FSA Annual International Seminar 2012

Prudential Plenary Session

Wednesday 28 November

Opening Remarks

Andrew Bailey
Managing Director, Prudential Business Unit, FSA
Executive Director, Bank of England

Overview of Prudential Regulatory Issues

Katharine Braddick
Director of Prudential Policy

28 November 2012

Prudential Policy & Judgment Based Supervision

- **The spirit and intended outcome of policies**
- **Policies represent the criteria by which supervisors judge firms**
- **Policy development is an international endeavor in which we will seek to participate actively.**

In Basel

Current Agenda

- Trading book review
- Securitisations
- Exposures to CCP's
- Margins
- Large Exposures
- LCR

Forward Agenda

- Simplicity & Comparability
- Bank disclosures

In IAIS

- ComFrame
- Systemically important insurance institutions (G-SIIs)

In Europe – Banking Union

- UK is supportive of Single Supervisory Mechanism, but not as an opting-in member
- Important to preserve the integrity of the single market
- Requires a strong & functioning EBA
- Voting & dispute resolution arrangements are therefore important

In Europe - CRDIV

- Basel III in Europe and a single rulebook to support the single market and SSM
- More and better capital and setting the path to binding liquidity and leverage standards
- SIFI buffers and macro-prudential tools
- A strong foundation for our new approach to supervision, compatible with ESRB recommendations

In Europe – Liikanen & Structural Reform

- Momentum is building behind idea of structural reform of large banking groups: Liikanen, UK, France.
- Detail of implementation is essential for meaningful separation of activities
- If successful, ring fencing reduces the risk of taxpayer bailouts and ensures the continuity of essential services

In Europe – Solvency II

- Confusion & disagreement about future timing
- Negotiation of technical standards must continue.
- Member states have to consider domestic implications and our responses

In Europe – Recovery & Resolution Directive

- Support the inclusion of the bail-in tool
- Resolution funding remains controversial.
- Critical dependency with Banking Union

Insurance Resolution

- **HM Treasury consultation over the summer**
- **Need for resolution powers currently considered at tripartite**
- **Connection with**
  - IAIS work on G-SII
  - PRA policyholder protection objective

Conclusions

- Achieving greater stability through more and better capital and improved liquidity

- Work still to be done on the framework for the trading book and counterparty/trading issues

- Need to continue to refine our thinking on new elements of the framework: macro prudential regulation, structural reform of banks and resolution for insurers and banks.

- Implementation of single rulebook in Europe is challenging and we are committed to working for the right standards across the single market

- Reform of the European structures will be significant not only in terms of the operation of regulation, but more importantly the stability of the Eurozone.

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The role of the FPC

Martin Brooke

28 November 2012

Responses to the 2007-09 crisis:

- Basle III capital & liquidity standards
- Additional capital buffers for SIFIs
- Macropru frameworks
- CCPs for derivatives trades
- Regulation of shadow banks?
- Enhanced resolution regimes

FPC Objectives

- **To contribute to achievement of financial stability:** identification, monitoring, and taking action to remove or reduce systemic risks to protect and enhance resilience of UK financial system.

- **Subject to the FS objective, to support the economic policy of HMG, including its objectives for growth and employment**

Systemic risks:

- Structural features of financial markets or the distribution of risk
- Unsustainable levels of leverage, debt or credit growth

Tools of Interim FPC

- Only Recommendations for now
- Legislation likely to come into force from April 2013

FPC tools:

- Powers of Direction:

  - Counter-cyclical capital buffer
  - Sectoral capital requirements
  - Leverage ratio

FPC tools:

- Powers of Direction:
  - Counter-cyclical capital buffer
  - Sectoral capital requirements
  - Leverage ratio

- Possible additions:
  - a time-varying liquidity tool
  - Margin requirements on collateralised transactions
  - Disclosure requirements
  - LTV and/or LTI limits

FPC tools:

- Directions - more suited to targeting systemic cyclical risks. Applied to regulated firms.
- Structural risks better addressed via Recommendations
- Recommendations to PRA & FCA: comply or explain basis
- Recommendations to other bodies (eg HMT on regulatory perimeter, or to banks)

Interaction with MPC

- Potential for conflicts between FPC and MPC ?

- Unlikely:
  - Both committees likely to want to tighten in upswing of cycle
  - Transmission channels not the same: can act to change the composition of growth
  - common ‘subject to’ objective
  - overlapping membership & scope for joint meetings
  - same staff providing analysis

FPC accountability

- FSR publication twice a year
- Published Record of each policy meeting
- Parliamentary hearings
- Speeches

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End

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References

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http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf

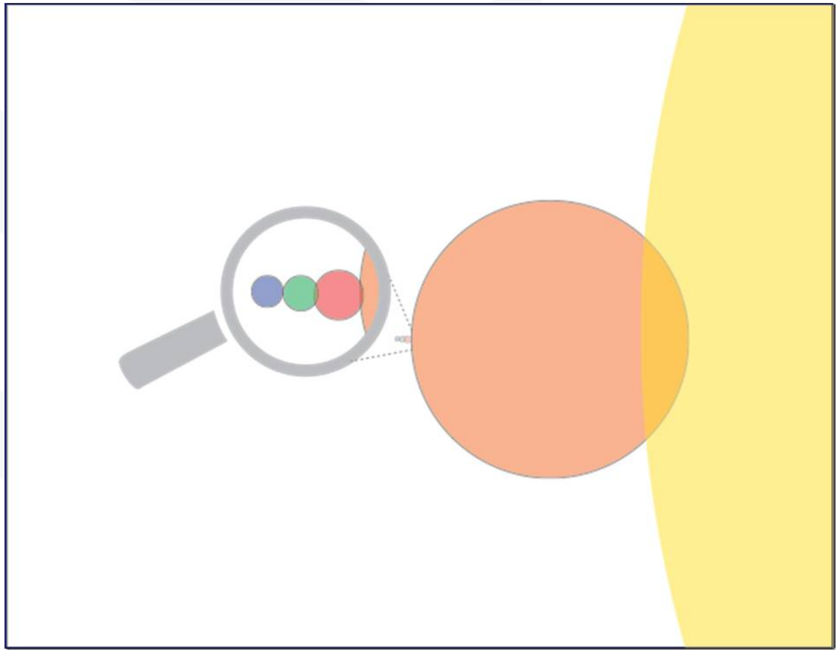
http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf

http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf

http://www.hm-treasury.gov.uk/d/fin_fs_bill_policy_document_jan2012.pdf

What the institutional structure for UK regulation means for prudential supervision

From Macro to Micro and back again



Lyndon Nelson
Director, Financial Stability and Macro Prudential Supervision Division
Financial Services Authority

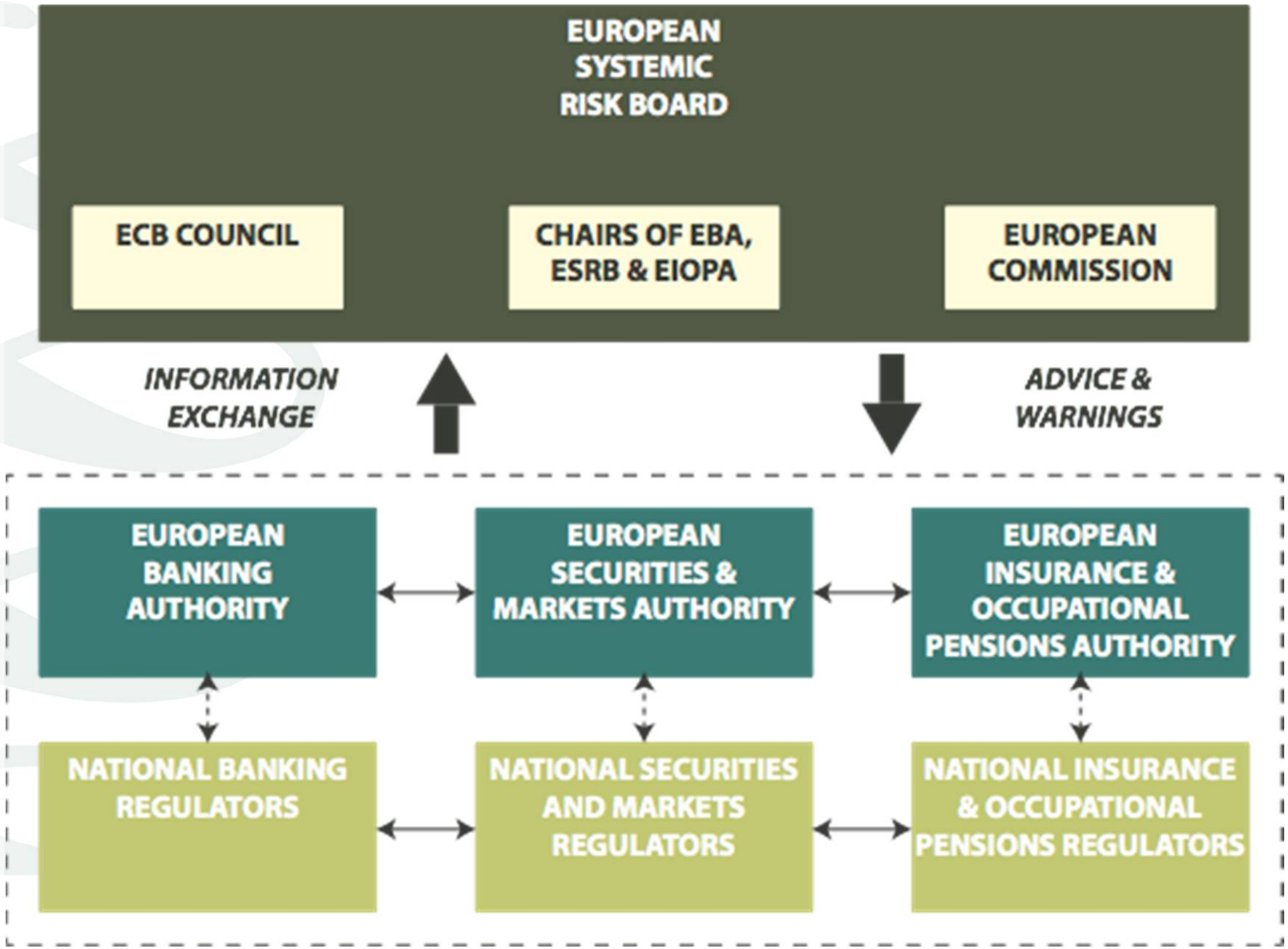
Global Macro-Prudential

Global agenda

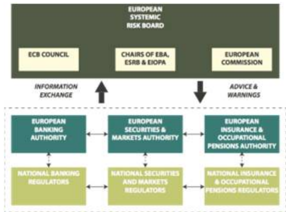
- Basel leverage ratio
- Fundamental review of trading book
- Effective Resolution
- Shadow Banking
- G-SIBs
- new Basel Core principles
- Data collection
- Opaque Funding

- IAIS Com Frame
- G-SIIs
- Insurance data pool
- IOSCO Memo on enforcement
- FATF revised assessment process

European Macro-Prudential



European Agenda

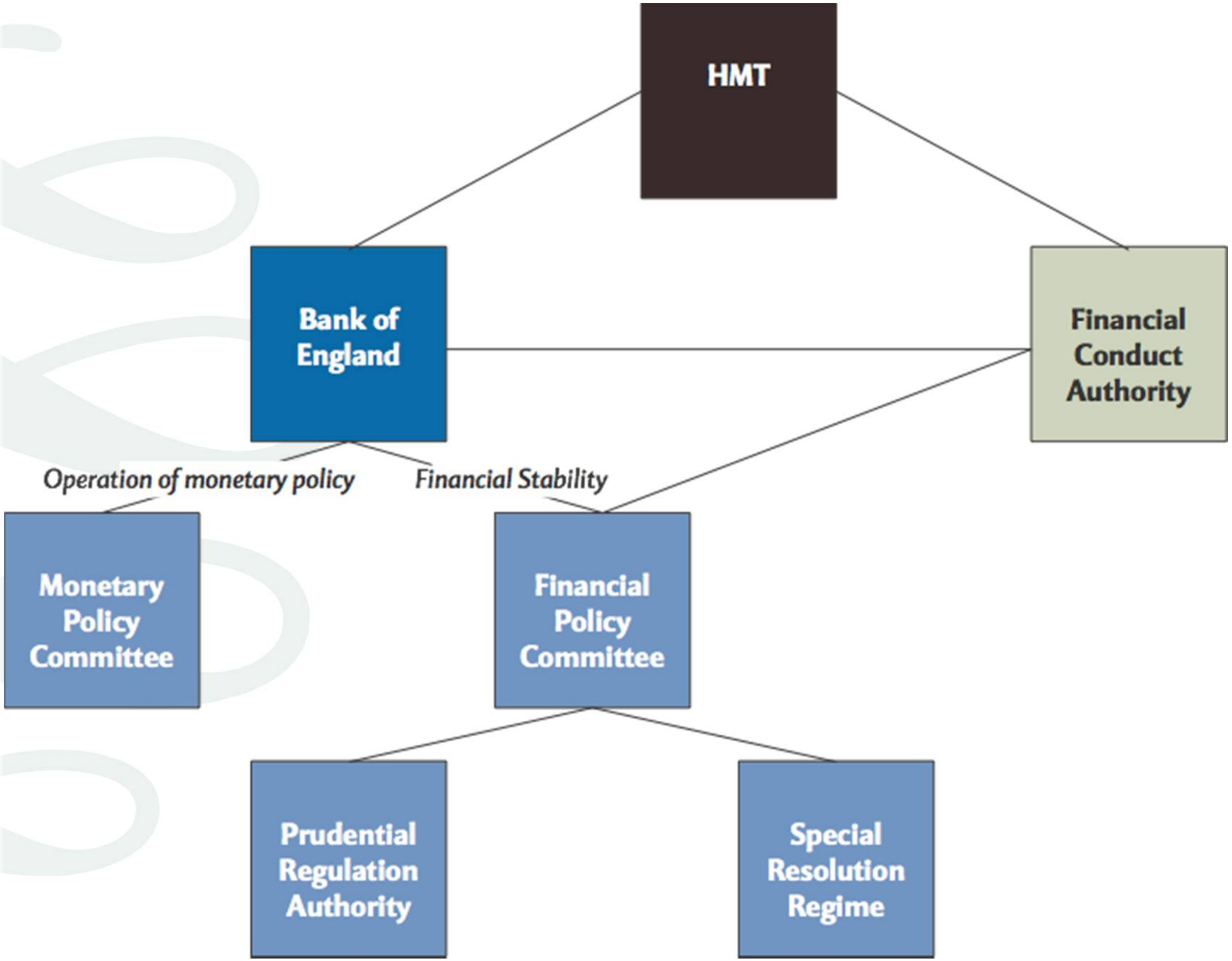


- Implementation of CRDIV
- EBA Recap 2012
- GSIB/DSIB in EU
- EU Retail banking (CARRPD, DGSD, PSD, 2EMD)
- ESRB interconnectedness
- Solvency II
- Insurance Product directives (IMD2, PRIPs)
- EIOPA Crisis Management
- EIOPA 3rd party regimes
- EIOPA Data
- Consumer Protection (MIFID2, UCITS V, AIFMD)
- Markets Legislation (EMIR, MIFID, MAD, TD, CRA3)
- ESMA Short-selling
- Payment Systems
- ESMA Crisis Management

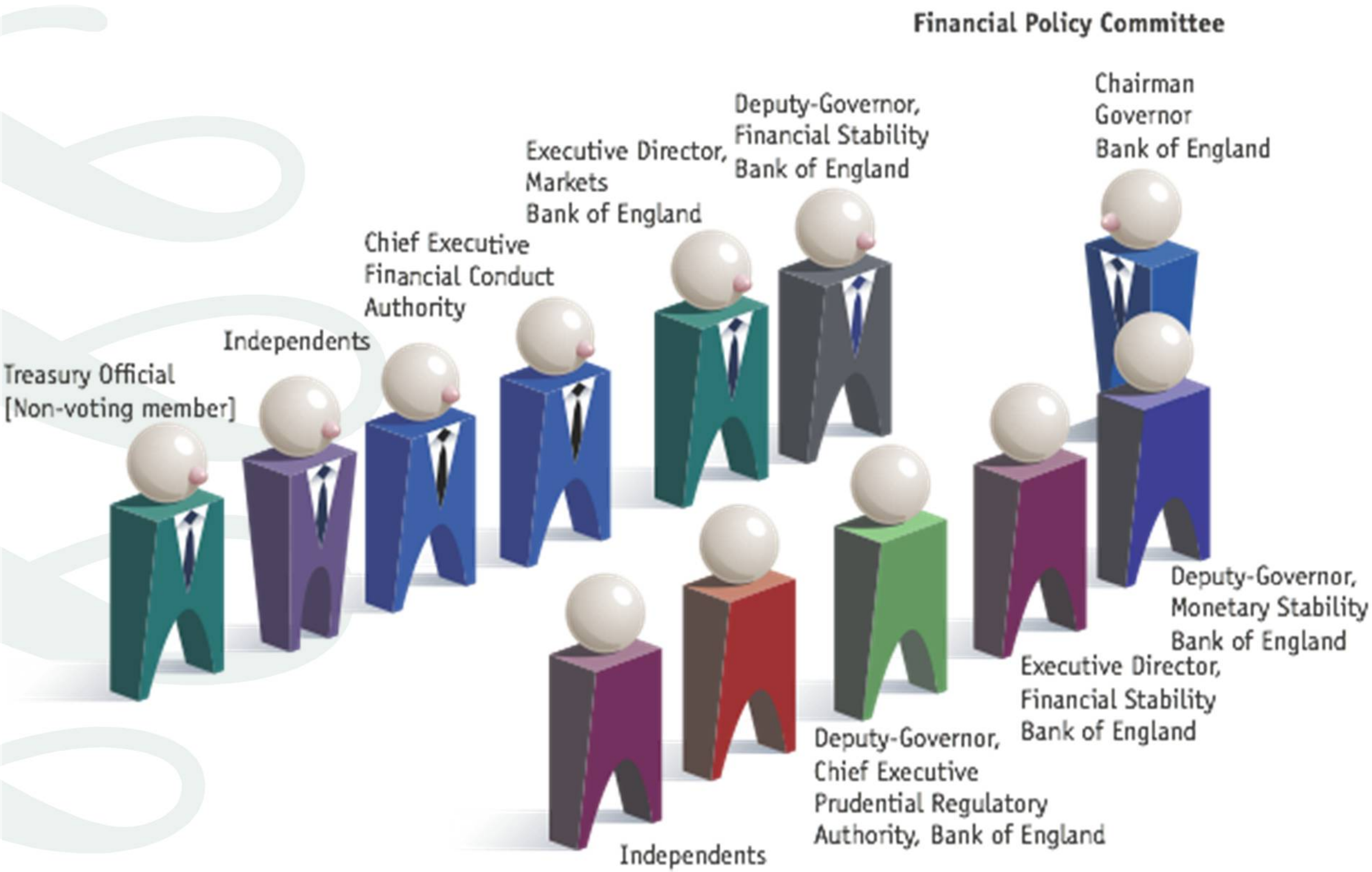
UK Agenda

- Regulatory Reform
- Vickers Report on Banking
- Resolution and Recovery of failed banks

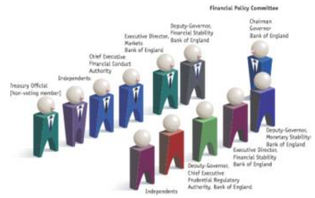
UK Macro-Prudential



Interim Financial Policy Committee

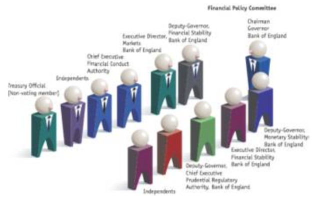


Powers



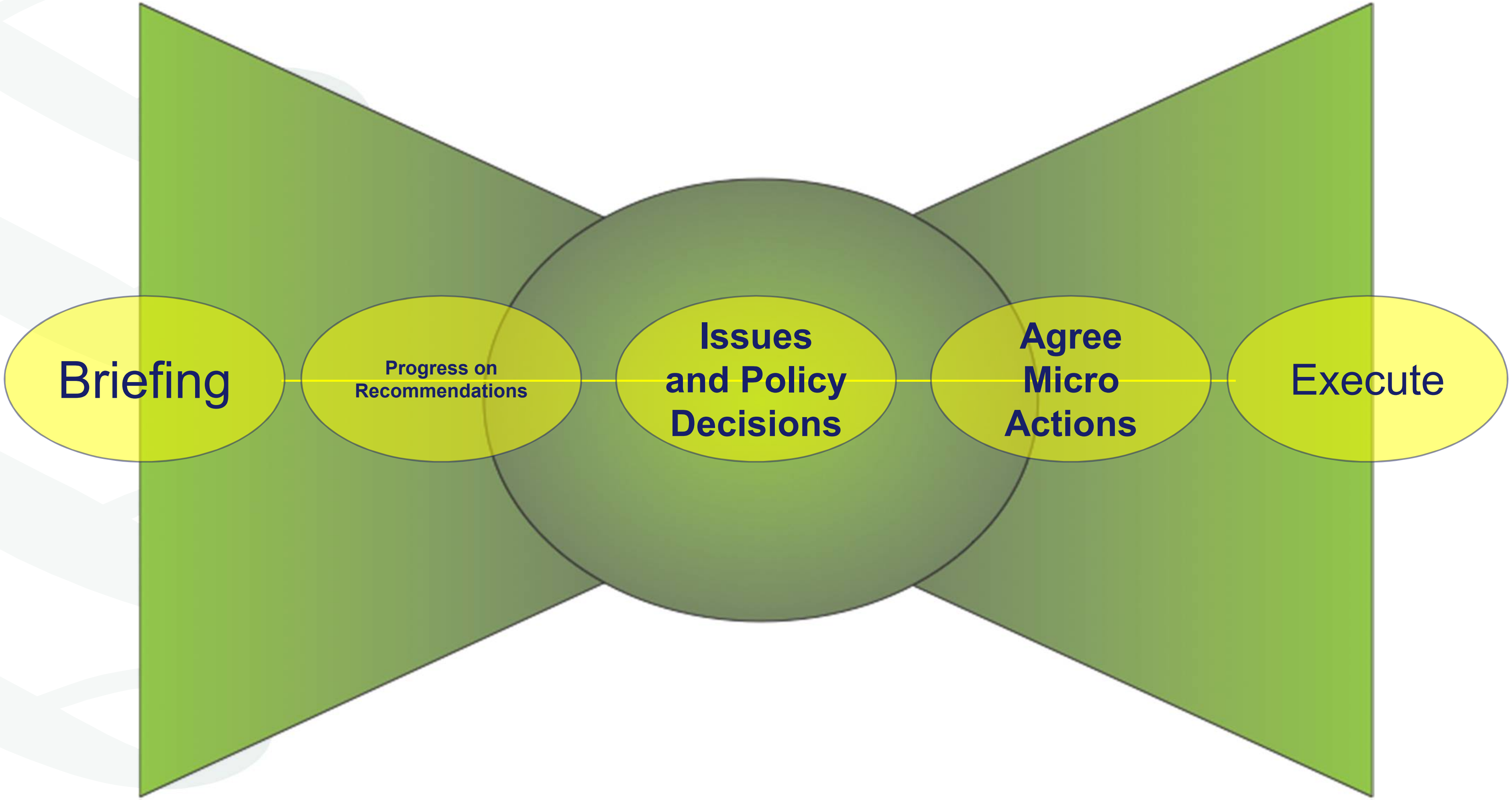
- **FPC can issue**
  - –Recommendations in public or private to anyone.
    - FCA or PRA must comply or explain why they are not
  - –Issue directions to FCA or PRA
    - must be complied with in a timely manner
    - however FPC cannot direct a timeframe

Toolkit

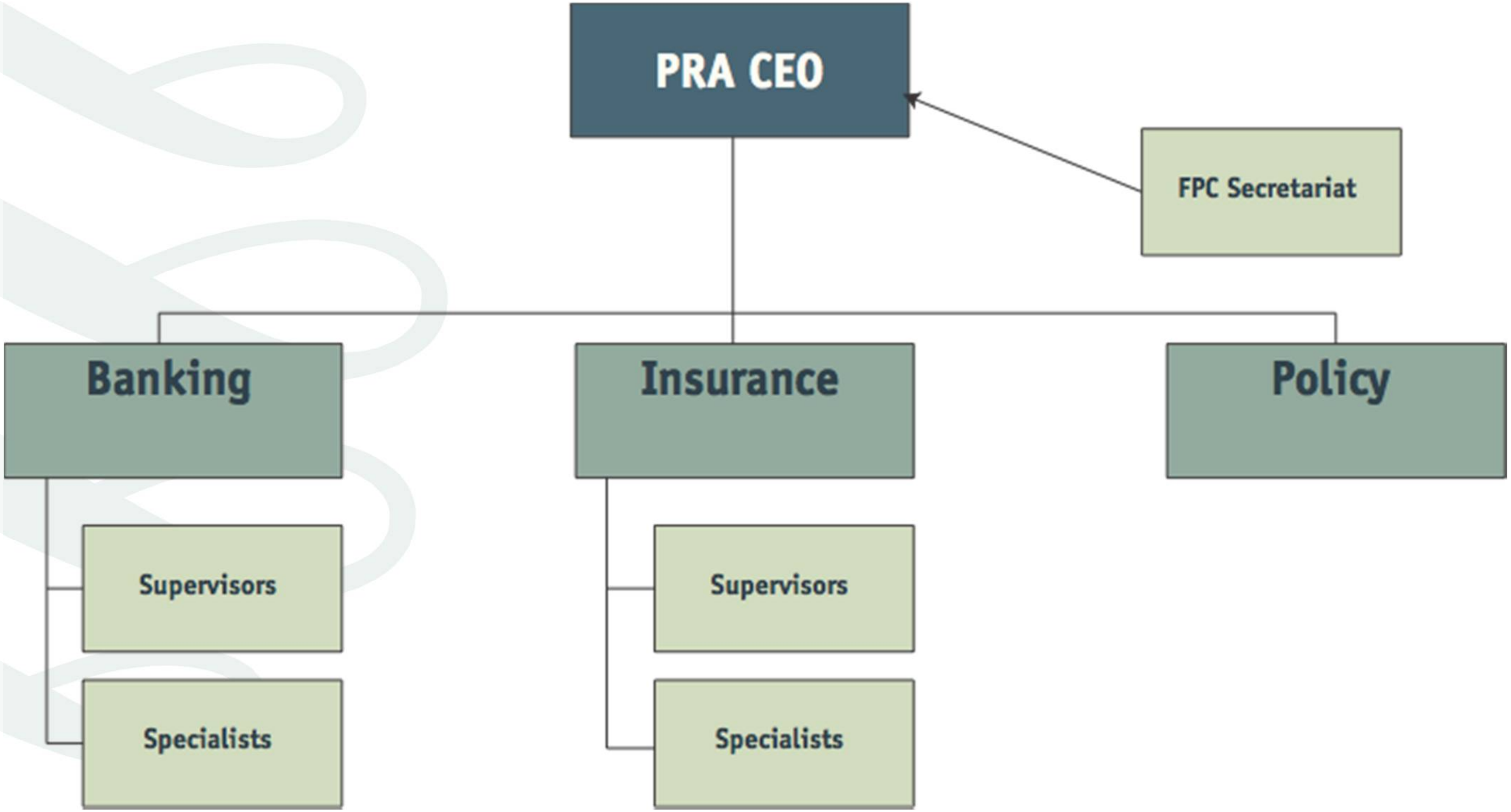


Key Amplification Channels/tools	Time-varying risk			Cross-sectional risk: distribution of risk; opacity; complexity
	Leverage	Intra-financial system activity	Maturity transformation	
Balance Sheet Tools	✓ ✗ *Restrictions on distributions* ?		?	
	✓ ✗ *Time-varying provisioning practices*	✓ ✗ *Time-varying liquidity buffers*		
Terms and conditions of transactions	??	✗ *Margining requirements*		
Market Structures		✗ *Use of central counter-parties*		✗ *Use of central counter-parties* ✗ *Design and use of trading venues*
		?		

FPC process


Briefing
Progress on Recommendations
Issues and Policy Decisions
Agree Micro Actions
Execute

Simple PRA Organisation Chart



Briefing

- **Events**
  - –Results
  - –Policy changes
- **Risks**
  - –Capital
    - stresses
    - exposures
    - generation
  - –Liquidity
- **Themes**
  - –valuation

Reporting on Progress

- **Recommendations**
  - –large number
  - –each covered in turn
- **FPC evaluates response**

Table 4.A Summary of recommendations

Id.[(a)]	Short title	Lead	Status[(b)]
11/Q2/1	Improved disclosure of exposures by major UK banks	FSA	Implemented
11/Q2/6	FSA monitoring of earnings retention of UK banks	FSA	Superseded by 11/Q4/1 and 11/Q4/2
11/Q3/1	Strengthened capital and liquidity without constraining lending	UK banks	Superseded by 11/Q4/1 and 11/Q4/2
11/Q3/2	Balance sheet management to limit fragility	FSA	Superseded by 11/Q4/1 and 11/Q4/2
11/Q3/3	Flexibility in EU legislation to enable national discretion	HMT	Action under way
11/Q4/1	Building capital by limiting distributions and raising external capital	UK banks	Superseded by 12/Q2/1
11/Q4/2	Strengthening balance sheet resilience without constraining lending	FSA	Superseded by 12/Q2/2 and 12/Q2/3
11/Q4/3	Disclosure of leverage ratios	FSA	Action under way
12/Q2/1	Build a sufficient cushion of loss-absorbing capital against current risks	FSA	New
12/Q2/2	Improve balance sheet resilience, including through prudent valuation	FSA	New
12/Q2/3	Manage and mitigate balance sheet risks from euro-area stress	UK banks	New
12/Q2/4	Clarify usability of regulatory liquid asset buffers in liquidity stress	FSA	New
12/Q2/5	Work towards consistent and comparable Pillar 3 disclosures	UK banks, FSA and BBA	New

(a) Identifiers, shown in this column, allow ongoing tracking of recommendations. An identifier 11/Q2/3 refers to the third recommendation made at the 2011 Q2 FPC meeting.
(b) The status of each recommendation is described as one of: 'New', 'Not implemented', 'Plan agreed', 'Action under way', 'Implemented' or 'Superseded'.

Issues and Policy Decisions

- **Issues**
  - –Focus
  - –Draft responses
- **Policy**
  - –Discussion
  - –Decision (voting)
  - –Communication

Macro to Micro

- **Detailed Action Plan**
  - –Scope
  - –Tools
  - –Calibration
- **Communication Plan**

Execution

- Execution
- Monitoring
- Evaluation

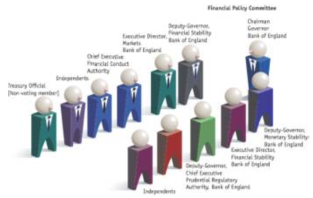
Operational Differences between FPC and MPC

Monetary Policy Committee		Financial Policy Committee
Nine Five Bank of England Executives Four Independent Members	Members	Eleven Five (Six) Bank of England Executives One PRA Executive
Inflation Target clearly defined and observable	Target	Financial Stability Target not clearly defined
Interest Rates Quantity of Money	Tools	Many hundreds and an Infinite number in combination
In direct control of the Bank of England	Execution	Intermediated both by regulators
Delivery of target Established accountability mechanism if failed	Success Criteria	Not defined Accountability not yet established

Current FPC Recommendations

- Taking into account each institution's risk profile, the FSA works with banks to ensure they build a sufficient cushion of loss-absorbing capital in order to help to protect against the currently heightened risk of losses. That cushion may temporarily be above that implied by the official transition path to Basel III standards and would support additional lending to the real economy, including via the planned 'funding for lending' scheme. Banks should continue to restrain cash dividends and compensation in order to maximise the ability to build equity through retained earnings.
- The Committee reiterates its recommendation to the FSA to encourage banks to improve the resilience of their balance sheets, including through prudent valuations, without exacerbating market fragility or reducing lending to the real economy.

Current FPC Recommendations



- Banks work to assess, manage and mitigate specific risks to their balance sheets stemming from current and future potential stress in the euro area.
- The FSA makes clearer to banks that they are free to use their regulatory liquid asset buffers in the event of a liquidity stress. The ability to do so is enhanced by additional contingent liquidity made available to banks by the Bank. The Committee also recommends that the FSA considers whether adjustments to microprudential liquidity guidance are appropriate, taking some account of this additional liquidity insurance.
- UK banks work with the FSA and the BBA to ensure greater consistency and comparability of their Pillar 3 disclosures, including reconciliation of accounting and regulatory measures of capital, beginning with the accounts for the current year.

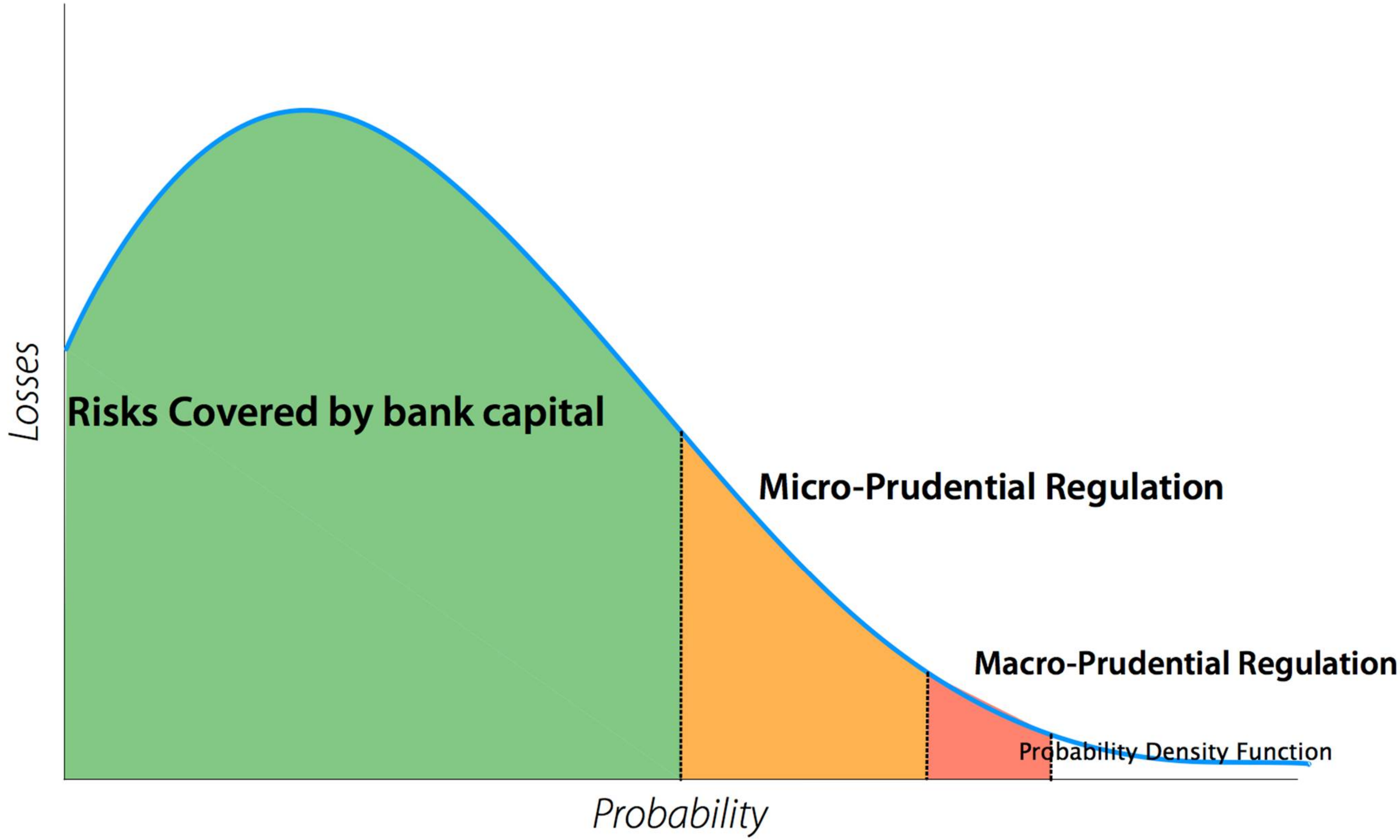
Current Risks

- **Environment**
  - Eurozone
  - UK
  - Geo-political
  - Global Imbalances
  - Inequalities of income and wealth
- **Capitalisation**
  - Quantum of capital
    - credit risk
    - counter-party risk
    - hedging
    - Basel III glidepaths
    - Distributions
    - Basis Risks
- **Policy Change**
  - UK Regulatory Reform
  - International Reform
- **Funding**
  - Challenging conditions
    - Downgrade
    - Collateral
    - MMFs
    - Retail
  - Lending
  - Currency Mismatching
- **Business Model**
  - Conduct Issues
  - Low interest rates
  - Forced separation of business
  - Asset disposals
  - unsustainable business models
- **Resolution**
- **Infrastructure**

Theoretical Case Study

- Evidence that residential property market is overheating
- Banks are undercapitalised for a plausible stress of a fall in property prices
- Micro-prudential regulator has already raised capital for the 10 biggest lenders - accounting for over 90% of the market
- Financial Policy Committee imposes a higher sectoral risk weight on residential property

Case Study

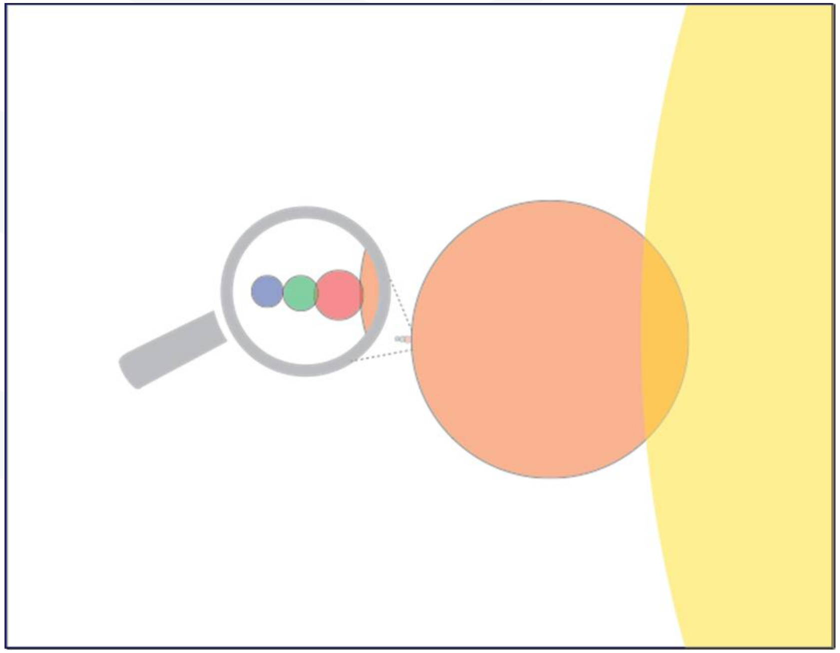

Losses
Risks Covered by bank capital
Micro-Prudential Regulation
Macro-Prudential Regulation
Probability Density Function
Probability

To make this work

- Need to know where you are in asset-price cycle
- Need to assess capitalisation of banks against plausible stress
- Need to assess extent of micro-prudential regulator's response
- Need to assess the gap between macro-prudential desired outcome
- Need to calibrate the tool to respond
- Need to understand the lags

What the institutional structure for UK regulation means for prudential supervision

From Macro to Micro and back again



Lyndon Nelson
Director, Financial Stability and
Macro Prudential Supervision Division
Financial Services Authority

Recent financial crime developments

Rob Gruppetta
Financial Crime & Intelligence Department

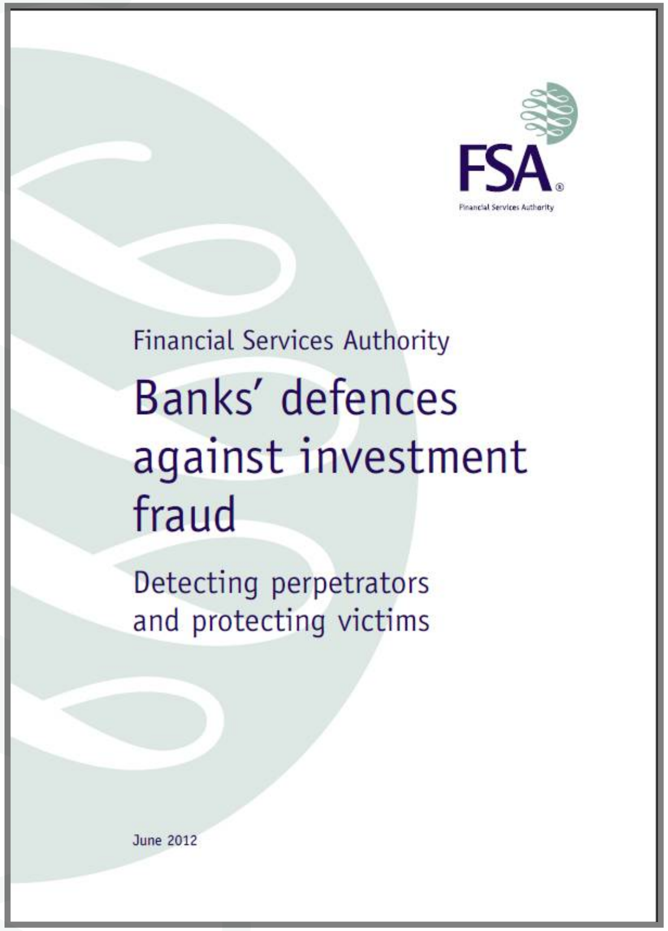
Today's presentation

- **Recent FSA thematic work**
  - *Banks' management of high money laundering risk situations* (June 2011)
  - *Anti-bribery and corruption controls in investment banks* (March 2012)
  - *Banks' defences against investment fraud* (June 2012)
- **Associated enforcement action**
- **Regulatory reform and our future work on financial crime**

Thematic work

- Key FSA tool
- Sets out our assessment of the industry's performance
- Examples of good and poor practice
- Incorporated into our document *Financial Crime: A Guide for Firms*, as formal Guidance

Banks' defences against investment fraud


FSA
Financial Services Authority

Financial Services Authority

Banks' defences against investment fraud

Detecting perpetrators and protecting victims

June 2012

- Lack of governance/senior management involvement in the issue – result of poor MI and risk assessment
- Haphazard resource allocation but some good efforts by more junior individuals
- Weaknesses in AML monitoring
- Controls seemed weak compared with types of fraud where bank financially exposed

http://www.fsa.gov.uk/static/pubs/other/banks-defences-against-investment-fraud.pdf

ABC controls in investment banks

- Investment banks too slow and reactive on ABC
- Most firms had historical systems and controls issues
- Significant recent progress but some firms had more to do
- Bribery Act 2010 a major catalyst – no regard given to previous FSA work on ABC

http://www.fsa.gov.uk/static/pubs/other/anti-bribery-investment-banks.pdf

Banks' management of high money-laundering risk situations


FSA
Financial Services Authority

Banks' management of high money-laundering risk situations

How banks deal with high-risk customers (including politically exposed persons), correspondent banking relationships and wire transfers

June 2011

- Very serious weaknesses in AML controls over high risk/PEP customers – affecting ¾ of banks, including major banks
- Some banks apparently unwilling to exit very profitable business when the ML risk was unacceptably high
- Likely that some banks are handling the proceeds of corruption

http://www.fsa.gov.uk/pubs/other/aml_final_report.pdf

Enforcement action

High risk customers/PEPs

- March 2012 – Coutts & Co - £8.75mn
- May 2012 – Habib Bank AG Zurich - £525k and its MLRO - £17.5k

Correspondent banking

- August 2012 – Turkish Bank (UK) Ltd - £294k

All these fines followed a 30% discount for early settlement

The future

- FSA's Enforcement and Financial Crime Division transfers to FCA in 2013
- Continued strong focus on financial crime issues
- Continued use of thematic reviews
- New Systematic AML Programme

The Prudential Regulation Authority (PRA): supervisory approach

Presentation to the FSA Annual International Seminar

Deborah Chesworth

Head of Banking Prudential Regulatory Reform

Context

- **The PRA will prudentially regulate approximately 1500 firms: all deposit-takers and insurers; and some 'designated' investment firms**
- **The PRA has two objectives:**
  - promote the safety and soundness of PRA authorised firms
  - contribute to the securing of an appropriate degree of protection for those who are or may become policyholders
- **Focus on the potential harm that a firm could do to the UK financial system, either in the way it carries out business or on failure**
- **Law will say explicitly that it is not the PRA's role to ensure that no firm fails**
- **Firms must meet and be likely to continue to meet the threshold conditions**

The PRA's supervisory approach

- **Focused** – The PRA will weight its supervision towards issues and firms that, in its judgement, pose the greatest risks to the stability of the UK financial system and policyholder protection

- **Judgement-based** – Supervisors will reach judgements on the risks that firms pose to its objectives, and how to address any shortcomings identified, judgements will take place in a framework of policy

- **Forward-looking** – The PRA will assess firms not just against current risks, but also against those that could plausibly arise further ahead and it will intervene early where necessary to reduce those risks

The PRA's policies

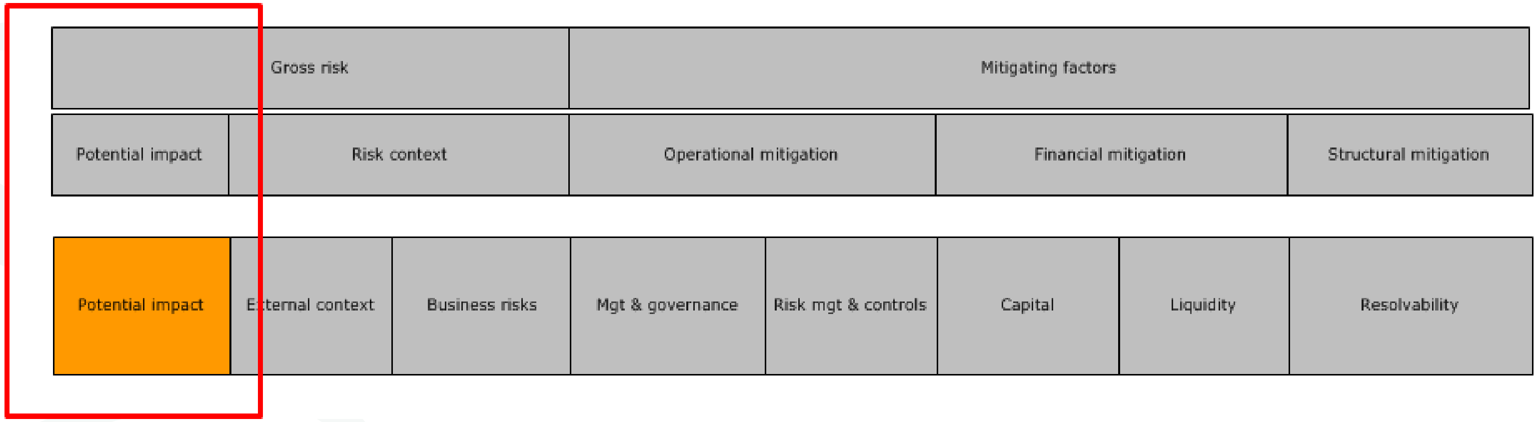
- **The PRA will have a set of 'policies' – criteria against which it will judge whether firms are safe and sound and providing appropriate policyholder protection**
  - Policies are expressed as detailed rules (e.g. in the Handbook) and high-level expectations (e.g. in the PRA 'Approach' documents)
  - Supervisory judgements will be made within a clear and coherent framework provided by these policies
  - The PRA will expect firms to comply with the spirit as well as the letter of its policies
  - Policies will be supported by EU/International rules and directives
  - The PRA will be an active participant in both international and European institutional structures

PRA Risk Assessment Framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risks	Mgt & governance	Risk mgt & controls	Capital	Liquidity	Resolvability

- **The risk assessment framework is the lens through which the PRA views firms**
- **Framework captures three key elements:**
  - Potential impact of firm failure/stress on the financial system
  - How macroeconomic and business risk context in which a firm operates affects its viability
  - Mitigating factors that combine to determine the safety and soundness of a firm

Potential impact



- **Significance of a firm to the stability of the UK financial system – quantitative approach with qualitative overlay**
- **Used to:**
  - determine intensity of supervision
  - help focus supervisory strategy
- **Firms divided into five 'categories' based on:**
  - capacity to cause disruption to the UK financial system because of size, interconnectedness, complexity, business type
  - (for insurers) capacity to cause disruption to a significant number of policyholders because of size, type of business

Risk context

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risks	Mgt & governance	Risk mgt & controls	Capital	Liquidity	Resolvability

- **Consideration of macro-economic and system-wide risks, including Financial Policy Committee views**
- **Sectoral analysis**
- **Business model analysis:**
  - (eg) where/how a firm makes money, risks it takes, funding model
  - sustainability and vulnerabilities
  - potential to create adverse effects on other participants in the system
  - peer analysis as a diagnostic tool
- **Whether PRA can effectively supervise firm's activities**

Mitigating factors

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risks	Mgt & governance	Risk mgt & controls	Capital	Liquidity	Resolvability

- **Continuous assessment cycle**
- **Frequency and intensity of core assessment activity will vary by category and other factors, such as whether UK legal entity or branch**
- **Focus on key risks means that supervisory activity will depend on a firm's particular circumstances**
- **Proactive Intervention Framework:**
  - assessment of a firm's proximity to failure (5 stages)
  - derived from assessment of risk context, and operational and financial mitigation
  - designed to ensure that PRA puts into effect its aim to identify and respond to emerging risks at an early stage

Use of formal powers

- **Formal powers will be used to support the PRA's forward-looking approach to supervision**
  - Preference for the PRA to act in advance to avoid risks crystallising
  - Where necessary the PRA will remove or restrict a firm's permission to operate
  - Enforcement powers can also be used if necessary

Coordination

- **Effective delivery of the PRA's approach will require coordination with the FCA**
  - Focussed at the firm specific level
  - MoU and colleges to ensure statutory duty to coordinate is effective in practice
- **Firm-specific supervision alone is not sufficient to deliver financial stability and must be complemented by an effective macroprudential regime**
  - Frequent two-way flow of information and exchange of views between the PRA and the FPC
  - PRA responsible for implementing relevant FPC recommendations on a 'comply or explain' basis
  - FPC will have powers to direct the PRA

Further information

- More details on the transition and related documents can be found on the FSA and Bank of England websites (www.fsa.gov.uk/about/what/reg_reform and www.bankofengland.co.uk/financialstability/Pages/overseeing_fs/default.aspx)

- More details on the PRA's proposed supervisory approach and a number of its high-level 'policies' are set out in the PRA 'Approach' documents, published in October 2012, these can be found at the links above

Panel Discussion
The Global Regulatory Agenda

The Financial Stability Board's standards for systemically-important financial institutions

Terry Allen
Prudential Policy Division, FSA

November 2012

International regulatory reform agenda

- Regulators, resolution bodies and macro-prudential authorities necessarily focus on potential ‘bad outcomes’ and tail risk. The costs of financial failure are heightened where failure generates very large society-wide externalities (systemic risk). But the absence of adequate regulatory tools can result in perceptions of too-big-to-fail (TBTF), compounding the authorities’ problem.

- The G20 (London Summit) called for regulatory oversight of all systemically important financial institutions, instruments & markets.

- This has been central to the work of financial authorities in recent years – both domestically and collaboratively through fora such as the Financial Stability Board, the Basel Committee, IOSCO and the International Association of Insurance Supervisors as well as the IMF and the BIS.

Systemic firms

- In an FSB context, the label systemically-important financial institution (or SIFI) has become a term of art, with particular attention being given to the set of SIFIs (global SIFIs or G-SIFIs) whose failure would have global consequences.

- Global SIFIs are institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries. Standards for large global financial firms should be commensurate with the system-wide expected losses that their failure would produce.

- Much of the SIFI debate has focused on systemic banks (SIBs) and global SIBs but there are important work streams looking at market infrastructure, insurance (global systemically-important insurers (G-SIIs) and other types of non banks (in FSB and IOSCO).

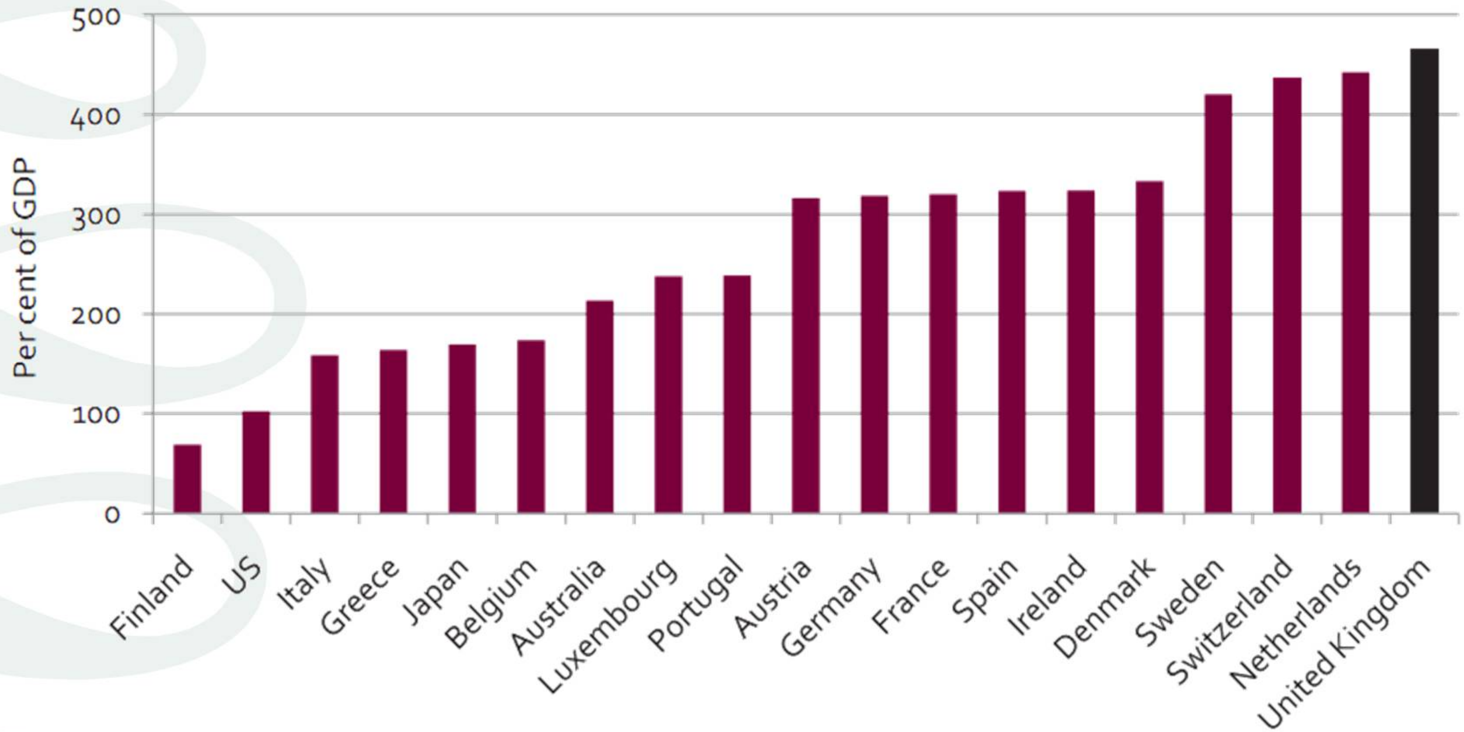
- Potential for a class of firms or activities beyond the bank regulatory perimeter to generate bank-like risks (shadow banks). Incentive effects of higher capital.

International framework systemic banks

- Basel Committee methodology for identifying global systemically-important banks or G-SIBs (factors employed include: size, complexity, substitutability & connectivity).
- Three pillars to the G-SIB regime: capital surcharges, supervisory intensity and resolution (*Key Attributes of Effective Resolution*).
- Other potential tools being discussed at a national level – e.g. levies, ring-fencing, structural change.
- Annual FSB process of listing the cohort of potential G-SIBs – 28 G-SIBs listed in November 2012 (following publication of an initial cohort in late 2011). Associated system of capital surcharges, ranging from 1.0% to 2.5%.
- Basel approach to the treatment of domestic systemically-important banks or D-SIBs.
- International agenda sets minimum requirements for UK, although EU requirements may incorporate maximum harmonising elements.

Scale of UK banking system

For the size of the country, the UK has a very large banking sector



Domestic banking assets as a % of GDP consolidated by nationality of headquarters (2009)

Navigating Domestic and Global Risks in Emerging Markets (EM)

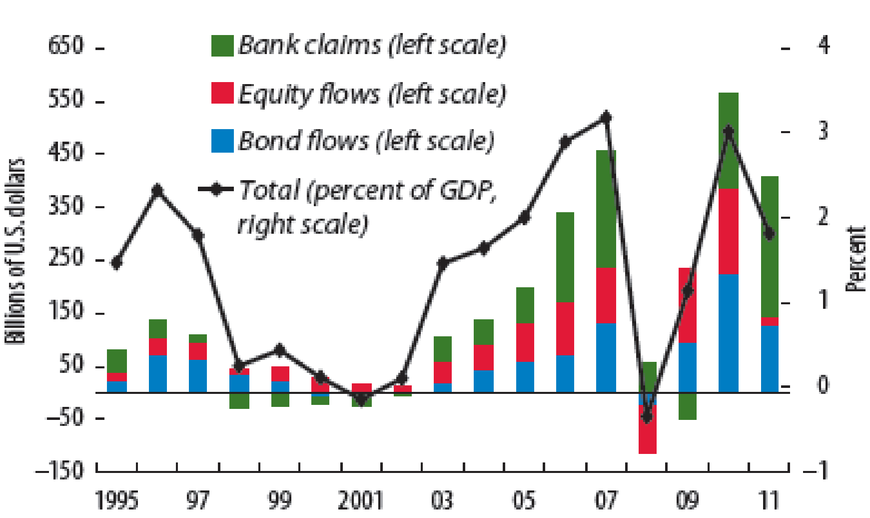
Reinout De Bock

IMF London Representative

FSA Conference, November 28, 2012

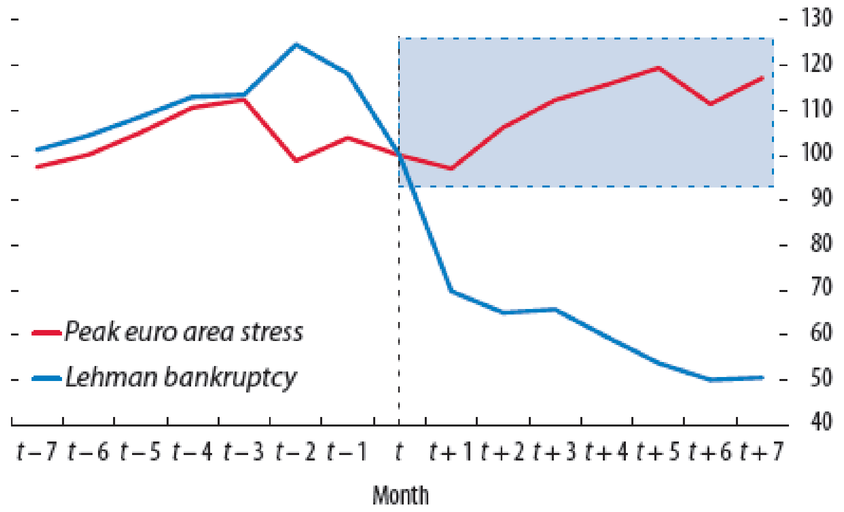
Will capital flows remain strong?

Bank and Portfolio flows to EM, 1995-2001



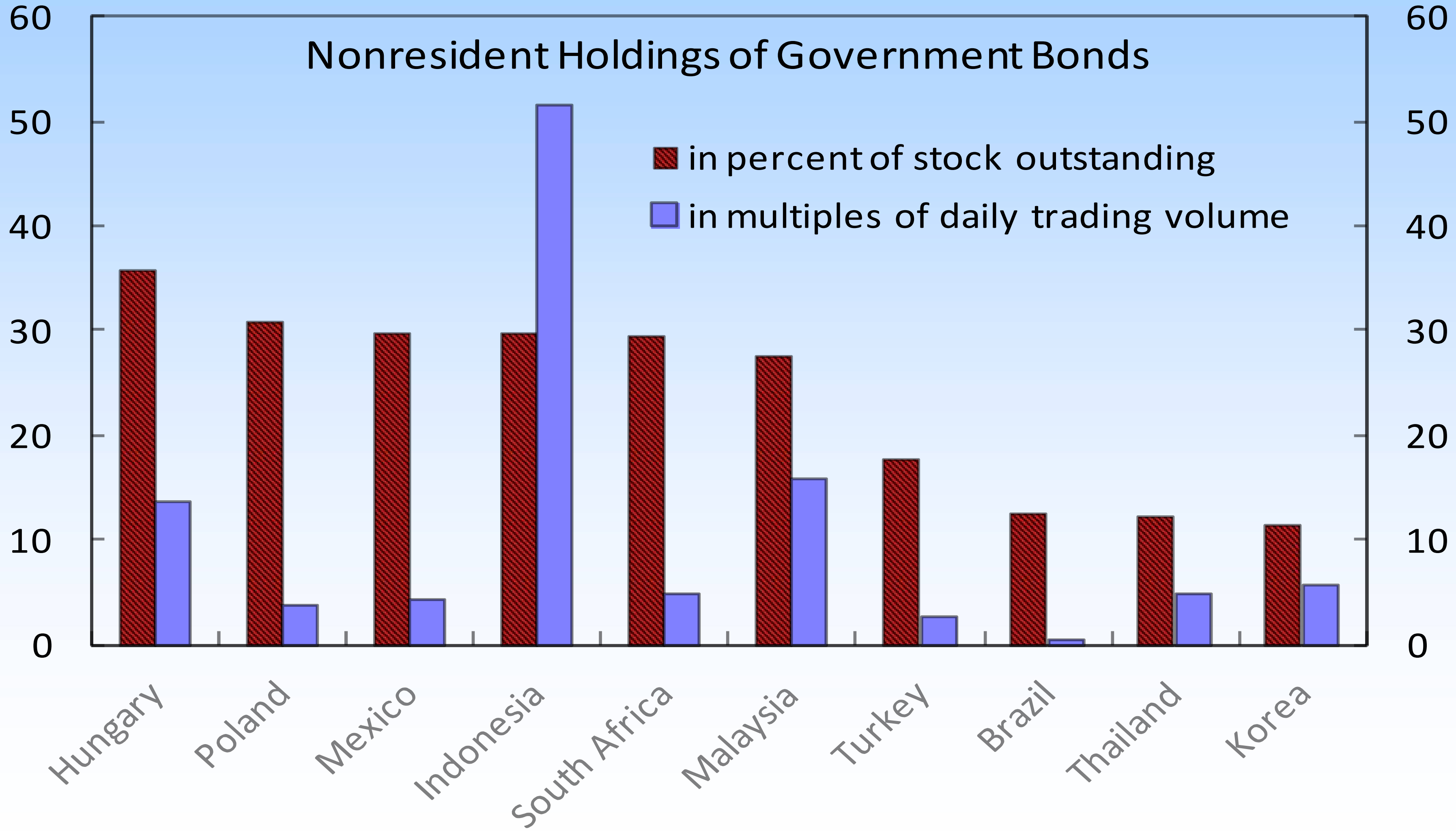
Sources: Haver Analytics; IMF, International Financial Statistics and World Economic Outlook databases; and IMF staff estimates.

Resilience of inflows into EM local-currency bonds



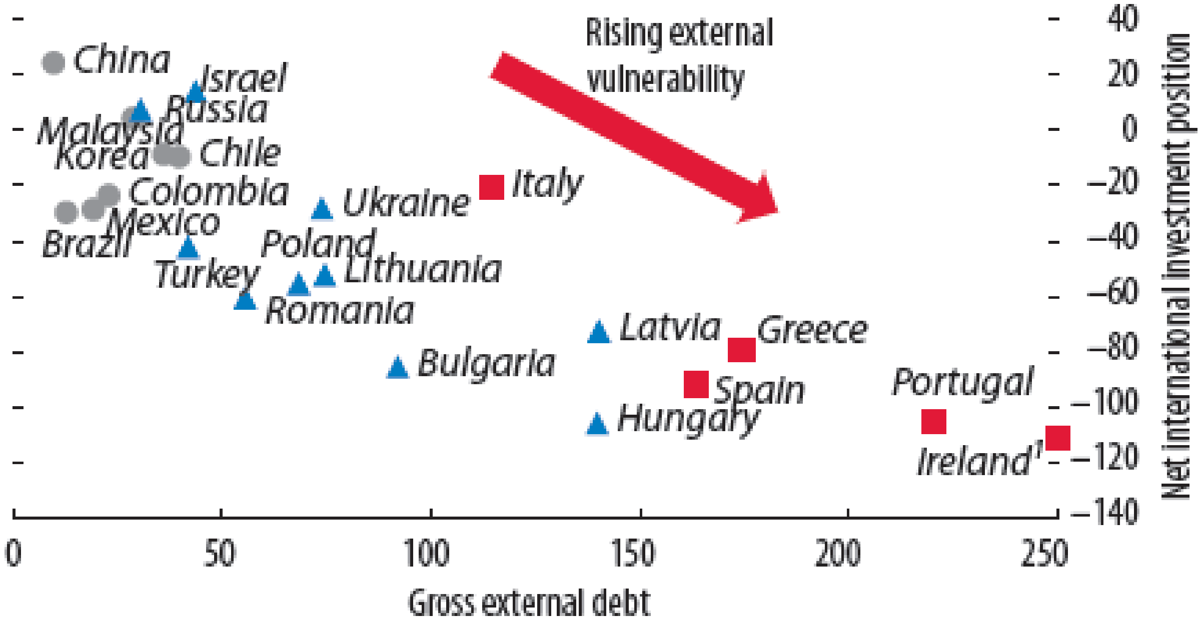
Sources: EPFR Global; and IMF staff estimates.
Note: Peak of stress (month = t) for euro area stress is November 2011; for Lehman bankruptcy it is September 2008.

Portfolio flow volatility is particular risk, especially for EMs with large nonresident investments…



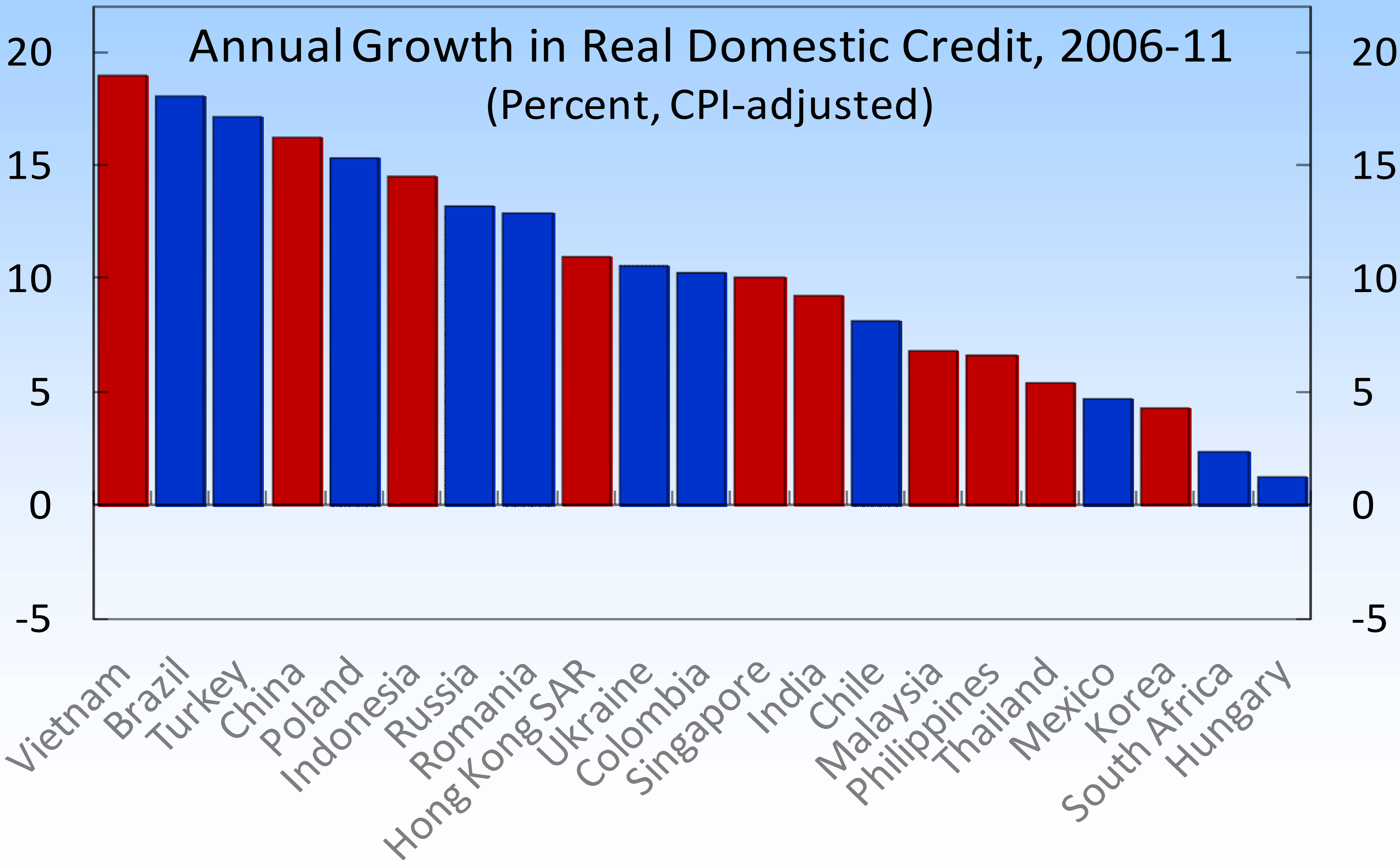
Emerging Europe particularly vulnerable

Figure 2.47. Net International Investment Position versus Gross External Debt, Selected Economies, 2011
(In percent of GDP)

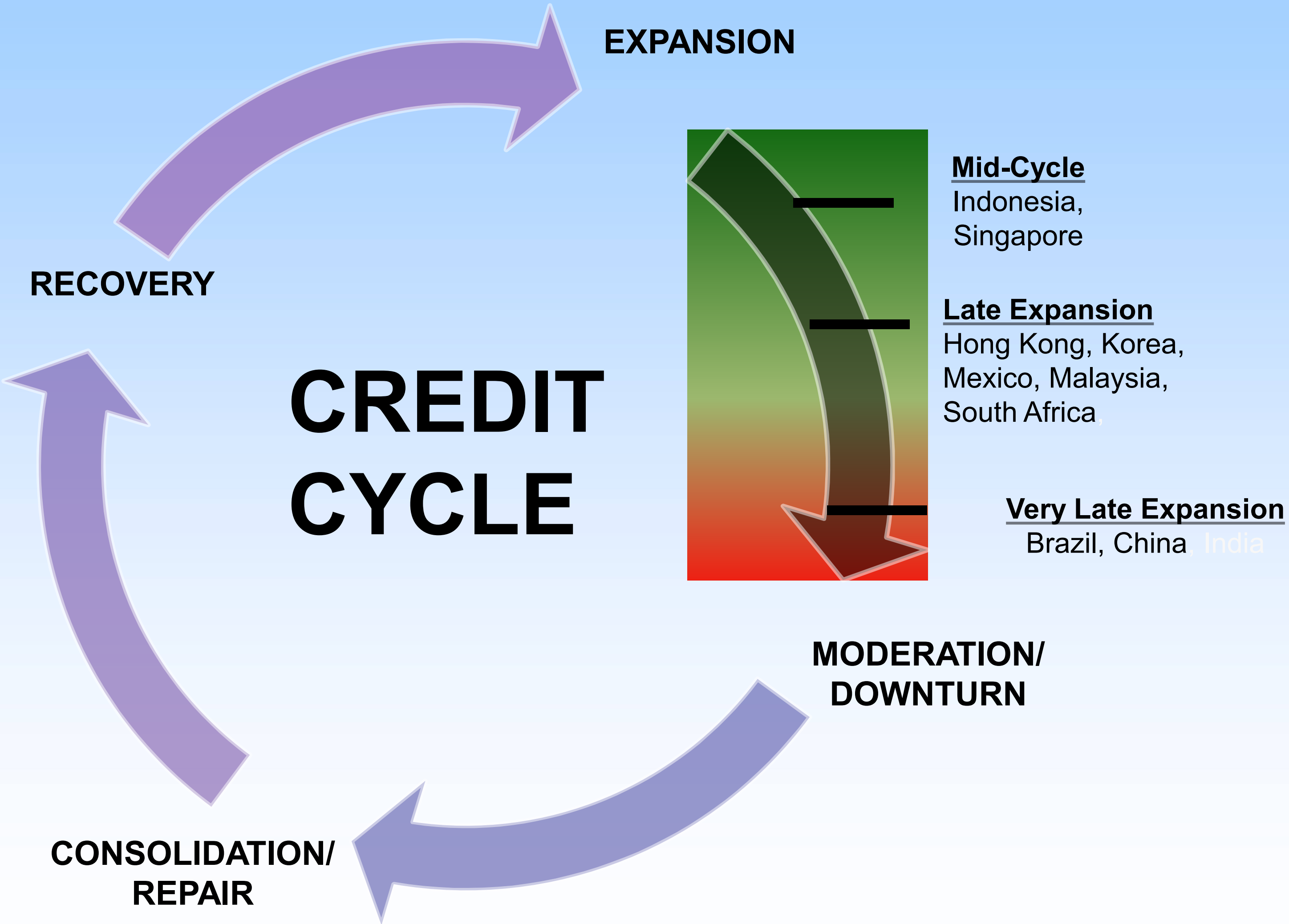


Sources: Haver Analytics; and IMF staff calculations.
[1]For Ireland, gross external debt was 1,063 percent of GDP at end-2011 (truncated in the figure); net international investment position excludes its International Financial Center.

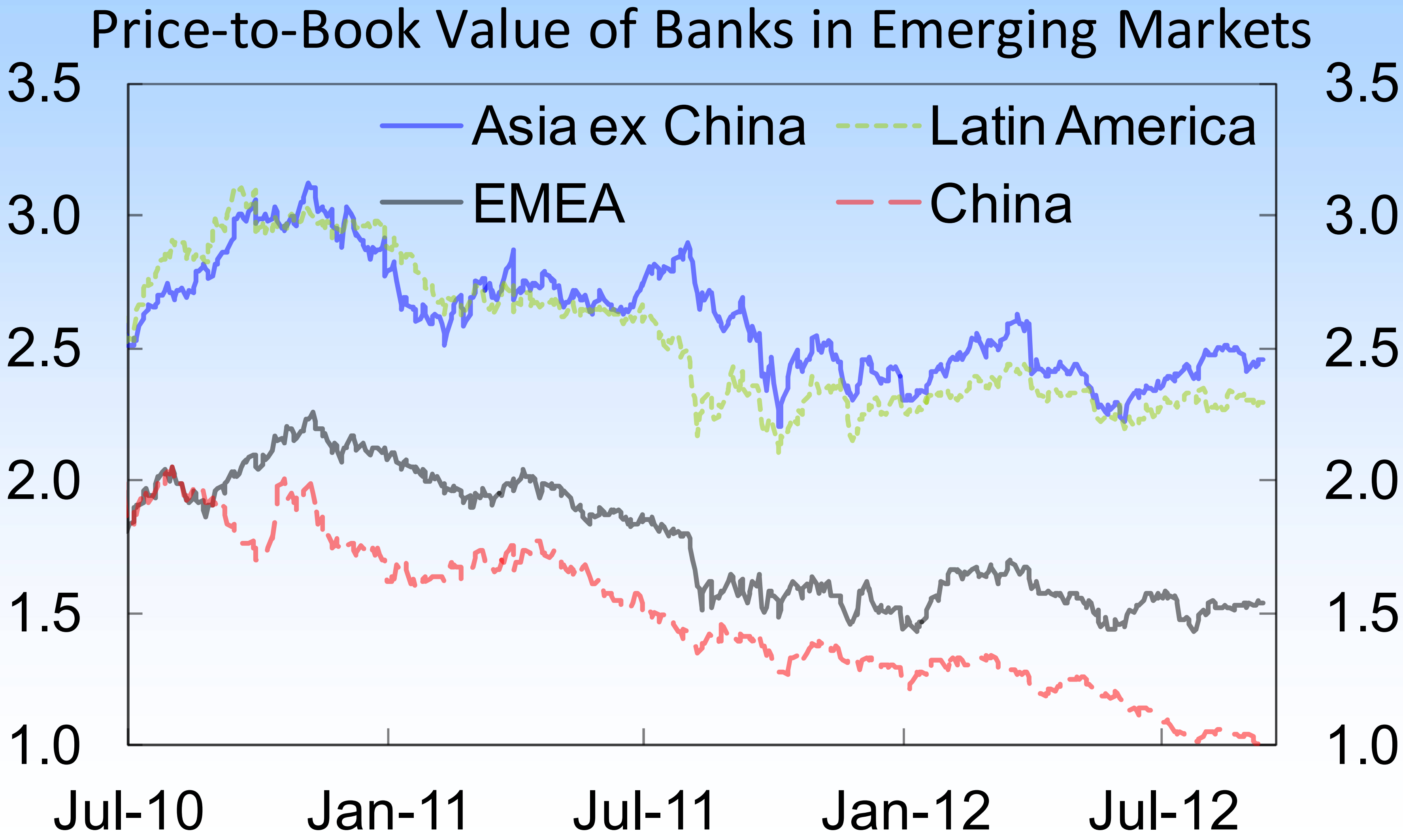
Some EM face home-grown vulnerabilities, after years of rapid credit growth…



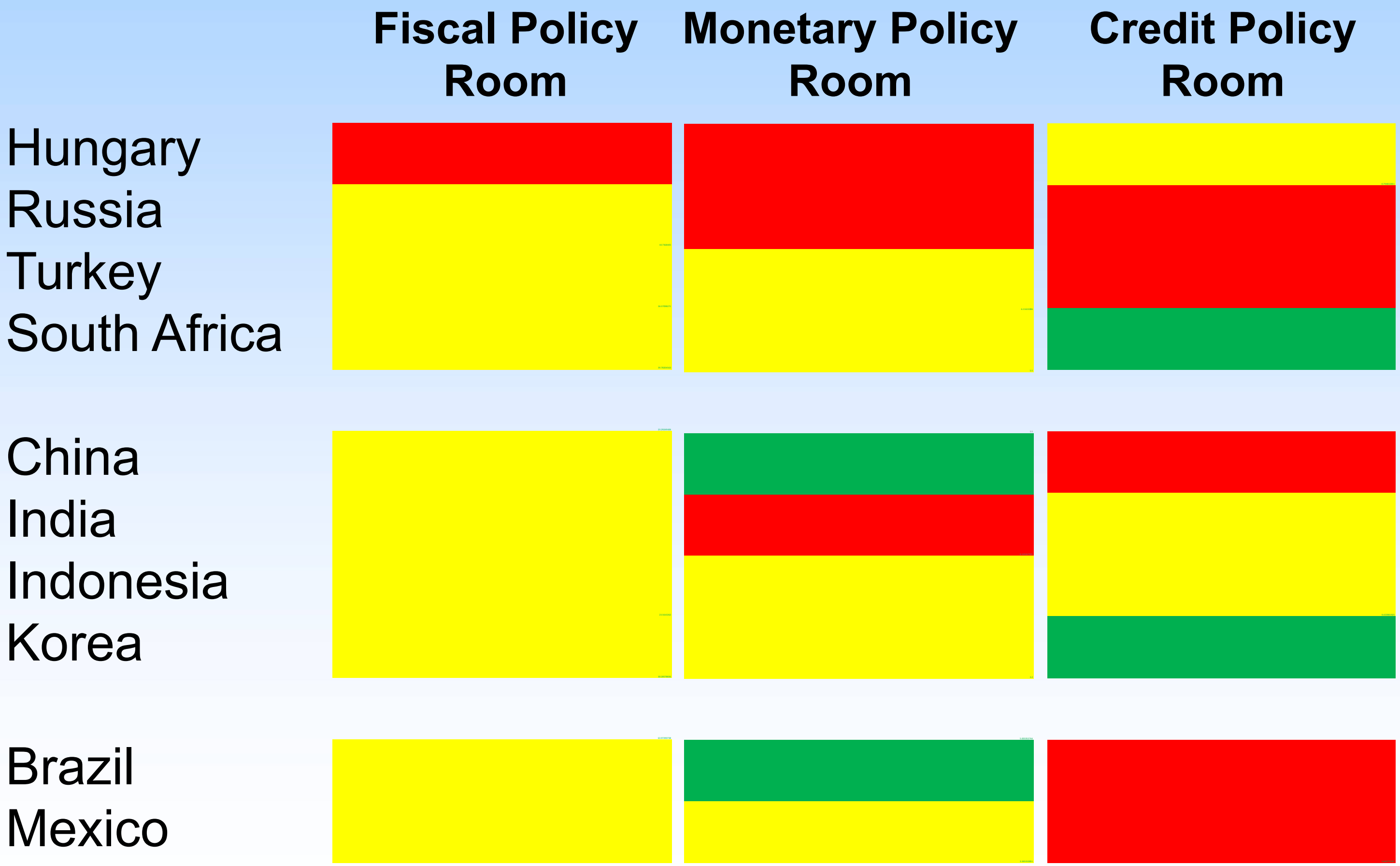
Late Credit Cycle Challenges



Financial markets are already anticipating weaker asset quality and bank profits...



…but several EM still have some “policy space” to absorb negative shocks.



…to help further insulate EM against dollar liquidity risk and the euro area crisis:

- Develop a coordinated response to manage disruptions in wholesale dollar funding markets
- Assess impact of Basel III and calibrate implementation to limit adverse macro effects
- Examine effect of capital outflows on bank asset quality and CAR (see GFSR October 2011 and De Bock and Demyanets (2012))
- Develop regional capital markets for LT finance

Panel Discussion
Insurance Prudential Regulation

Solvency II: The end of the Journey

Anthony Brown

November 2012

The pre Solvency II landscape

The European wide – 'Solvency I' regime

- An original 1970's directive
- Overlaid with new laws and directives in a patchwork fashion
- A 'minimum harmonised' regime
- Only focussed on quantitative requirements
- Basic standards set
- Implemented in different ways in different countries
- An overlay of wide-scale gold plating
- An opaque industry – difficult to invest in

The birth of the Solvency II project

The lack of consistency needed to be addressed

Different solvency standards across Europe

A need to drive up standards

Insurers undervalued as unclear business models

Various reports commissioned including the Sharma Report (2002)

Governance is critical

Market consistency is best valuation method

Risk sensitive capital requirements are vital

The framework: What do we want to achieve

Consistency across Europe

A common market for products

Harmonised supervision especially for groups

An increase in standards

Risk based capital

Market consistent balance sheet

Governance and risk management requirement

Higher level of supervisory assessment

Harmonised reporting and disclosure

The framework – how is it achieved

FSA®

Consistency across Europe

Three-pillar approach

Pillar 1:	Pillar 2:	Pillar 3:
Quantitative requirements	**Qualitative requirements and supervisory review**	**Reporting, disclosure and market discipline**
• Balance sheet (including technical provisions) • Minimum capital requirement (MCR) • Solvency Capital Requirement (SCR)	• Governance, risk management and required functions • Own risk and solvency assessment • Supervisory review process	• Supervisory Process • Disclosure • Transparency • Support of risk-based supervision through market mechanisms
Market-consistent valuation **Risk Based requirements**	**Business governance** **Risk-based supervision**	**Disclosure** **Transparent markets**

The political journey

Developing policy in Europe is a complicated business…

…especially in a such a difficult economic climate for insurers

A three-level framework

Level 1 – The Directive

Level 2 –Delegated Acts and IM

Level 3 – Standards and Guidance

Difficulties on the journey

2011: The Directive re-written due to Lisbon Treaty

At a time of economic crisis

Focus on long term products

Discussion pulled into Directive discussion

A political/technical decision still to be made on the best way to provision for long term guarantees

Looking forward

Implementation date of 1/1/14 unrealistic

→ More time to prepare

→ A need for an interim solution

Current discussions on the interim solution

Early adoption of parts of the framework?

Implementation will come soon enough

Heavy industry investment already

Work in colleges and groups continues

Thank you

Anthony Brown

Insurance Policy

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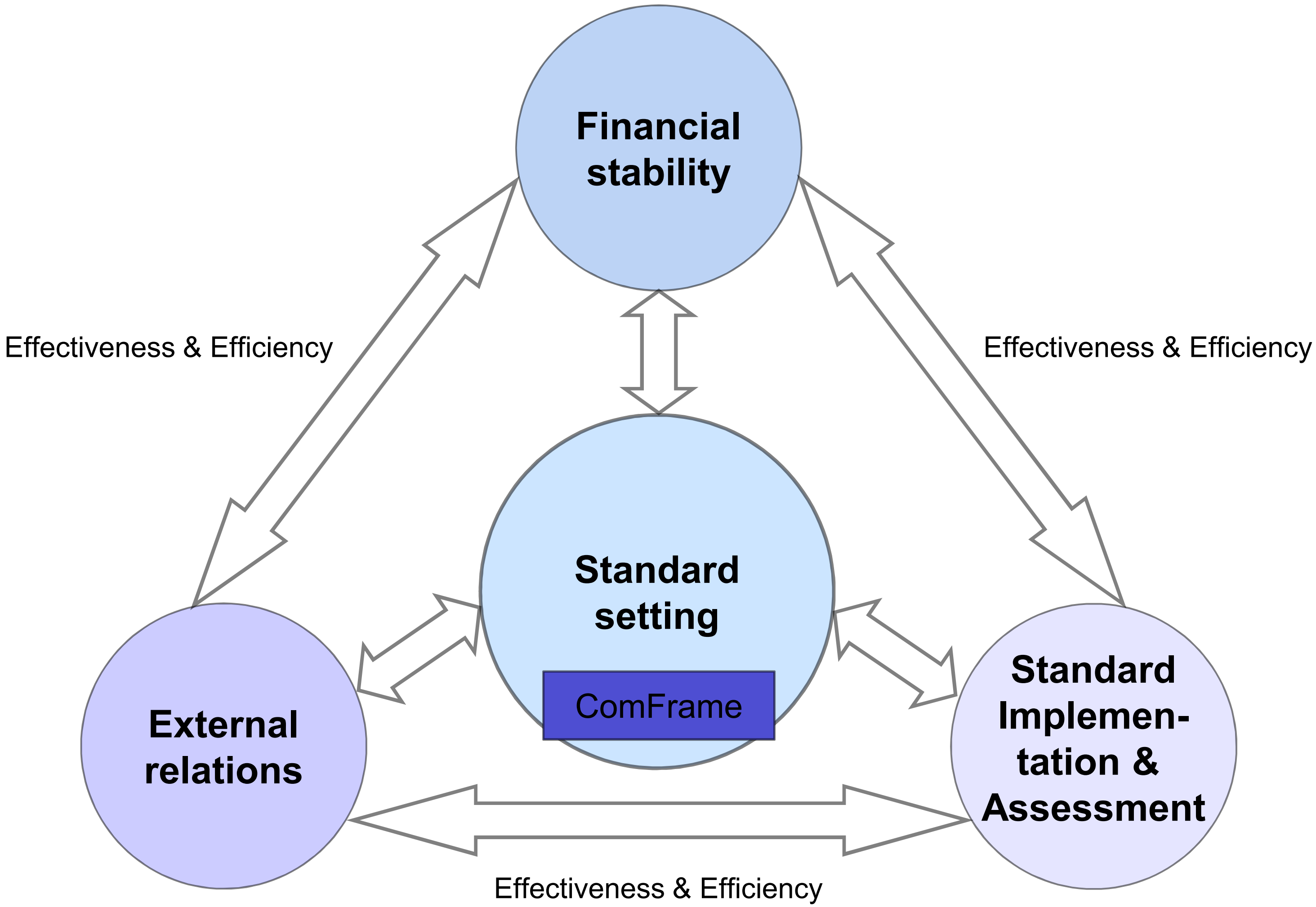
Insurance prudential regulation: the international agenda

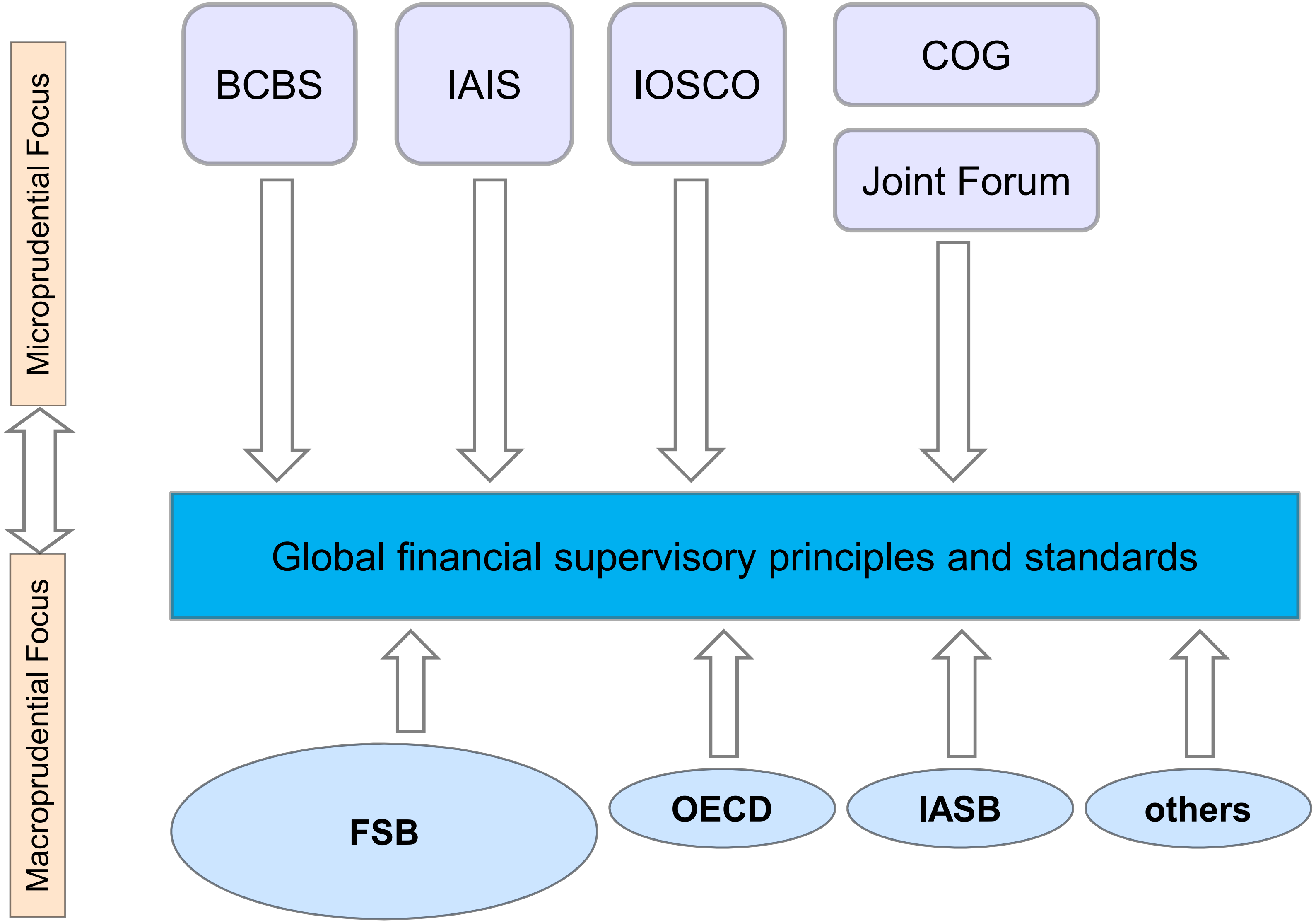
Catherine Lezon
Deputy Secretary General
International Association of Insurance Supervisors

FSA Annual International Seminar
London
28 November 2012

IAIS activities



Standard setting – global structure



Outline

1. Background
2. ICPs
3. ComFrame
4. G-SIIs
5. Conclusion

1. Background

- Global financial crisis & insurance
- Interconnected markets/products/financial institutions
- Key lessons learnt
  - ❑ Group-wide supervision
  - ❑ Macroprudential approach
  - ❑ Coordination

Outline

1. Background
2. **ICPs**
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2-The new ICPs - what has changed?

Why were new ICPs needed?

Better structure

Highlights of major changes

Further enhancements

ICP on-line tool

2- Why were new ICPs needed?

- **Decision to review 2003 ICPs made in 2007 before the financial crisis**

- **Review incorporated lessons learned from crisis where relevant:**

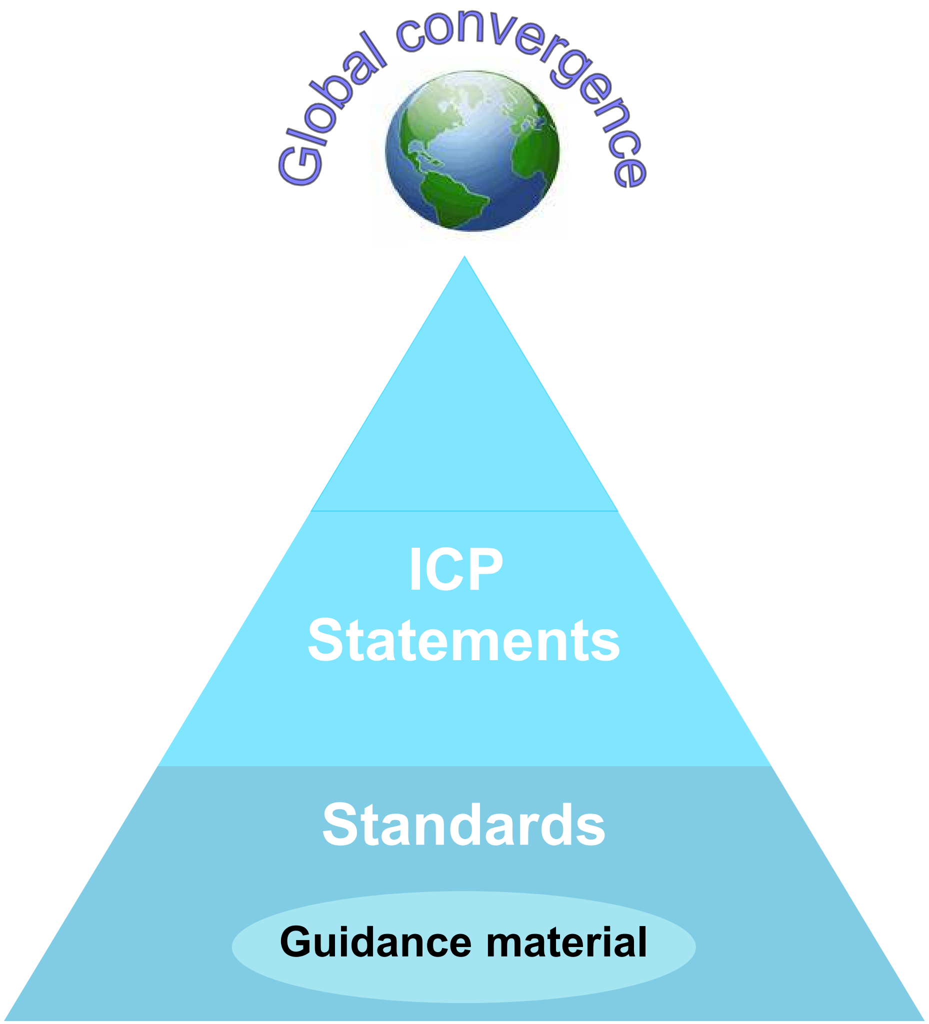
- Mis-management → Need for robust governance and risk-management

- Globalisation → Need for strong group-wide supervision

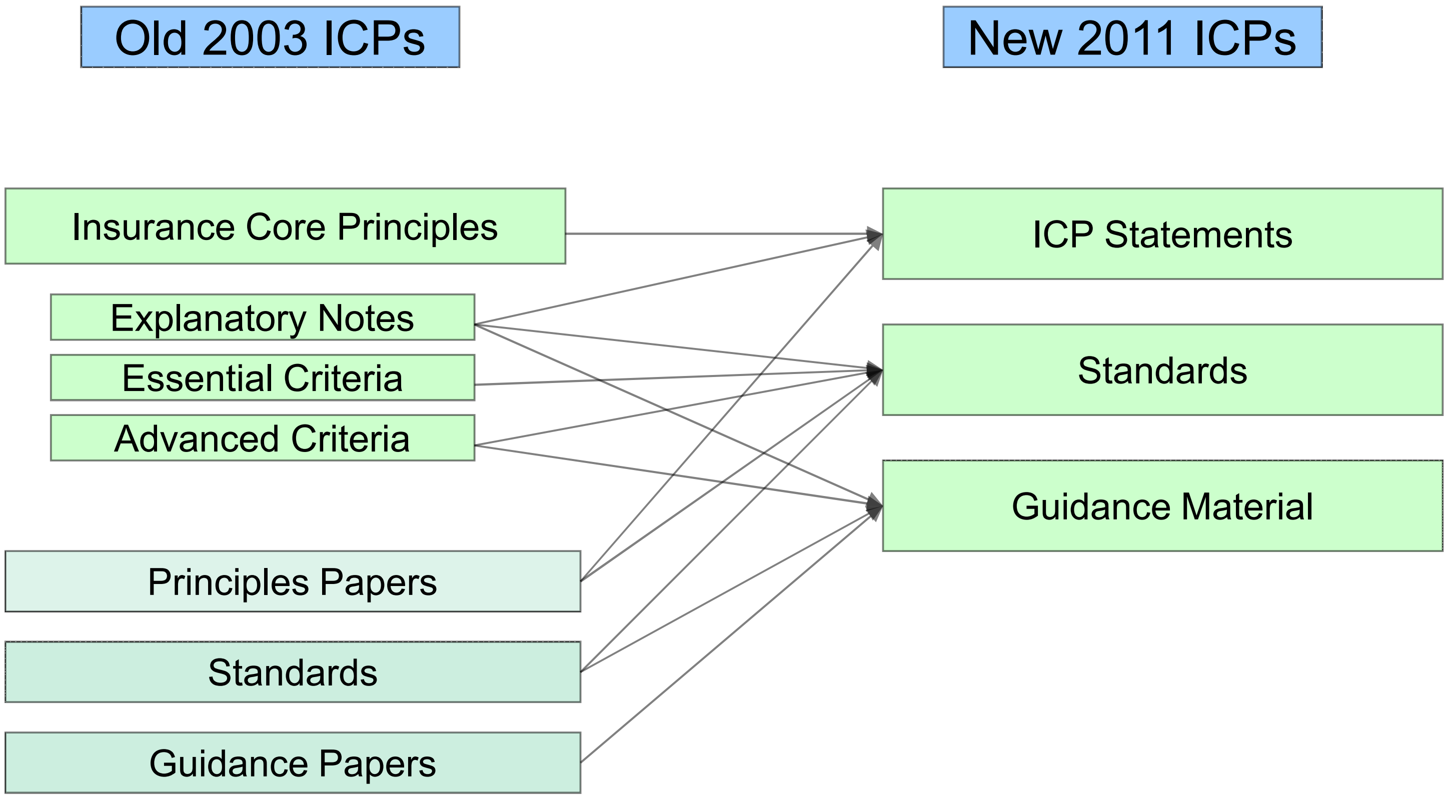
- Lack of broad picture → Need for macroprudential approaches

➔ **Urgent need for action**

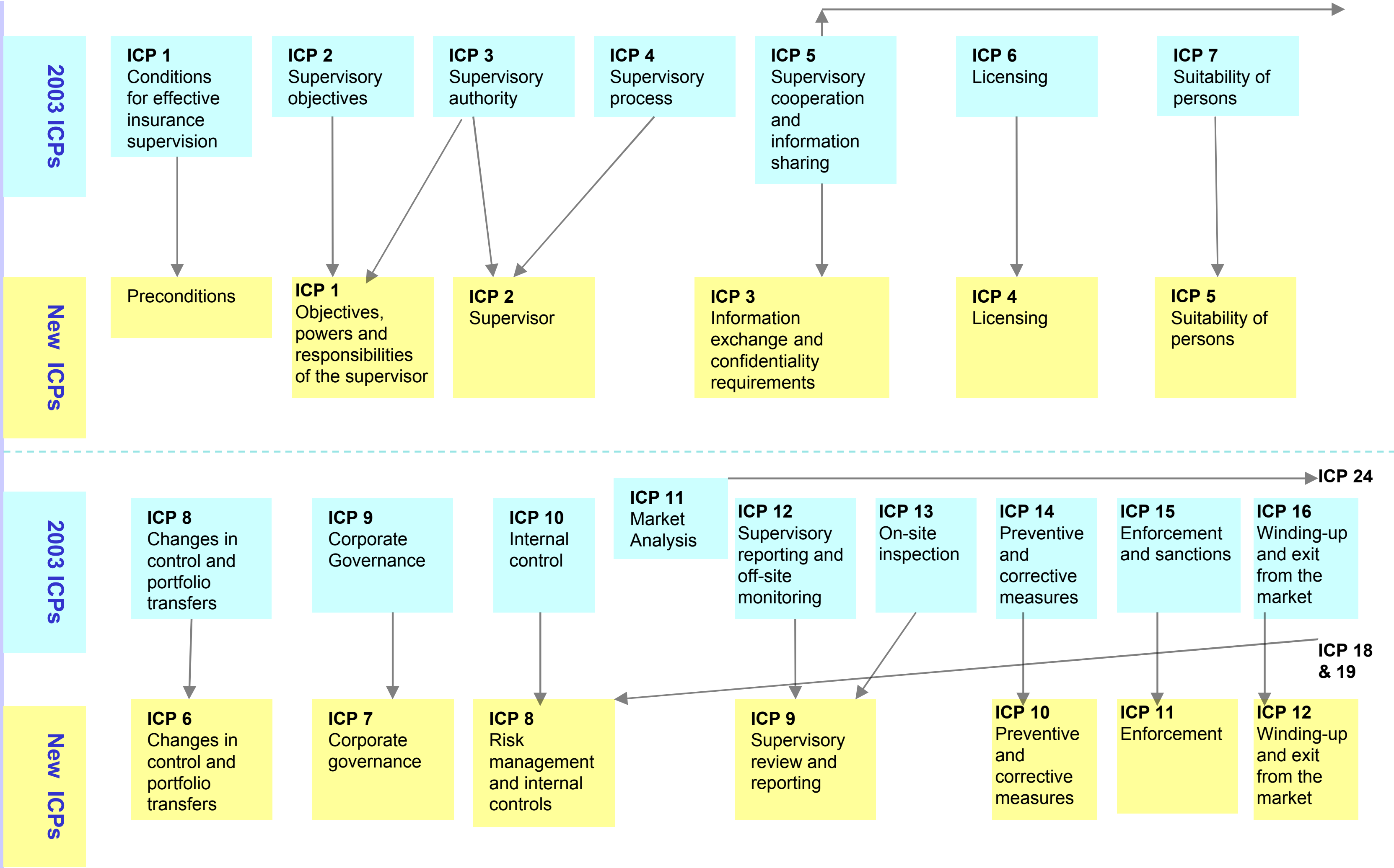
2- The new ICP hierarchy



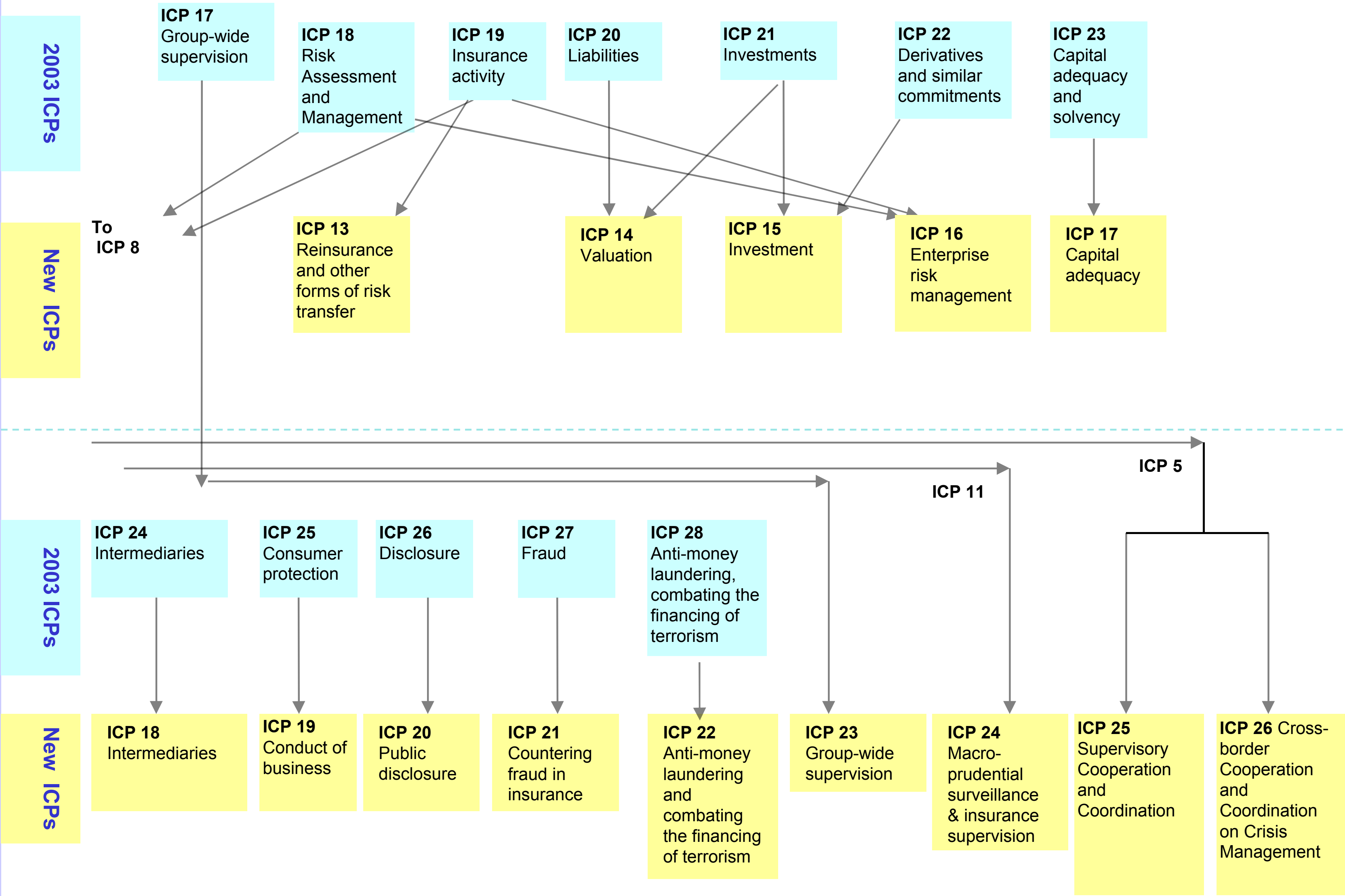
2- ICP restructuring



Old and new ICP structure (1/2)



Old and new ICP structure (2/2)



Stronger principles - raising the bar

- More elaborated supervisory material and guidance for all principles
- Focus on risk-based approach
- Focus on proportionality
- Wider scope and stronger requirements

Focus on risk-based approach

- ICPs require a risk-based approach to supervision
- Supervisory focus on key risks at individual insurers including:
  - Business
  - Technical
  - Market
  - Credit
  - Liquidity
  - Operational

Focus on proportionality

- Supervisory actions and requirements tailored to the **nature, scale and complexity** of individual insurers
- Proportionality principle embodied in ICPs and standards where relevant
- Proportionality works in both directions

Four main reinforced areas

- Corporate governance
- Risk management
- Group-wide supervision
- Macro-prudential surveillance

Corporate governance

Wider scope and greater depth in requirements on:

- Board strategy and oversight
- Board composition, suitability and effectiveness
- Remuneration policy and practices
- Suitability requirements *(also in ICP 5)*

Risk management (1/2)

ICP 8 *Risk Management and Internal Controls*

The new ICP 8 on *Risk Management and Internal Controls* is the result of reviewing and updating two existing ICPs:

- 2003 ICP 18 on *Risk Assessment and Management;* and
- 2003 ICP 19 on *Insurance Activity*.

The two previous ICPs were rolled into a new ICP 8 on *Risk Management and Internal Controls* with significant enhancements on various control functions including risk management, compliance, actuarial, and internal audit.

Risk management (2/2)

Enterprise risk management

- A risk management policy
- A risk tolerance statement
- A risk responsiveness and feedback loop
- An own risk and solvency assessment (ORSA)

Macroprudential surveillance

Requires supervisors to:

- look at the financial system as a whole and not only individual insurers
- analyse market trends and developments
- use that analysis for insurance supervision

ICP 24 – Macro-prudential surveillance and insurance supervision

ICP Statement:

The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact insurers and insurance markets and uses this information in the supervision of individual insurers. Such tasks should, where appropriate, utilise information from, and insights gained by, other national authorities.

Group-wide supervision

Supervision of **group in totality**

- All ICPs and standards apply to groups unless otherwise specified
- Direct and indirect approach recognised

Insurance group supervision **includes**

  - Holding company
  - Other regulated entities
  - Non-regulated entities
  - Special purpose entities

Further enhancements

- Enhancement of ICP Statement 9 and standards and guidance on supervisory review and reporting – endorsed at the 2012 AGM
- Development of a Common Framework for Internationally Active Insurance Groups (ComFrame) ➔ on-going
- Assessment of observance of new ICPs (Self assessments, peer reviews, FSAPs, FSB-CFIM)

Where to find the ICP material?

On the public website www.iaisweb.org

Displays hierarchy of ICP material

- Introduction
- Assessment Methodology
- ICP statements
- Standards
- Guidance

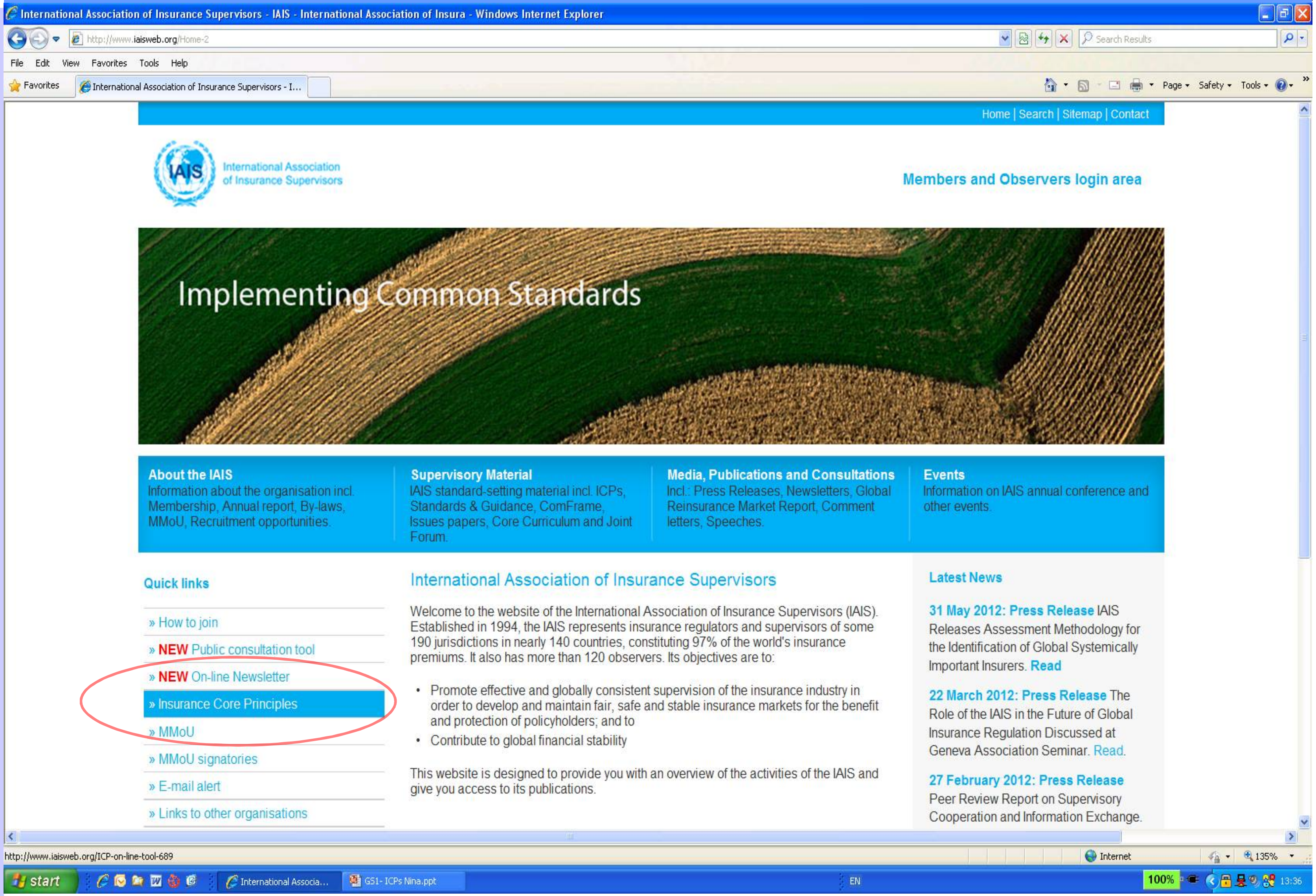
Choose level of detail

Search function

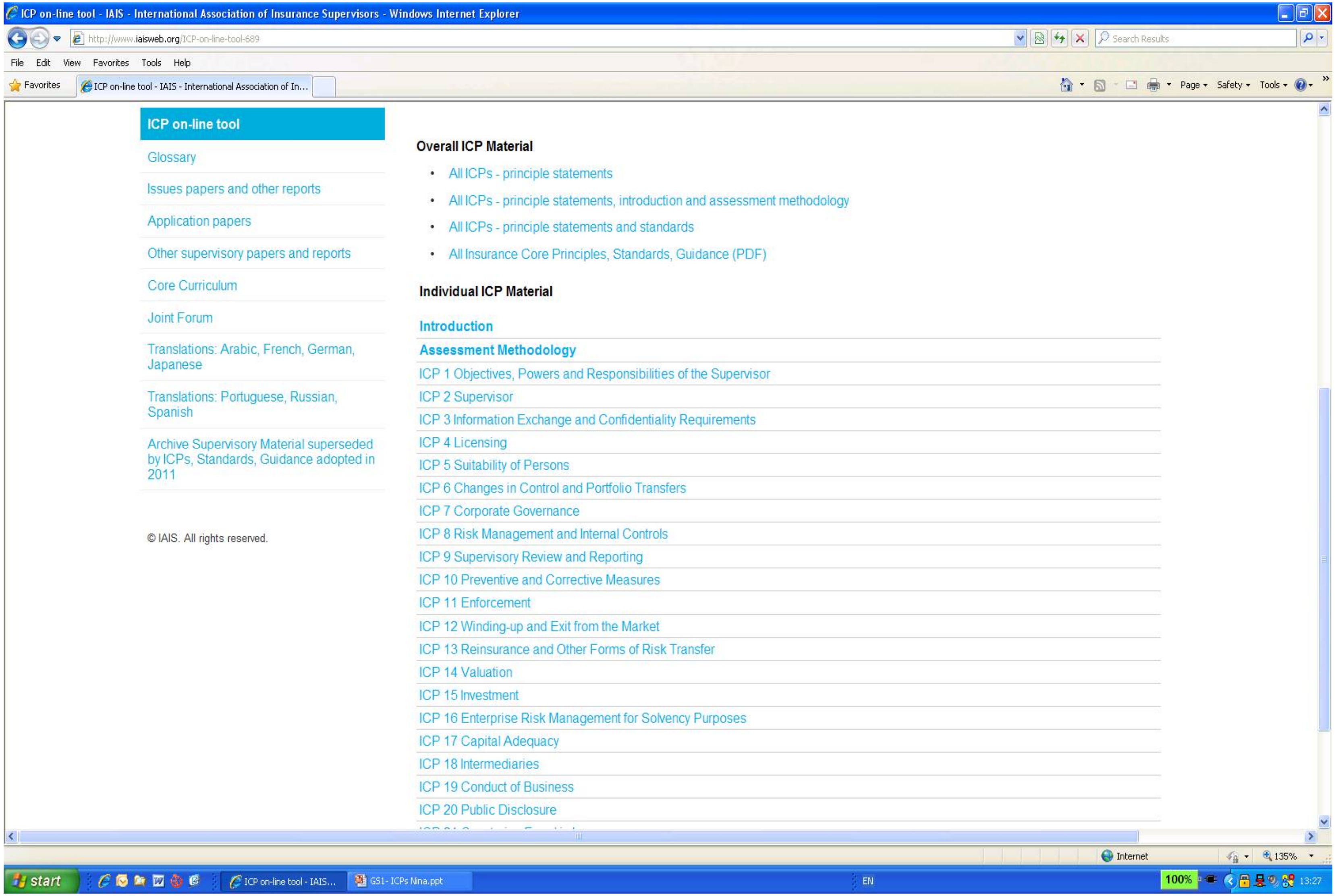
- search words or phrases – choose where to search (e.g. in standards and/or guidance…)

Print and save

ICP on-line tool (1/2)



ICP on-line tool (2/2)



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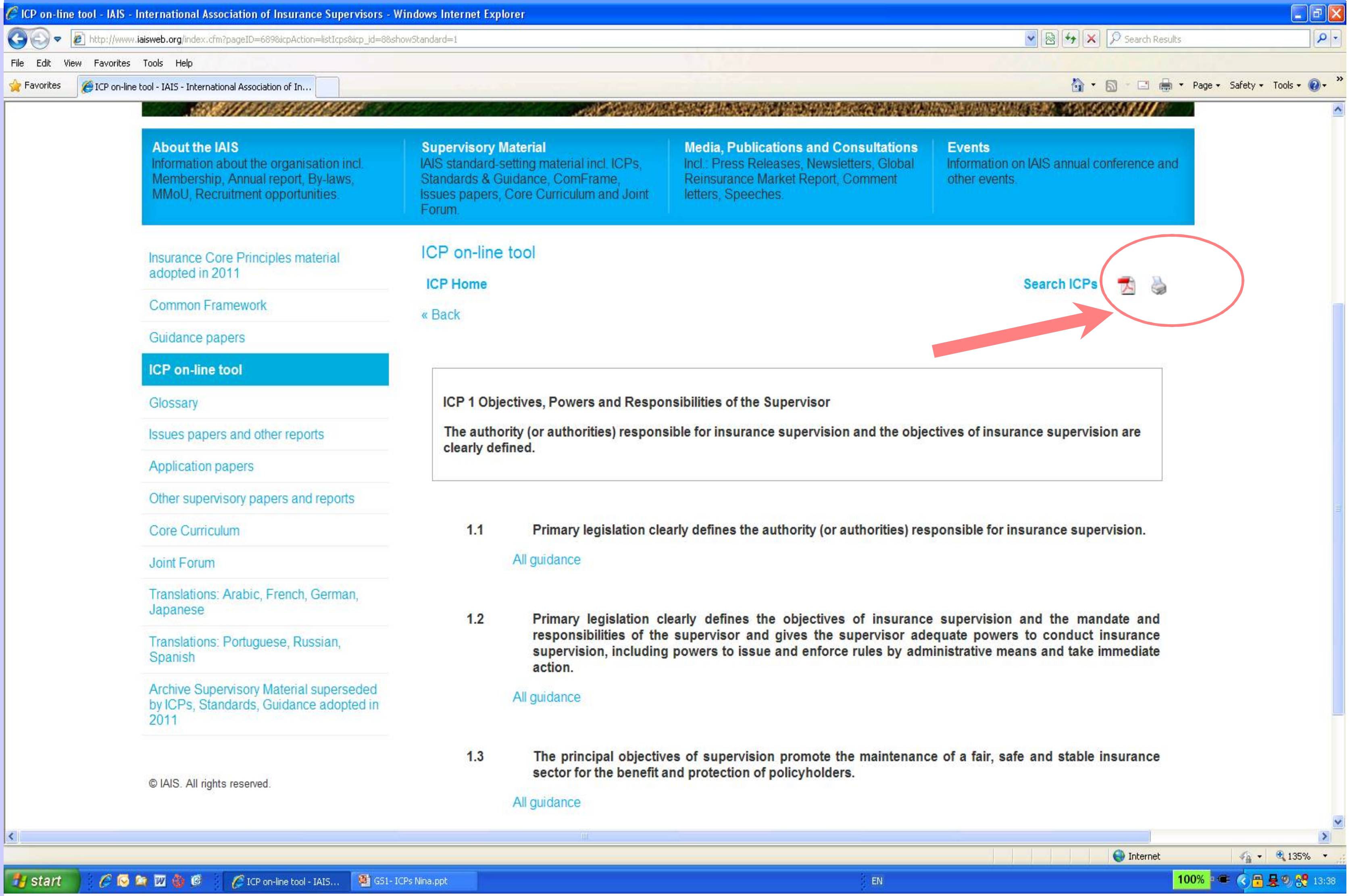
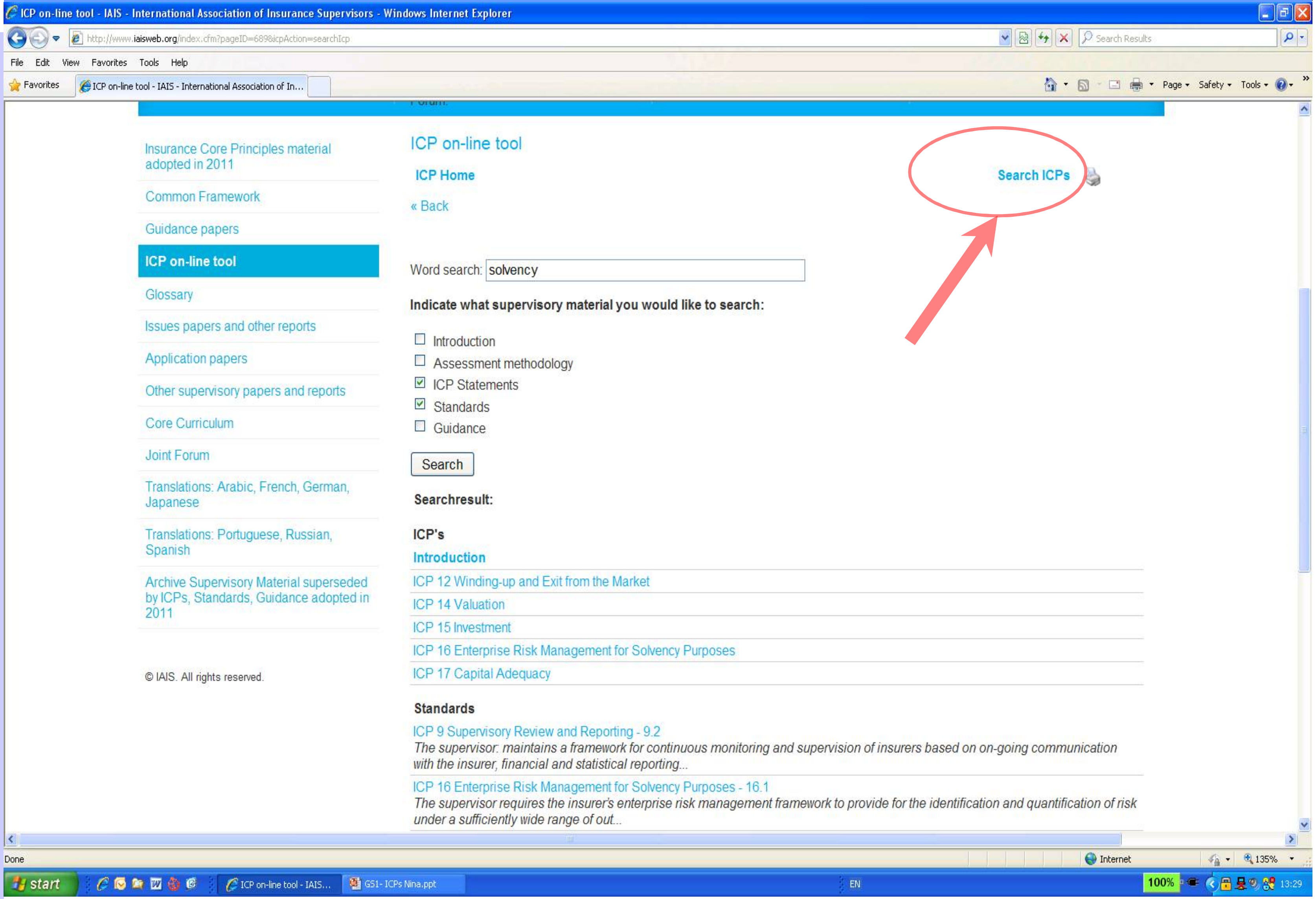
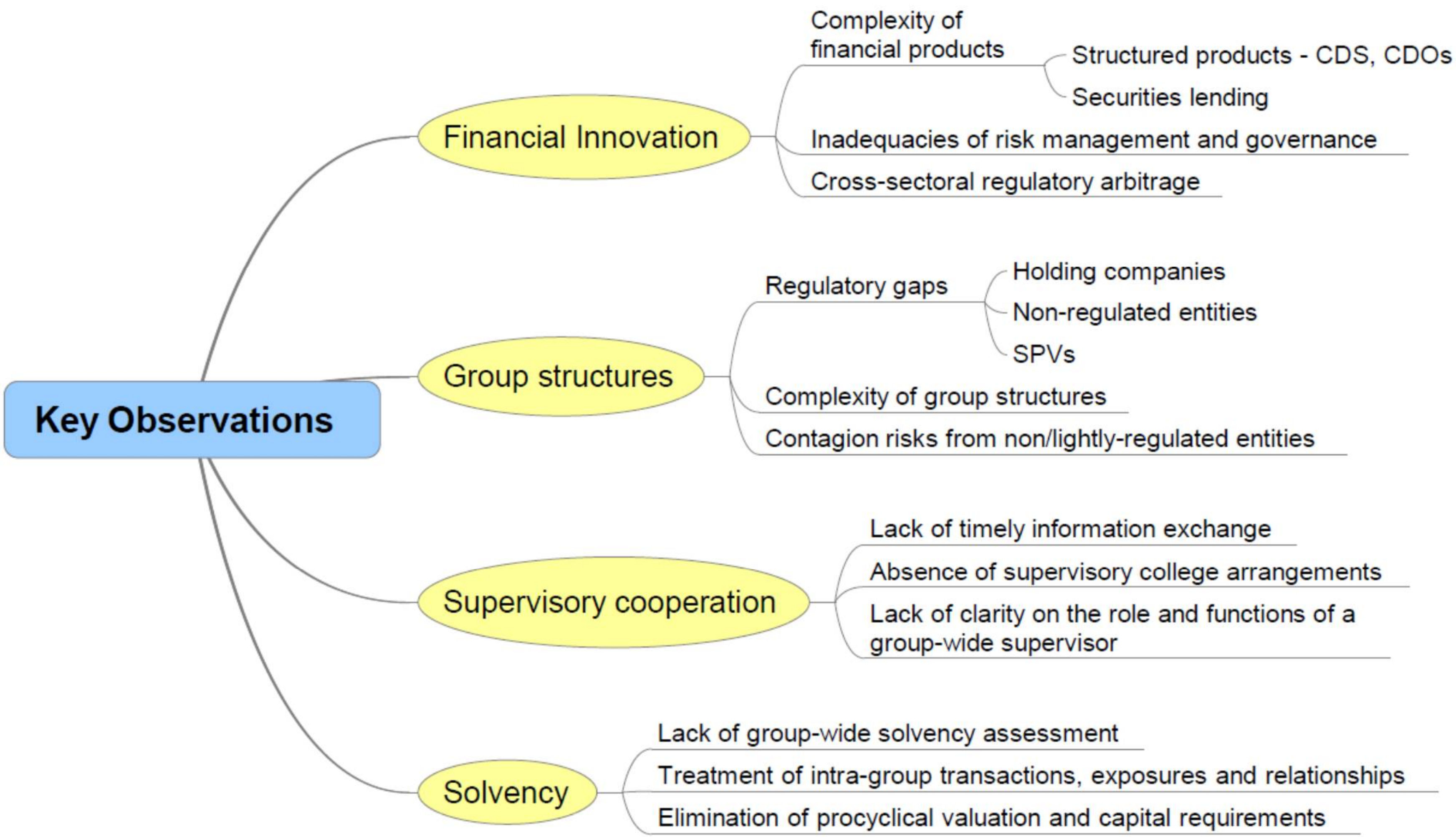


Search in ICPs



Lessons learned from the financial crisis – group-wide supervision perspective



Outline

1. Background
2. ICPs
3. **<u>ComFrame</u>**
4. G-SIIs
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3. ComFrame - Aims

Common Framework for Supervision of Internationally Active Insurance Groups (IAIGs) aims to:

Establish a comprehensive framework for supervisors to address group-wide activities and risks

Foster global convergence of regulatory and supervisory measures and approaches

3. ComFrame - Structure

Module 1 Scope of ComFrame	Module 2 The IAIG	Module 3 The Supervisors	Module 4 Implementation of ComFrame
M1E1 Identification of IAIGs	**Group Governance**	**Group Supervisory Process**	M4E1 Applicability of ComFrame to all IAIS jurisdictions
M1E2 Process of identifying IAIGs	M2E1 Governance	M3E1 Supervisory Process	M4E2 Peer review and peer assistance mechanism
M1E3 Scope of ComFrame Supervision	**Group ERM**	**Supervisory Cooperation**	M4E3 ComFrame data compilation platform/mechanism for macroprudential surveillance purposes
M1E4 Identification of the group-wide supervisor and involved supervisors	M2E2 Enterprise Risk Management	M3E2 Cooperation and Coordination	* Placeholder with the possibility of referring these issues to relevant Working Parties
	Group Structure and Strategy	M3E3 Roles of group-wide supervisor and involved supervisors	
	M2E3 IAIG's legal and management structures from an ERM perspective	M3E4 Use of Supervisory Colleges	
	M2E4 IAIG's strategy from an ERM perspective	**Crisis Management and Resolution**	
	M2E5 Intra-group transactions and exposures from an ERM perspective	M3E5 Crisis management among supervisors	
	Group Financial Condition	M3E6 IAIGs and resolution	
	M2E6 Liabilities/technical provisions and assets/investments		
	M2E7 Valuation		
	M2E8 Group Capital Adequacy Assessment		
	Group Reporting and Disclosure		
	M2E9 Reporting and Disclosure		

Module 1 – Scope of ComFrame

Module 1 **Scope of ComFrame**	Module 2 **The IAIG**	Module 3 **The Supervisors**	Module 4 **Implementation of ComFrame**

- **Identification** of which insurance groups or financial conglomerates will be IAIGs
- Current proposed criteria are:

Size criteria

- GWP > USD 10 billion

OR

- insurance assets > USD 50 billion

Int'l activity criteria

- operates in ≥3 jurisdictions

AND

- sources >10% of its GWP from outside home market

Module 2 – The IAIG

Module 1 **Scope of ComFrame**	Module 2 **The IAIG**	Module 3 **The Supervisors**	Module 4 **Implementation of ComFrame**

- Requirements applying to IAIGs in a **multidisciplinary approach**
- **Holistically address** the risks arising in IAIGs
  - Expectations for Group Governance and Group ERM
  - Group Structure and Strategy
  - Group Financial Condition
  - Group Reporting and Disclosure

Capital adequacy (1)

Strategic Direction (Nov 2011)

A partly harmonised set of standards and parameters which sets out a narrow range of target criteria and time horizons for measurement of those risks is to be developed.

A common definition of capital resources is to be established by 2013

Capital adequacy (2)

Strategic Direction (October 2012)

Comparability among IAIGs – Clear objective of ComFrame

Field testing –stress tests (scenario-based approaches)

Module 3 – The Supervisors

Module 1 **Scope of ComFrame**	Module 2 **The IAIG**	Module 3 **The Supervisors**	Module 4 **Implementation of ComFrame**

- **Requirements for supervisors** addressing both the group-wide and host supervisors' perspectives

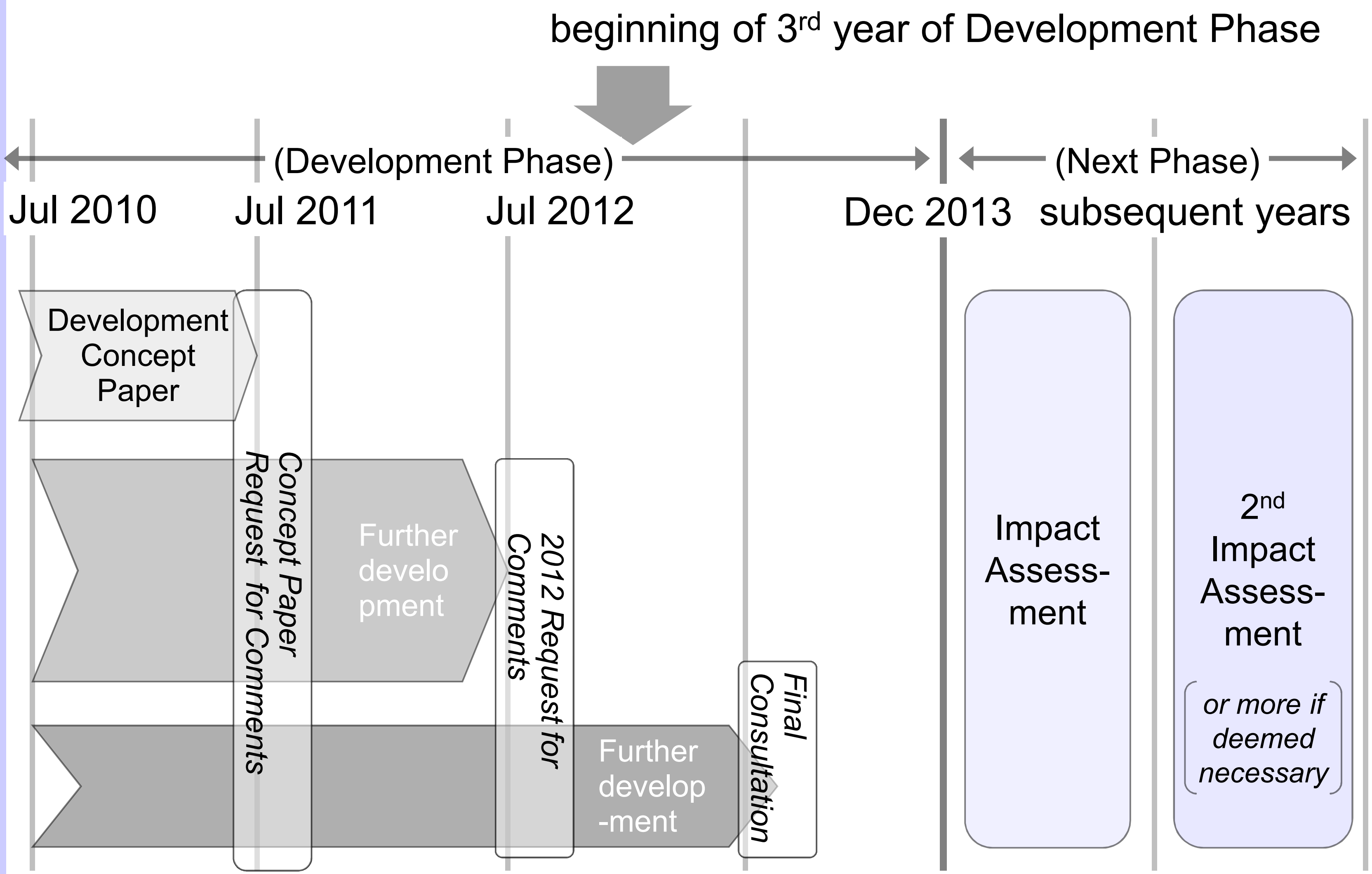
- **Sets out a commonly understood approach** to
  - supervisory process at the group-wide level
  - supervisory cooperation
  - crisis management among supervisors and resolution

Module 4 – ComFrame Implementation

Module 1 **Scope of ComFrame**	Module 2 **The IAIG**	Module 3 **The Supervisors**	Module 4 **Implementation of ComFrame**

Prerequisites reflect that involvement in group-wide supervision requires **adequate powers, responsibilities and resources**

3. ComFrame: Time table



Outline

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4. G-SIIs (Global Systemically Important Insurers)

Insurance and Financial Stability

- Traditional insurance
- Non traditional/non-insurance financial

4. G-SIIs

G-SIIs methodology and policy measures

- Methodology
  - 5 indicators
  - Non-traditional, Non-insurance/ Interconnectedness/Size/Global activities/Substitutability
- Policy measures
  - Intensive supervision
  - Enhanced resolution
  - Higher loss absorbency

4. G-SIIs: Time table

Process by April 2013

- Data collection by October 2012
- Supervisory judgment by early 2013
- Methodology development by early 2013
- Policy measures development by early 2013
- G-SIIs designation by early 2013

Outline

1. Background
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5. **<u>Conclusion</u>**

5. Conclusion: Interrelations – ICPs, ComFrame and G-SII Package

Type of entity	Legal entity	Group	IAIGs	G-SII (=IAIG)	G-SII≠IAIG (theoretical case)
1st tier ICPs	ICPs that apply only to legal entities	ICPs that apply to legal entities and groups			
2nd tier: ComFrame			ComFrame		
3rd tier: G-SII package				G-SII package	

5. Conclusion: Key policy issues

- Group wide supervision
  - Formulate a framework
  - Operationalise it
- Convergence of regulatory requirements
  - Qualitative requirements
  - Quantitative requirements (solvency, valuation etc.)
- Enhanced coordination
  - Across the borders
  - Across the financial sector

Thank you very much

www.iaisweb.org

catherine.lezon@bis.org