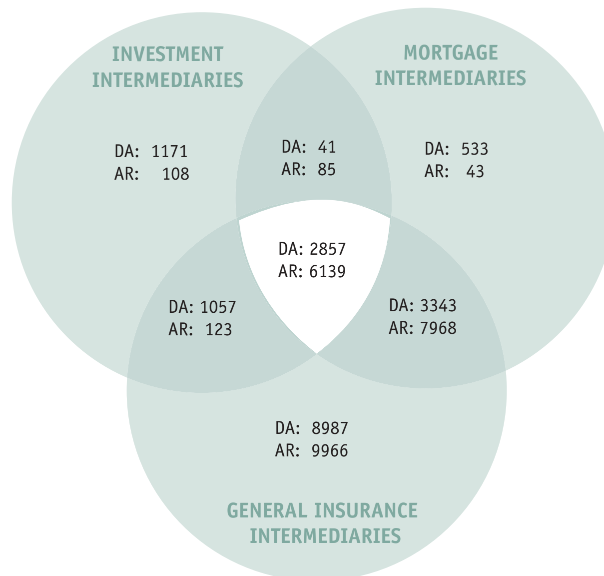
Retail intermediaries

Many financial products are complex and are often geared to meet uncertain or deferred consumer needs. Consumers often find financial products difficult to choose, negotiate or 'shop around' for, as shown by our financial capability work. These problems are compounded by the information asymmetries that exist between financial providers and distributors on the one hand, and consumers on the other. The financial intermediary sector therefore plays an important role in helping consumers meet their financial needs. However, it is clear that many consumers have low levels of trust in this sector, which will continue to face change in 2007 and beyond, from demographic changes, competition, technological advances, and regulatory and legislative pressures.

The retail intermediary population

In the retail market, intermediaries broadly service three key sectors: investments and pensions, mortgages, and general insurance.

Chart D10: Retail-intermediary population



Note: DA refers to directly authorised intermediaries and AR refers to appointed representatives. Overlaps represent firms carrying on more than one type of retail intermediary activity.
Source: FSA

As at December 2006 there were 17,989 retail intermediary firms and 24,432 appointed representatives.[38] Between July and December 2006 there was a 3% rise in the numbers of intermediary firms and a close to 5% fall in the number of appointed representatives. In the context of the overall number of firms, the shift is not historically significant, and there is movement in both directions underlying these figures.[39] However, a significant decrease in the number of retail intermediary firms, particularly if this led to fewer advisers overall, could present a risk to consumers as they would have less access to financial advice and suitable products as described in our *Priority Risk* on retail distribution.

The current economic environment is still benign and rising incomes and wealth are likely to lead to an increase in demand for advice. Demand for financial advice is also set to increase due to the increased need for retirement planning and the increasing complexity of many investment products. However, there are risks to this outlook (refer to our *Central economic scenario*, Section B). A crystallisation of these risks could lead to falling demand for advice as consumers would have less income to invest. This could lead to more pressure on firms to sustain a profitable and regulatory compliant business. If interest rates were to increase further, this could lower demand for mortgages, which in turn could lead to a reduction in business for mortgage intermediaries. On the other hand, the continuing strength in the housing market could lead to growing demand for mortgages and pressure for lenders to provide mortgages on high loan-to-income ratios. Some consumers could also seek to re-mortgage their property to provide an additional source of finance. It is therefore important that intermediaries carefully consider affordability issues when providing mortgage advice. As discussed in our *Deterioration in personal credit quality* scenario, Section B, there is a reputational risk to firms if consumers were to claim that they have been mis-sold their mortgage. Intermediary firms will therefore need to pay particular attention to the suitability of their sales.

Financial advisers

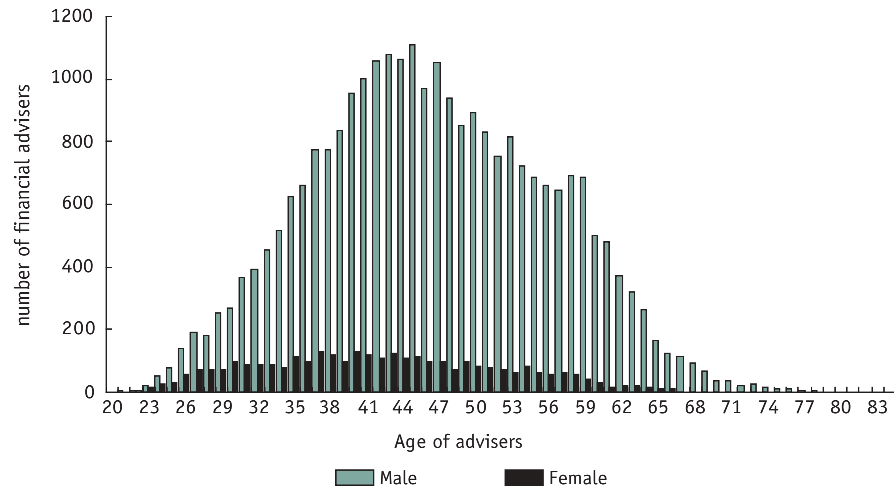
The total number of advisers in the sector has remained largely constant

Recent commentary has suggested that the structure of the retail intermediary sector is changing with more firms relinquishing their appointed representative status to become directly authorised due to the misconception that directly authorised firms receive less regulatory attention under our risk-based regime. Against the background of a long-term increase in the number of appointed representatives, we have recently observed a small decrease in numbers, with a corresponding increase in directly authorised firms. However, most importantly, the change in status has not diminished the amount of advice still available; there has been no real change in the number of advisers in the sector, and the indications are that this will remain relatively stable in the immediate future.

38 Firms wishing to undertake regulated investment, mortgage, or general insurance business can either become directly authorised or become an appointed representative of an authorised firm. Under the latter, the appointed representative enters into an agreement with the authorised firm under which it accepts full responsibility for the appointed representative's actions.

39 The failure of two large financial adviser firms is reflected in these figures.

Chart D11: Age profile of financial advisers



Source: FSA

There have also been concerns about the demographics of the sector, with the average age of financial advisers commonly quoted as being 55 years and the implications of this being a sudden outflow of advisers when they reach retirement. However, our research suggests that the average age of advisers is closer to 46 (with two-thirds being aged between 35 and 55 years), which should diminish concerns over the impending retirement of many advisers. Nevertheless, we do accept that the industry may be failing to recruit and retain new talent. Recruitment by advisory firms commonly targets existing practitioners in rival organisations instead of attracting new talent to the sector, which could eventually lead to shortages of advisers.

Increased longevity indicates that consumers need to plan for a longer retirement (see *Demographic changes and longevity risk*). Therefore, firms need to manage the risks and opportunities of longevity to an unprecedented extent. Consumers who are approaching retirement or who have already retired are particularly dependent on good advice to help make decisions about how best to provide an adequate income in retirement, when (perhaps for the first time) they need advice on decumulation products, typically annuities or equity-release products. The demand for this kind of advice is expected to grow. By 2017 there will be 12 million people over the age of 65 in the UK, a quarter more than in 2004. Our thematic work on equity release has shown that there are some serious shortcomings in the quality of advice provided in the sale of these products. Fair treatment of this customer group is essential as there is little scope to put things right should consumers end up with inappropriate outcomes.

Economic incentives do not necessarily encourage advisers to act in the best interest of the consumer

There is a risk that advisers do not always act in consumers' best interests. The most common method of remuneration for advisers continues to be by way of commissions from providers to intermediaries, based on the values of products that they sell to consumers (see our *Priority Risk* on retail distribution). Advisers are required to act in the best interests of their clients, but the economic incentives do not necessarily encourage this.

It is not uncommon for advisers to be rewarded in such a way that they are encouraged to churn product policies. This may lead to consumers being advised to buy a product which is not the most suitable for their needs. We believe that this is particularly acute where consumers are not always advised on transactions which fail to remunerate, or offer little by way of commission, to the adviser. Of the adults surveyed, 28% claim to not know how financial advisers are remunerated and 11% of adults who had used an adviser in the last ten months before they were surveyed in September 2006 were unaware of how they are remunerated.[40]

On provider bias, the assumption is that, if advisers did not take into account the incentives involved while acting on behalf of the consumer, there would be no reason for providers to compete on commission rates. Yet there are many examples of providers managing demand – up or down – by adjusting commissions in a way that can lead to unsuitable sales. Even if the adviser does not act on these incentives, consumers may understandably be left with the suspicion that they are so influenced. This may be preventing consumers from seeking the necessary advice and, as a consequence, from obtaining suitable financial products. There are signs that provider bias is starting to be counteracted by some advisers' shift from commission to fee-based income. However, the number of exclusively fee-based advisers remains very low. We will be gathering further evidence during 2007 to develop our understanding of the extent and effects of product bias.

There are ongoing concerns about the sustainability of the sector

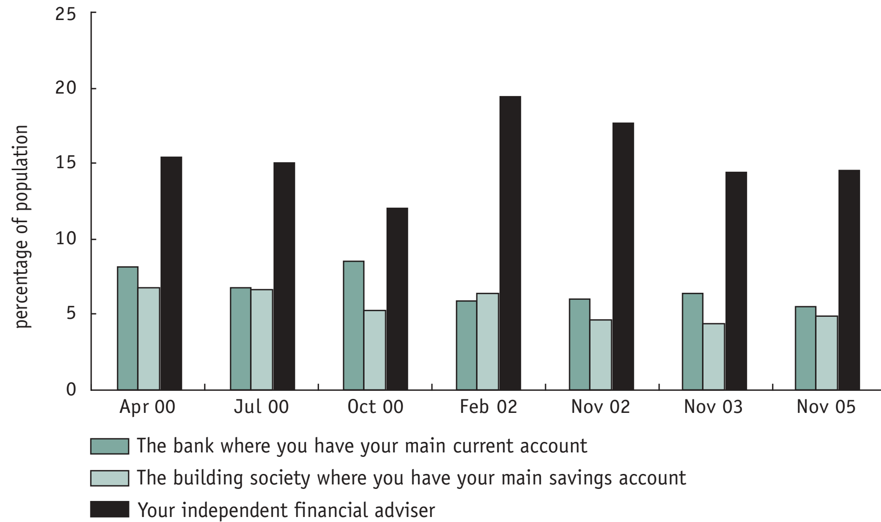
The current model of business between provider and intermediary may not be sustainable. We are aware that many of the larger intermediary firms are struggling to develop a strong, intrinsic value to their business, with sustainability being a growing risk. Much of the value created by the business is still captured by advisers' personal remuneration. Finally, the predominant model of one-off commissions on sales lacks the sustainability of recurring commissions or fees.

Consumers lack trust in financial advisers, yet many feel heavily reliant on advisers when taking important financial decisions

A more immediate threat to the sector is that consumers do not feel comfortable using a financial adviser. In part, this may be because of reputational damage brought on the sector by past mis-selling episodes. While the overall level of trust has improved somewhat since 2002, when concerns about pensions mis-selling were at their peak, consumers had much lower levels of trust in financial advisers relative to banks and building societies. Practitioners' perceived lack of professionalism is creating a real risk that consumers will not engage with the industry during the very time when they need to do so. Two-thirds of adults in the UK agree with the statement that they do not know enough about pensions and investments to choose ones that are suitable for their circumstances without consulting a financial adviser.[41]

40 GfK Omnibus Survey, September 2006.
41 *Levels of Financial Capability in the UK: Results of a baseline Survey*, FSA Consumer Research Paper 47, March 2006.

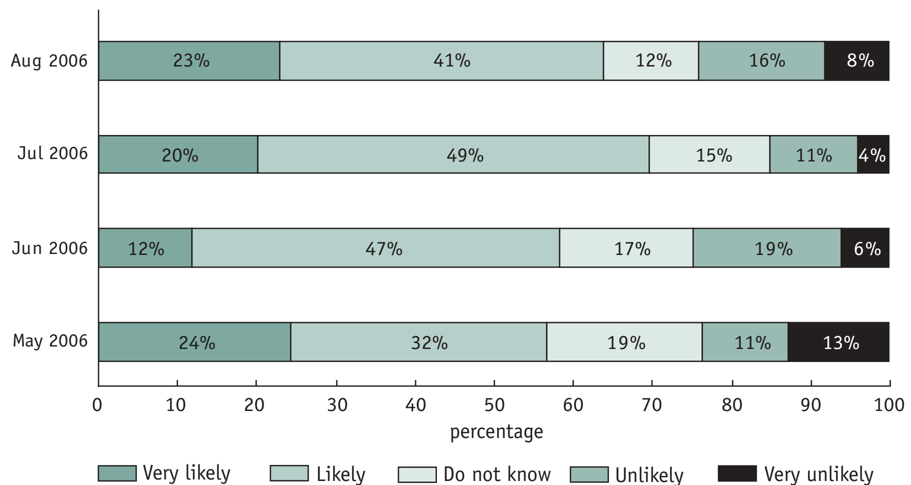
Chart D12: Proportion of consumers who distrust their financial adviser



Source: Henley Centre Headlight Vision, Planning for Consumer Change 1995 - 2005

We are aware of the changes that wrap platforms[42] may bring to the sector (and we will be monitoring market developments closely to see how they unfold). We believe that wraps could offer potential benefits to the sector, including improved administration, comprehensive management of, and fee-based advice for, a whole portfolio, and additional product ranges and adviser tools. However, we acknowledge that there are potential risks, including whether the wrap will be used inappropriately due to lack of knowledge, that the wrap is used even when it is not in the interest of the consumer, or that products or assets are tied to a wrap so consumers are prevented from switching between wraps or away from them. If this were to become prevalent, the same problems of lack of portability which affect some individual products today might be transferred to the whole of a client's portfolio.

Chart D13: The likelihood of firms not currently using a wrap platform deciding to use one in the future



Note: Based on financial advisers who have not used a wrap platform in the last 12 months. Figures may not add up to 100% due to rounding.
Source: NMG IFA census

42 Wrap platforms are web-based tools designed to enable financial advisers to manage their underlying assets within their client's portfolio.

Mortgage and general insurance intermediaries

Intermediaries and brokers play a key role in the distribution of mortgage products and other financial products that are often sold alongside mortgages such as life insurance and payment protection insurance. The share of new mortgage business sold via intermediaries has increased and stood at 58% in September 2006.[43] The market for new mortgage business could tighten if interest rates were to rise further or house price appreciation began to moderate. Intermediaries are particularly active players in the distribution of mortgages to consumers with impaired credit status or those consumers who do not conform to normal lending criteria such as self-employed individuals. New mortgage products such as guarantor mortgages are helping to service this need. The evidence from our analysis of consumer indebtedness shows this to be a growth area of business, but at the same time this presents potential risks about the fair treatment of customers.

Our financial capability work has highlighted weaknesses in the way that consumers plan ahead for unforeseen events, often with inadequate provision to cope with a loss of income. Mortgage payment protection insurance (MPPI) when sold correctly can help some consumers mitigate these risks. However, the overall volume of new policies sold has declined markedly in the last three years. There are several potential explanations for this trend, including affordability, optimism in the future and lack of confidence in the advice given about the product. As noted in *General Insurance*, Section C, intermediaries who sell MPPI need to ensure that the product fully meets the needs of their customers and that they consider their ability to repay should their circumstances change. We are currently reviewing whether the conduct of business rules (ICOB) provide appropriate consumer safeguards for the sale of protection policies (for a further discussion of ICOB, refer to *General insurance*, Section C).

On the general insurance side, risks to profitability continue to grow as general insurance intermediaries face increasing competition from free information, offerings from non-financial services companies (such as supermarkets) and comparison sites on the internet. Online insurance sales look set to continue to increase; motor insurance bought online is forecast to increase from 8% in 2004 to 29% by 2009 and travel insurance is forecast to increase from 4% to 17% over the same period.[44] The drive for this change comes as much from insurers seeking to reduce costs as consumers becoming more confident to shop online.

43 FSA data.
44 Datamonitor.

Financial crime

There were many promising developments in the anti-financial crime arena in 2006. However, the rapid evolution of financial crime means that new risks have arisen that will need to be addressed in the future. There is also a need for strengthened leadership and resources from all parties to improve the existing frameworks and embed new anti-financial crime 'architecture' in 2007 and beyond.

Financial crime risks continue to evolve more quickly than we and the industry can respond. In the previous edition of the *Financial Risk Outlook* we highlighted the use of corrupt low- and mid-level employees by organised crime as a method to evade anti-fraud and anti-money laundering (AML) systems and controls. This is still the case, but 'insiders' now appear to be facilitating high-tech crime by also allowing criminals access to systems, stealing data and revealing weaknesses. While new technologies, such as Chip and PIN, have reduced fraud in some areas, criminals have found ways to circumvent some of these fraud prevention measures. We expect this evolution to continue and perhaps increase, as criminals exploit the advances of the 'information economy'.

Information security

Over the last 12 months organised crime has become more innovative

The technological competition between firms and law enforcement agencies on the one hand and fraudsters on the other continues. Firms and law enforcement have been at a disadvantage in this competition, in part due to the historically disjointed approach to combating financial crime (especially financial fraud) by industry, government and law enforcement.

Information-security risks (both high-tech and low-tech) continue to increase in importance, due to technology's rapid evolution and criminal exploitation of our reliance on personal data for verification and remote access to financial products and services. Information security and data protection are becoming more significant issues for our financial crime and consumer protection statutory objectives. Although a firm may suffer direct losses when personal and financial data is lost or stolen, it also creates identity-fraud risks for consumers, which can have both direct financial and additional

non-monetary costs, such as time or distress. There have been a number of high-profile incidents where firms have lost data due to an unacceptable disregard for the identity-fraud risk to consumers. These incidents also demonstrate that the reputational risk to firms of significant data loss is very high.

Third-party information security is a growing problem. As financial firms tighten their information security, criminals are targeting sectors that hold the same or similar data, but have weaker data-protection systems and controls. For example, some telecoms, utility or non-financial retail firms may have inadequate systems and controls which are more vulnerable. However, the public and the media often blame the banking industry, even though they have little control over the actions of these other businesses. This public reaction could reduce confidence in innovative and efficient delivery channels, such as internet banking and off-shoring.

Money laundering and terrorist finance

The main changes to the AML environment in 2007 will be systemic, with a significant amount of 'regime change'

The industry is adapting to the new AML regime that came into effect in September 2006, when our new Handbook provisions and the revised edition of the Joint Money Laundering Steering Group (JMLSG) Guidance came into force. Firms have been reviewing their procedures as a result of these policy changes. However, there is a risk that firms' implementation of a more risk-based approach to financial crime will be undermined if the processes put in place are not dynamic and flexible enough to adapt to the constantly evolving operating environment. In the previous edition of the *Financial Risk Outlook* we highlighted that some firms or sectors were incorrectly interpreting the move to a risk-based approach as our de-prioritising AML. We believe that this misconception is less prevalent, but it is still something that we are concerned about and will vigorously seek to correct.

Changes to the AML regime create opportunities and risks

In the previous edition of the *Financial Risk Outlook* we discussed the tensions created by some aspects of the Suspicious Activity Report (SAR) regime, particularly those regarding feedback to industry and the 'Consent regime'.[1] These tensions still exist, but there appears to be fresh impetus on all sides to resolve them. The Lander Review of the SAR regime is being implemented by the Serious Organised Crime Agency (SOCA), and expectations that the regime will fully deliver on its vast intelligence potential are high. However, as with other aspects of the anti-financial crime architecture, the risk remains that the expectations of some stakeholders may be higher than the results delivered by others. This could lead to stakeholders complying with the letter, rather than the spirit, of the legislation and a less-than-effective SAR regime.

The UK continues to lead the way in a risk-based approach to AML and financial crime. The implementation of the Third EU Money Laundering Directive and the Financial Action Task Force's (FATF) evaluation of the UK's AML regime both offer opportunities and risks for the AML regime. Raising international standards is beneficial for us and the industry, especially with the risk-based approach being institutionalised internationally. However, the risk remains that the UK may come under pressure to implement a more prescriptive approach.

1 The 'Consent regime' allows persons and businesses generally, not just those in regulated sectors, to avail themselves of a defence against money-laundering charges by seeking the consent of the authorities to conduct a transaction or undertake other activity about which they have concerns. The legislation gives the authorities seven days to respond. Where consent is refused, the transaction or activity must be frozen for a further 31 days.

Increasing globalisation has reduced barriers to trade, and UK markets have benefited from this trend. However, increasing globalisation has also increased UK markets' and firms' exposure to jurisdictions where counterparties are not subject to equivalent rules for reducing financial crime. There is a risk that this could lead to more incidents of financial crime in UK markets, including large money-laundering scandals.

The July 2005 terrorist attacks in London demonstrated the strengths and weaknesses of the Counter Terrorist Financing regime. The difficulties in recognising terrorist-related account activity, coupled with the low amounts needed to carry out the attacks highlight the challenges for firms and law enforcement in identifying terrorist attack planning. However, the cooperation and information yielded from firms after the attack was vital for the investigations. Financial intelligence and evidence provided by the sector continues to play a crucial part in developing both proactive and reactive counter terrorist investigations. The current level of terrorist threat may increase the high level of demand on firms to support proactive and post-incident investigations. We expect terrorist funding to continue to be a major source of reputational risk for the financial services industry in the future. Those individuals intent on funding terrorism here and abroad show the same ingenuity as organised criminals but often a different pattern. For example, funding for terrorism can come from legitimate sources as well as the proceeds of crime.

Fraud

We welcome the recommendations of the recent Fraud Review

The public-sector response to fraud has been hampered by the fragmented structure of the UK's anti-fraud framework and the lack of a coordinated strategy for dealing with fraud. For example, figures produced by CIFAS – the UK's Fraud Prevention Service – show that during the first nine months of 2006, the volume of reported fraud grew by over 9%, with identity fraud rising by 17%, compared to 15% for the same period 12 months previously. However, a number of recent proposals have the potential to improve this situation. The government's Fraud Review has recommended a National Fraud Strategic Authority and a National Fraud Reporting Centre to gather a consistent measure of fraud. The Fraud Review also recommends the creation of a national lead police force for fraud and that fraud should be made a policing priority. We, like industry, have welcomed the findings and conclusions of the Fraud Review. However, there is a risk that the recommendations are not fully implemented due to disagreements over funding and control of the new powers.

The Fraud Review also highlighted the need for more data sharing within and between the public and private sectors. There appears to be political appetite for this, with the responses to the Home Office consultation on New Powers Against Organised and Financial Crime recommending CIFAS as the most appropriate vehicle to share public and private information to prevent and detect fraud. This data sharing is a priority to tackle fraud, but there is a risk that some firms may not be willing to share this information for reputational or competitive reasons.

Fraud risk is ultimately the responsibility of senior management

As part of a risk-based approach to regulation we do not require firms to comply with detailed rules and guidance on fraud management. However, firms are still required to take reasonable care to establish and maintain effective systems and controls for countering the risk that the firm might be used to further financial crime. If anti-fraud messages are not sponsored at the highest level within a firm and embedded within the firm's culture, it is unlikely that an effective fraud strategy will develop. Employees take their lead from the actions of the most senior managers. Senior management need to continue to invest in systems and controls and manage their responses to fraud to avoid being targeted as the weakest link.

The industry continues to battle organised and opportunistic insurance fraud

There have been a number of positive developments for insurance claimant fraud over the last 12 months. For example, the Insurance Fraud Bureau is in operation, and it is hoped that this will help reduce the scope for organised crime to abuse the general insurance market. It is estimated that a quarter of claimant fraud is organised rather than opportunistic. The Association of British Insurers (ABI) is also promoting best practice in claims handling and is encouraging firms not to see fraud prevention as a competitive issue. However, opportunistic claimant fraud continues to be high, with firms having to tolerate a higher level of fraud than other sectors to keep honest customers satisfied. This is a persistent problem which requires concerted action to alter the public opinion of insurance fraud.

The introduction of Chip and PIN has led to an overall drop in card fraud, but there has been a shift in emphasis by fraudsters to card not present fraud and spending overseas, where Chip and PIN is less widely used.

Table E1: UK plastic card and online banking fraud losses

Type of fraud	January to June 2005	January to June 2006	+/-% (05/06)
Online, phone and mail order fraud	£90.6m	£95.3m	+5%
Counterfeit	£45.6m	£53.0m	+16%
Lost/stolen	£44.3m	£36.1m	-19%
Mail non-receipt	£22.8m	£9.8m	-57%
Card ID theft	£16.1m	£15.0m	-7%
Total	£219.5m	£209.3m	-5%
Contained within this total:			
Fraud abroad	£41.8m	£48.5m	+16%
Retailer (face-to-face)	£73.2m	£42.1m	- 43%
Cash machine fraud	£28.8m	£39.6m	+37%

	January to June 2005	January to June 2006	+/-% (05/06)
Online banking fraud	£14.5m	£22.5m	+55%
Phishing incidents	312	5,059	+1,471%

Source: APACS

Consumers can play an important part in preventing fraud

We have also seen organised criminals adapting old techniques to new technologies with traditional 'skimming'[2] attacks on the PIN entry devices. This involves tampering with the device and capturing details from the card's magnetic strip and PIN details. While the Chip remains secure, the ingenuity and resilience of the fraudsters is concerning. Online banking fraud is at a relatively low level, but the increase is worrying and can be partly explained by the explosion in 'phishing'[3] attempts.

According to research by APACS – the UK Payments association – many consumers are not acting in the most secure manner:

- 25% have disclosed their PIN to someone else;
- 27% use the same PIN for all their cards;
- 44% still let their cards out of their sight (in restaurants and bars for example); and
- 51% never check that a website address changes from 'http' to 'https' before making a purchase, indicating that awareness of secure shopping advice is low.

There is a risk that anti-fraud is seen as an issue for firms only. However, tackling this problem requires the development of an anti-fraud culture throughout society and is the responsibility of all who hold valuable financial and personal data.

While no comprehensive measure of the size of fraud exists, work by the Home Office on the harm fraud committed by organised crime causes to society suggests that it may be second only to Class A drug trafficking, and roughly equal to the harm from people smuggling and people trafficking combined.[4] The research we undertook on 'boiler rooms' demonstrates how the social harm of financial crime is often felt by the most vulnerable in society.[5]

Organised criminals know the weaknesses of internal anti-fraud controls

As noted throughout this section, the ways in which firms are defrauded have changed in recent years, with criminals showing themselves to be highly dynamic in reacting to changes to firms' anti-fraud systems and always looking for the 'weak link'. A reported and noticeable trend in recent years has been organised criminals (and terrorists) having knowledge of firms' anti-fraud measures, allowing them to defraud the financial services sector at levels that fall below firms' 'fraud appetite' and are outside of their control. For example, criminals have now begun to target asset management companies using Companies House – the official UK government register of UK companies – and other publicly available data. This risk is exacerbated because this sector has not traditionally been targeted by third-party fraud and so does not have the same level of prevention as other sectors, such as retail banking or general insurance.

2 'Skimming' is the act of electronically copying a card's magnetic strip details and putting them onto another (counterfeit) card.
3 'Phishing' refers to a scam in which an email is sent falsely claiming to be from a legitimate enterprise in order to persuade the user to surrender private information that will be used for identity theft.
4 *Fraud Review: Final Report*, Attorney General, 2006.
5 *Typical boiler room victim loses £20,000 warns FSA*, FSA Press release, 6 June 2006.

We expect firms to take into account the social harm of crime as well as the direct losses to themselves

However, we expect firms to take into account the social harm of crime as well as the direct losses to themselves when assessing their 'appetite' for fraud and other financial crime risks. We also expect firms to consider the full implications of the risks they face, which may have wider effects on their reputation, their customers and the markets in which they operate. Although firms have an obvious incentive to protect themselves from fraud, they do not always suffer all the direct and indirect costs. The negative externalities of fraud, due to rapidly evolving financial crime and the rise of organised criminality, are tackled best in partnership. The risk that firms do not fully engage with all relevant stakeholders appears to be falling in most sectors, but there is still work to do in embedding recent cooperation across all sectors and stakeholders.

Legal and regulatory framework

The international dimension to regulation

The high level of regulatory change, brought about in large part by the implementation of the Financial Services Action Plan (FSAP) and other major EU legislative measures, will continue apace in 2007. The implementation of the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD) will place the greatest demands on firms in the near term. Firms should be aware that they are likely to face greater compliance costs and disruption the longer they postpone making the necessary changes. We are conscious that these and other regulatory changes present practical compliance issues for firms operating across borders, and we will be focusing on enhancing supervisory cooperation and convergence to address these issues.

The *International Regulatory Outlook*, published in December 2006, offers a more detailed analysis of regulatory reform.

Legislative implementation pressures

Failure to keep pace with regulatory reform will result in compliance costs for firms

Firms should not underestimate the continuing challenge of implementing EU legislation. Two of the highest profile measures, MiFID and the CRD, come into force in 2007. Firms should be confident that they have the systems in place to meet the new or revised prudential, organisational and conduct of business requirements. Firms that underestimate or postpone the challenge are likely to incur significant last-minute costs and may face additional compliance risk.

The CRD was implemented in January 2007. Its aim is to bring regulatory capital requirements more in line with developing risk-management practices, thereby narrowing the gap between the economic and the regulatory approach to capital requirements. There are practical implementation challenges, facing both us and the firms we regulate, arising out of the cross-border application of the CRD and the Basel 2 framework. We are actively sharing practical experiences with fellow regulators in forums such as the Basel Committee's Accord Implementation Group and the Groupe de Contact within the Committee of European Banking Supervisors (CEBS).

MiFID will be implemented in November 2007. Our timetable for consultation and rule making was published in our MiFID implementation plan update.[1] Now that the Level 2 technical implementing measures have been adopted, the Committee of European Securities Regulators (CESR) and the European Commission are looking at ways of delivering consistent implementation and application of MiFID at Level 3.

We are now focusing on delivering the benefits of regulatory reform

Achieving EU regulation that is both effective and efficient for industry requires getting the right regulatory structures. We remain strong supporters of the Lamfalussy processes which we believe offer the best prospect of realistic regulatory convergence. In addition to their role in providing formal advice to the Commission on implementing measures in the context of new directives, these committees have a key role in delivering *de facto* convergence on a range of day-to-day regulatory issues. We consider that the committees are on course to deliver these outcomes, but a failure to do so would risk a fragmentation of regulation throughout Europe with attendant increases in risks and costs facing firms or, alternatively, calls for unrealistic Europe-wide regulatory solutions.

Continued evolution of a risk-based prudential regulation framework

Though we are in what the European Commission has termed a 'consolidation phase' and 2008 to 2010 looks less demanding from an implementation perspective, there are a number of significant regulatory initiatives which will continue to demand our attention. Among these, Solvency 2 is a fundamental and wide-ranging revision of the current Solvency 1 suite of Directives, affecting life and non-life insurers and reinsurers. The EU has a project to create a system of risk-based prudential regulation in the insurance sector, based on an appropriate adaptation of the Basel/CRD three-pillar framework. The overall aims of the project are to deepen the single market in insurance services, protect policyholders, and strengthen the competitiveness of the insurance sector.

While implementation of the Solvency 2 project is not expected until at least 2010, preparatory discussions are well advanced. Key policy decisions are likely to be taken over the forthcoming period in the run-up to the formal framework directive proposal, expected in Summer 2007.

Building on the adoption of the CRD, there is also renewed interest in measures concerning the composition of capital, the large exposures regime and liquidity-risk management. The objective is to ensure that the prudential regime reflects increasingly advanced risk-management capacity. The Joint Forum, the Basel Committee and CEBS, for example, have all begun to consider whether current rules on liquidity risk are sufficiently risk sensitive and reflect changes in liquidity risk-management practices.

Industry may yet influence regulatory reform

To influence policy, stakeholders need to be involved at an early stage in the development of policy making and to engage fully in consultation. Stakeholder participation is particularly relevant in a European context, where we have made a commitment to apply, wherever possible, a copy-out approach to the implementation of EU legislation. This will reduce the extent to which firms operating on a cross-border basis may find that our provisions covering a particular activity diverge from those applied by regulators in other Member States, thereby achieving greater consistency and reducing costs.

1 *Implementation Plan for MiFID – Update*, FSA, October 2006.

International supervisory cooperation

If the regulatory regimes in different jurisdictions are conflicting, this can lead to unnecessary costs for firms

Many firms organise their business on a cross-border basis and therefore operate cross-border controls. Regulators, however, are charged with achieving nationally defined objectives. Inappropriately supervised cross-border activity presents risks to our statutory objectives and imposes unnecessary costs on firms. A failure to ensure that cross-border business is adequately supervised could lead to gaps in regulatory coverage, and duplicative and inconsistent regulation could impose disproportionate costs on firms.

To maintain orderly markets and proportionate regulatory costs we need to collaborate with other national regulators. A recent example of where collaboration between industry and international regulators has been successful is in addressing the risk posed by the settlement problems in the credit-derivatives market (as discussed in *Priority Risks*, Section A, and *Asset management*, Section C). Similarly, in safeguarding financial stability – a shared objective of all financial centres – we will continue to develop crisis-management arrangements with international regulators (refer to *Financial stability*, Section B). It is also important that there is cooperation between international regulators on day-to-day operations and risk identification and mitigation.

Principles-based regulation and better regulation disciplines

Better regulation is intended to result in more effective risk mitigation

We have undertaken to pursue our statutory objectives using a more principles-based approach to regulation. This is primarily intended to enable us to better meet our statutory objectives. The more effective we are in pursuing our objectives, the more successful we will be in achieving orderly and efficient markets and consumer protection. A principles-based approach should also enable firms to better understand required regulatory outcomes in relation to their business, thereby delivering more proportionate regulatory costs.

To be most effective, better regulation disciplines, including impact assessments and timely consultation processes, need to be exercised at the international, as well as the domestic, level, as international standard setting can be a major contributor to domestic rules. At the European level, we are encouraged by the European Commission’s clear commitment to better regulation and by some aspects of practical progress to date in this.

Accounting and auditing

The transparency created by high-quality accounting, as well as the assurance provided by trusted auditing, are fundamental foundations of efficient capital markets. At this pivotal time in the development of accounting and auditing practices there are potential risks stemming from the move to International Financial Reporting Standards (IFRS), the convergence between IFRS and US Generally Accepted Accounting Principles (US GAAP), the concentration of audit services, and international coordination.

IFRS

All EU-listed groups are required to comply with IFRS

The potential benefits from IFRS are considerable and 2006, the first year of reporting under IFRS, both in the UK and across the EU, has been fairly smooth, albeit at a relatively high cost to preparers. However, there are two major risks to the continued success of IFRS: inconsistency across national economies; and the potential direction of the future development of the IFRS framework.

With regard to inconsistency, the true benefit of IFRS can only be realised through enabling a better comparison of similar entities across national boundaries, which, in turn, will provide enhanced transparency for markets and a more efficient global capital market. We also acknowledge that, under a principles-based accounting framework, there may be relevant economic and legal differences between countries such that similar transactions might legitimately be reported in different ways. However, should local custom or national interest operate to threaten the consistent application of IFRS, much of this anticipated benefit could be lost.

There is a great deal of work being undertaken internationally to ensure that IFRS is implemented in a way that is both consistent and responsive to local economic differences. However, judging whether or not this balance is being successfully achieved will only be possible after one or two more years have passed. We support and contribute to the work of CESRFin – CESR's permanent operational group of experts in financial reporting – which has the coordination of effective enforcement of IFRS across the EU as its central focus.

For the development of the IFRS framework itself, there are concerns that the standards in some areas are of lesser quality than those that they have replaced. There is also a growing concern that IFRS will be interpreted and audited in a more prescriptive and rules-based way than was typically the case under UK GAAP – a risk of more 'form-over-substance' when agreeing accounting treatments.

Going forward, the main areas of concern arise, in part from convergence with US GAAP and in part from the move towards 'decision usefulness' and an increasing emphasis on fair-value accounting.[2] While the latter has considerable conceptual appeal, the approach can be difficult to apply in practice. Very large volumes of disclosures and highly judgemental management estimates of current and expected future cash-flow-based 'fair

2 Fair value is the amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties.

values' may combine to offer users of accounts a more complex, subjective and confusing volume of reported information. A related risk is that management and the major audit firms default to a narrow, more rules- and precedents-based interpretation, which may not necessarily reflect their best judgement about the underlying economic reality of the business. As a result, accounts may only be fully understood by technical experts leaving many investors and shareholders worse off in terms of interpreting the results and the prospects of a company.

Convergence

Increased convergence of reporting standards could lead to more prescriptive rules

The so-called 'roadmap' for the Securities and Exchange Commission (SEC) to determine that IFRS are equivalent to US GAAP could potentially lead to a more transparent and lower-cost global capital market, in which investors are better informed and companies can access sources of capital more cheaply. This is a desirable objective that we continue to support in principle.

However, across all stakeholder groups in the UK (preparers, auditors, investors and regulators) there is growing concern that the costs of convergence may outweigh the benefits being sought. In particular, there is a view that a converged set of accounting standards that is acceptable to the SEC will need to be more like US GAAP and more detailed and prescriptive than current IFRS, which are principles based, albeit increasingly underpinned with more detailed rules. At the same time, the nature of these standards may better support a US style of decision usefulness rather than an arguably more UK-relevant stewardship model of governance.

Should the move towards fair value for all assets and liabilities advance significantly, many question whether the resulting information would remain sufficiently reliable to enable investors to make informed decisions about the effectiveness of the stewardship of their companies. At the same time, the ability of the audit profession to apply judgement on what constitutes a 'true and fair' view might be ever more constrained by detailed rules, resulting in a 'presents fairly in accordance with' model of financial reporting. The progress made over the next 18 to 36 months will be critical in determining whether the potential benefits of IFRS and convergence are realised, or whether the costs connected and the ultimate outcomes experienced are potentially disproportionate, or even negative, for UK stakeholders.

Concentration of audit services

The concentration of audit services presents significant risks

There is a risk that, should one or more of the so called 'big four' accounting and audit 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. This could even result in certain companies being left without an auditor for a period. Combined with the very serious challenge of effectively managing the resulting conflicts of interest that would arise in transactions in public-quoted markets, we consider that this would be likely to undermine significantly confidence in capital markets.

Recent reports on the concentration of audit services identified the 'big four' as being the only four audit firms perceived by many market participants to be credible 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 the vast majority of the FTSE 100 firms.[3] For most, if not all, other firms there is a much wider pool of audit firms perceived as capable of and credible to perform a high-quality audit.

Given this concentration of service provision to the highest-impact authorised firms and quoted companies, the risks to our objectives, should there be a reduction in the number of major audit firms, are potentially severe. We consider that in the medium term, a market with three or fewer major firms would be unsustainable, and that the implications for audit quality are so profound that the smooth functioning of the capital markets could be seriously compromised.

The failure of Arthur Andersen illustrates that there are real risks to the stability of the remaining 'big four'. Events such as the 2005 tax case against KPMG in the US, and the more recent concerns over PricewaterhouseCooper's Japanese affiliate's audit of Kanebo and its subsequent two-month suspension, show that none of these firms can safely be judged to be immune from such risks in the future.

In this context, it is important that policymakers and regulators carefully evaluate the key sources of risk to the 'big four' firms, the best means of mitigating these risks, and that proper contingency planning is put in place. We consider that a combination of proportionate and coordinated regulatory responses to any problems arising; liability reform in major capital markets; more principles-based and proportionate independence rules; stronger risk management and governance in firms; and related regulatory oversight can substantially reduce, but not eliminate, the risks.

In addition, this is an international challenge and, while the Financial Reporting Council (FRC) is the relevant regulator in the UK, we often lead for the UK in the relevant international fora at the International Organisation of Securities Commissions (IOSCO), the Financial Stability Forum (FSF) and at CESRFin. This risk is now firmly established on the agenda at such fora, but achieving substantive and aligned progress across many economies on such a sensitive topic as audit regulation and oversight, is inevitably a complex and potentially long-term challenge.

International coordination

Historically, accounting and auditing have been predominantly nationally driven and aligned to local governance and legal systems. We are presently seeing a shift towards a much more international infrastructure, as highlighted by IFRS and convergence. We are also seeing moves towards International Standards on Auditing and an increased tendency towards cross-border aspects of audit regulation, such as that required under both Sarbanes-Oxley and the EU's 8th Directive.

3 *Discussion Paper: Competition and choice in the UK audit market*, FRC, May 2006 and *Study on the economic impact of auditors' liability regimes*, London Economics, September 2006.

There are risks and benefits associated with increased international coordination

Taking the optimistic view, it is possible to project a scenario in which the global capital market of the next decade is characterised by enhanced transparency and efficiency. This would be underpinned by a small number of truly equivalent and high-quality accounting and auditing frameworks, within an environment of joined-up regulatory oversight. This market might be served by the global capabilities of not only the 'big four' firms but a number of high-quality 'tier A' firms, which over time are successful at expanding their market share for increasingly large-scale quoted company audits.

Managing the many risks associated with the realisation of this desirable state of affairs will require effective international coordination, as well as progress at the national level. We will continue to work with the FRC towards these objectives. However, given the number of stakeholders, recent developments in many economies of new approaches to the regulation of the auditing profession, the growing extra-territoriality referred to above and the potential overlap of the activities of a number of interested international fora, achieving substantive and positive progress is a significant challenge that requires cooperation and commitment from a range of key stakeholders.

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